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THE UPS AND DOWNS OF CORPORATE LITIGATION

Dr. Matteo Arena calls corporate litigation an "external form of discipline," a mechanism that keeps C-suite executives and governing boards honest. He also says it can often be an inefficient form of discipline.

An assistant professor of finance, Arena studies corporate governance and debt, and some of his latest research looks closely at how companies' litigation risk affects their cash holdings. According to Arena, companies that are at greater risk of getting sued tend to hold onto more cash.

"It's intuitive," he says. "They need to be able to cover not just settlement costs, but also legal fees, including attorneys. And there are implicit costs: customer and supplier losses and negative publicity."

Curiously, though, Arena found that the converse is not true: Shareholders are not more likely to sue companies with high liquidity. "Just because a company has more cash," Arena explains, "doesn't mean they are more likely to get sued."

Arena points out that corporate lawsuits — and settlement amounts — have increased exponentially in the past 20 years. Further, his research found that the impact of litigation risk on cash holdings is not limited to firms that are actually sued. For instance, when a company is brought into class-action litigation, peer institutions in the same industry respond by increasing their liquidity to compensate for a perceived increase in risk exposure.

As a result, he says, companies across the board have become substantially more risk averse. And when these companies hold onto more cash, they invest less.

"This has significant implications on employment," Arena notes. "When companies hold onto cash, they're not growing, they're not hiring. Even though litigation is a form of external governance with potential benefits, it has also a counter-productive effect." — CS