



Contents lists available at [ScienceDirect](http://www.sciencedirect.com)

# Journal of Accounting and Economics

journal homepage: [www.elsevier.com/locate/jae](http://www.elsevier.com/locate/jae)



## Discussion of ‘shareholder litigation and changes in disclosure behavior’

Michelle Lowry\*

Smear College of Business, Penn State University, University Park, PA 16802, USA

### ARTICLE INFO

#### Article history:

Received 23 September 2008

Received in revised form

20 October 2008

Accepted 11 November 2008

Available online 25 November 2008

#### JEL classification:

M41

K22

#### Keywords:

Voluntary disclosure

Litigation risk

Class action lawsuits

### ABSTRACT

Rogers and VanBuskirk [2008. Shareholder litigation and changes in disclosure behavior. *Journal of Accounting and Economics* 40, 3–73] examine changes in sued firms' disclosure policies between the pre-lawsuit and post-lawsuit periods. They find that these firms decrease the magnitude and precision of disclosures following the lawsuits. The authors conclude that managers of sued firms perceive disclosure to contribute to (rather than decrease) the probability of being sued. While the evidence showing that the magnitude and precision of disclosure decreases post-lawsuit appears to be robust, I raise some questions about what we learn from this finding.

© 2008 Elsevier B.V. All rights reserved.

## 1. Introduction

The nature of the relation between disclosure and litigation risk is a subject of considerable academic research. In theory, higher disclosure should make it harder for plaintiffs to claim the firm was withholding relevant information from the market. Moreover, a policy of more frequent disclosure should decrease the likelihood of large stock-price drops, which tend to precipitate the filing of lawsuits. These effects suggest that higher disclosure should be associated with lower litigation risk. However, there is also the risk that plaintiffs will allege that the firm was intentionally misleading the market through its disclosures, for example, if disclosures of earnings forecasts ended up *ex post* being overly optimistic. This suggests that disclosure may contribute positively to litigation risk.

An understanding of the ways in which disclosure affects litigation risk is an important question. From firms' perspective, litigation is very costly. Firms have an interest in adopting policies that minimize these costs. From a policy perspective, market transparency is enhanced when firms adopt more open disclosure policies. Policy makers would obviously be concerned if private litigation was causing firms to limit their disclosures.

Rogers and VanBuskirk attempt a new approach towards this important question, by examining whether firms change their disclosure policies following a class-action lawsuit. They posit that managers who feel that company disclosures contributed to the lawsuit will decrease disclosure following the lawsuit. In contrast, managers who feel that their disclosures helped lessen the damage of the lawsuit will likely increase disclosure following the lawsuit. Findings are supportive of the former: both the quantity and the quality of disclosures decrease following firms' class-action lawsuits.

\* Tel.: +1814 863 6372.

E-mail address: [mlowry@psu.edu](mailto:mlowry@psu.edu)

My comments center on the contribution of this finding and the extent to which it informs the debate over the relation between disclosure and litigation risk. While the authors frame their analysis within this debate, it is not clear whether changes in disclosure for sued firms teaches us something that can be generalized across all firms.

Section 2 of the paper discusses the extent to which the findings in this paper contribute to the broader debate on the relation between disclosure and litigation risk. Section 3 relates the [Rogers and VanBuskirk](#) findings to the literature on the conservatism of disclosure. Section 4 concludes.

## 2. The relation between disclosure and litigation risk

The main finding of [Rogers and VanBuskirk](#) is that firms that are sued in class-action lawsuits decrease their level of disclosure following the lawsuit. The authors have been very careful in their analysis, and this finding appears to be quite robust. A fundamental issue, however, relates to the interpretation of this finding.

The authors suggest that the sued firms decrease their level of disclosure following the lawsuit because they feel that their prior disclosures contributed to the lawsuit. However, this finding is specific to sued firms, and it does not inform us on the relation between disclosure and litigation risk in a broader sample. Specifically, this finding tells us nothing about the effects of disclosure on litigation risk among the set of firms that were not sued. For example, suppose that managers of non-sued firms feel that their disclosures helped deter lawsuits. In this case, a similar study based on a sample of non-sued firms would yield results opposite to those of [Rogers and VanBuskirk](#).

There are specific reasons to believe that managers of sued versus non-sued firms might reach different conclusions regarding the effects of disclosure on litigation risk. For example, managers of sued firms are likely to directly observe the ways in which their prior disclosures are used (or at least attempted to be used) to prove wrongdoing. Following the filing of a lawsuit, plaintiffs attorneys tend to use any variety of means to prove that the firm intentionally misled the market. One obvious tactic is to allege that disclosures made during the class-action period were overly optimistic, even if such disclosures were actually made in good faith, based on all information available at that time. Managers of the sued firms could easily conclude that they would have been better off if they had not made such disclosures, and thus decrease such disclosures in the future.

In contrast, consider the sample of firms that was not sued. Why were these firms not sued? Controlling for other factors known to contribute to lawsuits (firm performance, firm size, etc.), managers of these firms may conclude that their open disclosure policies helped them to avoid a lawsuit. If so, such managers may be more likely to maintain or even increase disclosure levels in the future.

In sum, the [Rogers and VanBuskirk](#) approach of examining changes in disclosure policies among a group of firms is likely to generate different conclusions for different samples. By definition, disclosures *did not prevent* a lawsuit for the sample of sued firms. Thus, these managers are more likely to conclude that disclosures had a zero or positive effect on the probability of being sued. It is thus perhaps not surprising to observe that these managers decrease disclosure following the lawsuit. In contrast, by definition, disclosures *did not cause* a lawsuit for the sample of non-sued firms. These managers are more likely to conclude that disclosures had either a zero effect on or helped to avoid a lawsuit. By this logic, it is possible that managers of the non-sued firms would maintain or increase disclosure following avoidance of a lawsuit.

While we as researchers cannot directly observe the sample of firms that avoided a lawsuit through disclosure, the sample of dismissed lawsuits potentially provides some evidence on the extent to which different groups of firms might yield different conclusions regarding the effects of disclosure on litigation risk. A dismissed lawsuit can be considered a middle ground between avoiding a lawsuit altogether and fighting a lawsuit through to settlement. If the process of being sued causes managers to develop more precise estimates on the ways in which disclosure affects the probability of being sued, then we would expect no difference in the post-lawsuit changes in disclosure policies for managers of firms whose lawsuits were dismissed versus settled. Alternatively, if the outcome (sued/settled versus sued/dismissed versus not sued) affects managers' beliefs regarding the effects of disclosure, then results should differ among the groups. Specifically, the finding of a decrease in disclosure following litigation should be weaker among the sample of dismissed lawsuits, because managers of such firms are more likely to see the benefits as well as the costs of disclosure (while the managers of non-dismissed lawsuits are more likely to focus on the costs of disclosure). In fact, this is just what the authors report. Results are weaker for the sample of dismissed firms, suggesting that the experience of managers affects their conclusions on the effects of disclosure.

In light of these issues, one must be cautious regarding the inferences that can be drawn from the [Rogers and VanBuskirk](#) paper. The authors state 'The basic premise of our paper is that lawsuits cause managers to revise their beliefs about the costs and benefits of their current disclosure strategy, resulting in post-lawsuit disclosure changes.' While I agree with this point, I would also add that those firms that are not sued might also revise their beliefs, particularly if they observed other similar firms, for example, firms in their same industry, being sued. [Rogers and VanBuskirk](#) do not examine non-sued firms, and findings are based solely on sued firms. The revisions in disclosure strategies are potentially very different for these two different samples. As a result, the [Rogers and VanBuskirk](#) findings cannot be generalized to a broader group of firms. In sum, while the authors have motivated their analysis within the debate on the effects of disclosure on litigation, it is not clear that the findings of this paper shed any light on this debate.

### 3. Type of disclosure

Survey evidence by [Graham et al.](#) suggests that managers consider bad-news disclosures very differently from good-news disclosures. Specifically, approximately half of managers agree with the statement that they limit disclosure to avoid lawsuits (46% agree versus 25% that disagree). In contrast, the clear majority of managers agree with the statement that they disclose bad news faster than good news to avoid lawsuits (77% agree versus only 8% that disagree). This marked difference emphasizes the importance of examining the type of disclosure, i.e., good news versus bad news.

To address this issue, the authors examine management forecast errors, analyst earnings forecast errors, and earnings announcement abnormal returns before versus after the lawsuit. If managers are more inclined, following the lawsuit, to disclose bad news in a timely manner but withhold good news, then we should see each of these effects become more positive following the lawsuit. The authors find no support for this prediction, and therefore they conclude that this cannot explain their findings of a decrease in disclosure following the lawsuit, i.e., managers are not simply decreasing their disclosures of good news but maintaining (or even increasing) disclosures of bad news.

The findings of this analysis raise a variety of questions. First, why does the experience of being sued cause managers to revise their beliefs regarding the quantity of disclosure but not the type of disclosure? Were managers' beliefs regarding the effects of disclosure type on litigation 'correct' before being sued, while their beliefs regarding the total quantity of disclosure were 'incorrect' previously? Alternatively, in contrast, with the [Graham et al.](#) survey evidence, did managers of the sued firms learn that all types of disclosure need to be decreased, irrespective of the type of news conveyed?

Moreover, the analysis of analyst earnings forecast errors actually indicates that sued firms' analyst earnings forecast errors and earnings announcement abnormal returns are significantly *lower* in the post-lawsuit period. Based on the authors' discussion, this finding suggests that the process of being sued causes managers to conclude that they would be better off if they disclosed good news more quickly. The authors somewhat overlook this finding, as it goes in the opposite direction from what they are trying to test. However, it brings up the question as to why managers would conclude that disclosing good news more quickly would be beneficial. To the extent that plaintiffs tried to prove that the managers were purposefully using disclosures to mislead the market, the focus of this argument would certainly be on the good news disclosures—one might expect managers to decrease good news disclosures following such an experience, but it is hard to conjecture why they would expedite good news disclosures.

In sum, both survey and empirical evidence (see, e.g., [Skinner, 1994](#)) suggests that managers consider good news versus bad news disclosures very differently. Specifically, of the two types, managers tend to believe that bad news disclosures are more likely to help protect them against litigation. An understanding of the relation between disclosure and litigation risk must incorporate both the quantity and the type of disclosure. The majority of the [Rogers and VanBuskirk](#) analysis focuses on the quantity of disclosure. While they provide some evidence on the type of disclosure, results raise questions when compared to both prior literature and other results within their own paper.

### 4. Conclusion

[Rogers and VanBuskirk](#) find that managers of sued firms significantly decrease both the quantity and quality of disclosure following the filing of a class-action lawsuit. The authors have been quite careful in their empirical analysis, and results are robust to a variety of alternative specifications. They also provide a strong motivation for their analysis: what is the true nature of the relation between disclosure and litigation risk. This topic is of strong interest among academics, firms, and policy makers.

While the paper offers both a strong motivation and a robust set of empirical results, my concerns focus on the extent to which empirical results increase our understanding of the primary question being asked, i.e., on the relation between disclosure and litigation risk. While sued firms may conclude that disclosure increased their litigation costs, it is quite plausible that non-sued firms conclude that disclosure decreased their litigation costs. Results on the sample of sued firms cannot be generalized to the broader population of firms. Thus, we are still left with the same question: what is the nature of the relation between disclosure and litigation risk?

### References

- Graham, John R., Harvey, Cambell, Rajgopal, Shiva, 2005. The economic implications of corporate financial reporting. *Journal of Accounting and Economics* 40, 3–73.
- Rogers, Jonathan, VanBuskirk, Andrew, 2008. Shareholder litigation and changes in disclosure behavior. *Journal of Accounting and Economics*, this issue, doi:10.1016/j.jacceco.2008.04.003.
- Skinner, Douglas, 1994. Why firms voluntarily disclose bad news. *Journal of Accounting Research* 32, 38–60.