

**Melbourne Centre for Financial Studies
Academic Research Grant**

The Costs of Corporate Litigation in Australia

**Asjeet S. Lamba, Associate Professor, Department of Finance, University of Melbourne
Ian M. Ramsay, Professor, Law Faculty, University of Melbourne**

Discussion Paper (Not for Quotation)

1. Background and Aims of Project

A significant debate has been taking place in Australia in relation to the costs of litigation. As part of this debate, in 1994 the Australian Law Reform Commission conducted a major inquiry into litigation cost rules and in its report stated that recommendations in this area must be informed by empirical evidence. Our recent paper (Lamba and Ramsay, 2009) is the first study to provide direct evidence on the costs of litigation where at least one party involved was an ASX-listed company. Using data from 1993-98, the study measures the costs associated with corporate litigation for plaintiff and defendant companies around the: (a) litigation initiation, (b) settlement and (c) judgement dates.

We find that both defendants and plaintiffs experience statistically significant negative abnormal returns around announcements of litigation initiation. We also find that defendant companies experience negative abnormal returns when the other party is a listed company, a government entity or a foreign entity. In contrast, plaintiff companies experience significant negative abnormal returns only where the other party is a listed company. Around settlement announcements, only plaintiff companies experience statistically significantly positive abnormal returns when the other party is another listed company. As expected, both defendant and plaintiff companies earn significant positive abnormal returns when they win the lawsuit. However, losing defendants and plaintiffs do not experience statistically significant negative abnormal returns around the settlement announcement date. Finally, around judgement announcements, we do not observe any significant market reaction.

One drawback of our empirical analysis is that the samples of settlements and judgements are relatively small at 56 and 34, respectively, making it problematic for us to conclude that our results are not driven by these small sample sizes. In addition, the small sample sizes also make it problematic for us to be able to generalise the results from our sub-sample analyses.

This project aims to extend our existing database to 2008 resulting in a database spanning a 15-year period. This will allow us to examine significantly larger sub-samples of litigation initiations, settlements and judgements by type of counterparty and legal issue. The expanded database will allow us to extend our analysis to examining the effects of litigation on the long-run abnormal returns to plaintiffs and defendants. The database will also allow us to examine the impact of litigation on the likelihood of defendants becoming insolvent.

2. Significance and Innovation

The specific research questions addressed in this project are:

- a) The impact of a given damages claim on the value of the defendant company will depend on several factors including the risk of follow-up litigation and the disruptive

effects of litigation on the defendant's business. The impact of a lawsuit on the value of the defendant company may also be related to the perceived ability of the plaintiff to fund protracted litigation. Therefore, we would expect lawsuits by the government to have the greatest impact on company value compared with a corporate or foreign entity (Bhagat, et al, 1998). Also, are there systematic differences in the impact of announcements of settlements and judgements by the type of plaintiff involved? This issue has only been previously examined by Lamba and Ramsay (2009) but, as noted above, our analysis was based on small sub-sample sizes.

- b) Studies in the US have found that a judgment in favour of a plaintiff company causes the value of the defendant company to decrease by an amount greater than the increase in the value of the successful plaintiff (see, Bhagat, et al, 1998 and Engelmann and Cornell, 1988). The results of these studies indicate that litigation imposes costs on defendant companies that greatly exceed the benefits to the plaintiff companies. The difference is attributable to increases in the expected costs the defendant must bear in addition to any payment to the plaintiff. The results obtained by Lamba and Ramsay (2009) indicate little market reaction around judgement announcements but our analysis was based on small sub-sample sizes. The question also remains as to the sources of litigation costs and whether the type of legal issue being argued in the litigation has any bearing on these costs. For example, do the costs differ according to whether the litigation involves a breach of contract, a trade practices matter, an intellectual property infringement or a contested takeover?
- c) What are the long-run effects of litigation on the market values of the plaintiff and defendant companies, relative to a matched sample of companies? Is the market's initial appraisal of litigation costs correct? If the market systematically over-reacts (under-reacts) to its appraisal of potential litigation costs then the initial market reaction should be followed by a reversal (continuing drift) in abnormal returns, resulting in significant negative (positive) abnormal returns in the long-run. This market efficiency issue has not been addressed in the previous literature.
- d) Is the impact of litigation on the market value of the defendant company related to its effect on the likelihood of the defendant becoming insolvent? Is the impact of the litigation also related to measures of information differences or asymmetry between the company's managers and investors? If so, the impact of litigation should be related to proxies for information asymmetry, such as the defendant company's research and development expenditures or the ratio of the defendant's market value to its book value.

3. Description of Approach

The announcement date and long-run impact of litigation initiations, settlements and judgements is examined using the event study methodology with the latter involving examining the cumulative abnormal returns and holding period returns relative the market index and a control sample of companies matched by size and industry.

The impact of litigation events on the probability of insolvency of defendant companies is addressed using estimates of insolvency probabilities from a conditional logit model similar to Ohlson (1980). The explanatory variables for this model will include variables such as the company's size, its debt to equity ratio and its interest coverage ratio. The conditional logit parameter estimates will then be used in conjunction with the balance sheet and income statement for the sample companies to estimate the impact of litigation on the company's probability of insolvency. We

expect to find that the impact of a litigation event on a defendant company will be related to the effect of that event in increasing or decreasing the company's probability of insolvency. Clearly lawsuits will increase this probability, while settlement agreements will generally decrease it.

4. Selected References

Australian Law Reform Commission, 1994, *Who Should Pay? A Review of the Litigation Cost Rules*, Issues Paper 13 (October).

Bhagat, S., J. Bizjak and J. L. Coles, 1998, The Shareholder Wealth Implications of Corporate Lawsuits, *Financial Management* 27, 5-27.

Bhagat, S., J. Brickley and J. L. Coles, 1994, The Costs of Inefficient Bargaining and Financial Distress: Evidence from Corporate Lawsuits, *Journal of Financial Economics* 35, 221-247.

Bhagat, S. and Romano, R., 2002a, Event Studies and the Law: Part I - Technique and Corporate Litigation, *American Law and Economics Review* 4, 141-167.

Bhagat, S. and Romano, R., 2002b, Event Studies and the Law: Part II - Empirical Studies of Corporate Law, *American Law and Economics Review* 4, 380-423.

Bizjak, J. and J. L. Coles, 1995, The Effect of Private Antitrust Litigation on the Stock Market Valuation of the Firm, *American Economic Review* 85, 436-461.

Cutler, D. and L. Summers, 1988, The Costs of Conflict Resolution and Financial Distress: Evidence From the Texaco-Pennzoil Litigation, *Rand Journal of Economics* 19, 157-172.

Engelmann, K. and B. Cornell, 1988, Measuring the Cost of Corporate Litigation: Five Case Studies, *Journal of Legal Studies* 17, 377-399.

Fields, M., 1990, The Wealth Effects of Corporate Lawsuits: Pennzoil v Texaco, *Journal of Business Research* 21, 143-158.

Karpoff, J. and J. Lott, 1999, On the Determinants and Importance of Punitive Damage Awards, *Journal of Law and Economics* 42, 527-573.

Lamba, A. S. and I. Ramsay, 2009, The Costs of Corporate Litigation in Australia, *Company and Securities Law Journal* 27, 448-457.

Mnookin, R. H. and R. B. Wilson, 1989, Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco, *Virginia Law Review* 75, 295-334.

Ohlson, J., 1980, Financial Ratios and the Probabilistic Prediction of Bankruptcy, *Journal of Accounting Research* 18, 109-131.