The Dark Side of Private Benefits:

Implications from Block Trades

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Abstract

As a test of the agency theory, this paper examines the relationship between the size of the private benefits of the new blockholder and the likelihood of future litigation or earnings management. Using a sample of 391 US firms whose blocks of shares are traded over 1987-2002, we find that the incidence of securities litigation against the new blockholder or the new management team is positively related to the size of block premium at the time of the block trade. Our findings are consistent with the agency theory which suggests that controlling stakeholders are more likely to engage in corporate misconduct in the presence of greater private benefits.

JEL classification: G34; K42.

Keywords: agency theory; block trades; block premium; class-action lawsuits; earnings management

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In their classic article that introduced the concept of "agency problem," Jensen and Meckling (1976) argued that people who have been delegated the role of managing the company may not work in the best interest of shareholders. The agency problem becomes particularly pronounced when there exist private benefits to be enjoyed by the controlling stakeholders to the exclusion of minority shareholders. When the size of private benefits is large enough, the controlling stakeholders may elect to run the risk of engaging in illegal activities to capture private benefits by exploiting their power in the company. If such illegal activities undermine shareholder's wealth to a greater extent, shareholders would file lawsuits against the controlling stakeholders in order to protect their wealth.

While the presence of agency problem implies such clear linkage between the size of private benefits and the likelihood of shareholder lawsuits, previous literature has paid scant attention to the size of private benefits as a major determinant of the likelihood of shareholder lawsuits. The predictors of shareholder litigation studied in previous literature include stock market variables such as firm size (Francis et al., 1994; Jones and Weingram, 1996; Lu 2003), share turnover (Francis et al., 1994; Jones and Weingram, 1996; Lu, 2003), past stock returns (Alexander, 1991; Weingram, 1996), and market-to-book ratio (Strahan 1998). Accounting variables, such as leverage (Peng and Röell, 2008; Strahan, 1998) and abnormal accruals or sales growth (Johnson et al., 2007) have also been shown to predict shareholder litigation.

In this paper, we attempt to provide a test of the agency theory of Jensen and Meckling (1976) by examining the relationship between the size of the private benefits of the new blockholder who can exercise control in the company and the likelihood of future shareholder litigation. Specifically, we use the block premium approach to

measure the size of private benefits, and test whether such block premium can be a predictor of future illegal activities or accounting fraud, which are identified through shareholder class-action lawsuits and SEC enforcement actions.

The idea of using block premium to measure the size of private benefits originates from the seminal research of Barclay and Holderness (1989), who argue that the size of private benefits can be proxied by the difference between the price per share in the transaction of large-percentage blocks of common stock and the exchange price per share after the block transaction. Their reasoning is as follows. If all shareholders receive benefits in proportion to their fractional ownership, blocks have to be traded at the exchange price. However, if blockholders can enjoy private benefits that do not accrue to minority shareholders, blocks will be traded at a premium to the post-announcement exchange price.[1] For a sample of 63 block trades in the US over 1978-82, they find that the block premium averages 16 percent of the post-announcement exchange price and 4.3 percent of the total market value of the firm's equity. In a subsequent study that measures block premiums, Dyck and Zingales (2004) examine 412 control transactions in 39 countries over 1990-2000 and document that the premium ranges from –4 percent of the firm's value in Japan to 65 percent of the firm's value in Brazil. They conclude that, on average, the size of private benefits is worth 14 percent of the firm's equity value.

Using a sample of 391 US firms whose blocks of shares are traded over 1987-2002, we find that the size of private benefits is positively related to the frequency of

[1] Barclay and Holderness (1989) measure the premium by using the post-announcement price as a benchmark, because the price that follows the announcement will incorporate the expected effect of the transaction. That is, the post-announcement exchange price will reflect the shared or public benefits of the block trade. And since the privately-negotiated block trade price will reflect both private and public benefits, the difference between the block trade price and the post-announcement exchange price will reflect only the private benefits.

class-action lawsuits against the new blockholder or the new management team after controlling for other economic factors that may influence the probability of litigation. We also show that a similar, although weaker, relationship holds when we examine the likelihood of accounting fraud.

These results, taken together, show that those who enjoy greater private benefits are more likely to engage in corporate misconduct, which renders them vulnerable to litigation or accounting malfeasance. While there exist long-term benefits from building reputations, blockholders who enjoy private benefits seem to be tempted to capture short-term private gains in an illegal way, and choose to face the risk of losing more than these benefits through possible shareholder lawsuits in the near future.

Finally, we find that the relationship between the size of private benefits and the likelihood of litigation risk is, in fact, although statistically insignificant, negative when we consider only the subset of firms that are financially distressed. For financially distressed firms, many block trades occur at a discount, possibly because the expected cost of possible litigation outweighs the benefits of being a blockholder. Our results suggest that for firms whose blocks are traded at a discount, the possibility of litigation can be a major determinant of the price of the block, and therefore a larger block discount can indicate a greater likelihood of litigation.

The rest of the paper is organized as follows. Section 1 describes the background on securities class-action lawsuits. In Section 2, we explain the sample selection process and data sources. Section 3 examines the relationship between the size of private benefits and the incidence of class-action lawsuits. In Section 4, we examine the above relationship for financially distressed and non-distressed firms. In

Section 5, we analyze the relationship between the size of private benefits and accounting frauds. Section 6 concludes.

1. Background on Securities Class-Action Lawsuits

For minority shareholders, the incentive to monitor fraudulent behaviors of the controlling stakeholders is reduced by the free-rider problem (Shleifer and Vishny, 1997). This free-rider problem is addressed by the ability of lawyers to organize a class of shareholders and litigate for that class. Lawyers have the incentive to collect costly information because they typically receive one-third of the settlement (Martin et al., 1996). Therefore, securities class-actions are initiated by plaintiffs' attorneys, who file suits on behalf of shareholders. Typically, a filing is triggered by an information release such as the revelation of an accounting scandal or a disappointing earnings announcement that causes the firm's stock price to drop substantially. The plaintiffs' attorneys allege that managers or other executives in charge are guilty of fraud by directly engaging in wrongdoing or by at least concealing the negative information. The plaintiffs' attorney would argue that because the firm's stock price did not reflect the negative information during the class period, investors who purchased shares during the class period paid artificially inflated prices.[2] Further, if these shareholders held the stock until the negative information was released, they would have suffered losses and therefore would be eligible for compensation.

The securities law that is relevant to class-action lawsuits is the Securities Acts of 1933 and 1934. The Securities Act of 1933 regulates the process whereby companies make offerings of securities and the Securities Act of 1934 covers all aspects of securities trading for firms whose securities are traded on secondary markets. In the

[2] The class period is the period during which the fraudulent activities are alleged to have taken place.

Securities Act of 1933, Sections 11 and 12 cover fraudulent registration statements and noncompliance with registration rules and misrepresentation. In the Securities Act of 1934, Rule 10b-5 under Section 10(b) makes it unlawful to disseminate false information of a material fact or fail to disclose materially relevant information to investors. Many class-action lawsuits base their case under Rule 10b-5.[3]

2. Sample Selection and Data Sources

We collect samples of block trades of US companies over 1987-2002 from the SDC Platinum's Mergers and Acquisitions database. Then we use LEXIS/NEXIS Business News Search to find cases of securities class-action lawsuits among the sample of block traded companies. Specifically, we searched for the word "class action," along with the name of the company whose block of shares was traded.[4] The reason for examining block trades only up to 2002 is to find sufficient number of class-action lawsuits whose class period starts after the date of the block trade. Class-action lawsuits typically span several years from the start of the class period until the date of filing of the lawsuit. The longest span between the class period start-date and the filing-date in our search of class-action lawsuits is 7 years. However, the more we extend the period of lawsuit search, the more we must shorten the time period for collecting the block trade sample. Since most class-action lawsuits in our search span less than five years between the class period start-date and the filing-date, using block trades up to 2002 and searching for class-action lawsuits with a filing-date that lies within five years of each block trade seem to be a reasonable trade-off. After we search for class-action

[3] This is because under Rule 10b-5, plaintiffs are not required to prove that they relied on the misinformation. Furthermore, this misinformation is not restricted to the company's SEC filings and can include false press-releases and statements made by company officials.

[4] Another possible source for searching for class-action litigation is the Stanford Securities Class Action Clearinghouse. It provides detailed information on issuers that have been named in federal class-action securities fraud lawsuits. The limitation of using this source is that it covers only those class-action lawsuits since the passage of the Private Securities Litigation Reform Act of 1995.

lawsuit filings of up to five years following the block trade, we further restrict our sample of lawsuits firms to cases where the start of the *class period* is within three years of the block trade.

Our initial block trades sample from the SDC Platinum's Mergers and Acquisitions database involve the transfer of a block of shares that comprises 5% or more of the outstanding shares and is classified as a "block purchase" in the acquisition technique category of the SDC Platinum's Mergers and Acquisitions database. 5% is the cutoff point used for measuring the block premium because it is that point which triggers a mandatory filing with the SEC with regard to a block transaction.

From our initial sample of block trades, there must be information about the price paid per share for the block transaction and the exchange-traded price of the stock for the following day of the block trade announcement. Thus, we exclude cases where the price paid per share may not be valued objectively, such as transactions that involve convertible bonds, liabilities, options, warrants, and so forth. To rule out instances where the transaction price may not reflect private benefits, we also exclude cases where either the target or the acquirer is a subsidiary of the other party or is a government agency. We further exclude transactions that are open-market repurchases, tender offers, spinoffs, recapitalizations, self-tenders, exchange offers, repurchases, and acquisitions of remaining interest. Finally, to stay away from block trades that have any takeover motives, we rule out block trades that occur within six months prior to a merger or acquisition concerning the block traded company.

[Table I]

Table I furnishes the distribution of allegations in shareholder lawsuits of block traded companies. Among our sample of block traded firms over 1987-2002, we identify 46 class-action lawsuits for which the class period started within three years from the block trade and for which the filing-date is within five years of the block trade. Nearly all these lawsuits cite multiple causes of action. There are 31 lawsuits, where allegations included at least one accounting-related charge. Common examples of litigation cases are omission of material information: artificial inflation of earnings, revenue, sales, or assets; premature recognition of revenue; failure of accounts to conform to GAAP (Generally Accepted Accounting Principles); over-hyping of technology, product, or business success; failure to disclose problems in securing new debt capital; and the dissemination of misleading remarks to analysts or investors.

[Table II]

Table II presents univariate tests of the differences between lawsuit and non-lawsuit firms. A firm belongs to the "lawsuit firms" category if the block traded company is involved in class-action shareholder lawsuits after the block transaction. An average firm in our sample has a total asset size of $744 million, a market-to-book ratio of 3.57, and a leverage ratio of 0.23. Table II also shows that, as expected, lawsuit firms are larger and more actively traded than non-lawsuit firms. Lawsuit firms also have higher leverage when compared to non-lawsuit firms. An interesting result is that, although the difference is not statistically significant, lawsuit firms have a higher block premium than non-lawsuit firms, but lawsuit firms also feature more cases where block trades occur at a discount (or negative block premium) when compared to non-lawsuit firms. This may be due to the fact that some financially distressed firms face high *ex ante* litigation risks. Since financially distressed firms may have unique characteristics

with regard to the determinants of litigation, we categorize block traded firms into financially distressed and non-distressed firms and analyze those subsamples separately in Section 4.

3. Private Benefits and Class-Action Lawsuits

Previous empirical research has identified a number of predictors of shareholder litigation. We categorize these predictors into stock market variables and accounting variables.[5] With regard to stock market variables, studies (for example, Francis et al., 1994; Jones and Weingram, 1996; Lu, 2003) show that both the size of the firm and share turnover are positively associated with the incidence of lawsuits. This is because larger companies have more assets that are available for the recovery of damages, and shareholder damages generally increase with the number of shares traded. Further, consistent with our expectation that firms with worse stock price performance are more likely to get sued, Alexander (1991) and Jones and Weingram (1996) show that the recent period cumulative return is negatively related to the incidence of lawsuits. Strahan (1998) shows evidence that firms with lower market-to-book ratios are more likely to face lawsuits. He reasons that since the market-to-book equity ratio captures managerial quality (Morck et al. 1988), high market-to-book firms are firms that are well-managed and therefore, less likely to be sued.

The second set of variables represents either indications of or incentives for aggressive accounting. Peng and Röell (2008) and Strahan (1998) show that the

[5] Some studies (for example, Beasley, 1996, and Dechow et al., 1996) document that weak corporate governance is associated with enforcement actions by the SEC. However, in a recent study, Johnson et al. (2007) find little evidence of an association between governance structure (average tenure, outside holdings, independence of outside directors) and lawsuit filings. Similar results are shown by Schrand and Zechman (2008). Also, Peng and Röell (2008) and Strahan (1998) find that insider ownership of a company's stock has no significant effect on the incidence of lawsuits. Therefore, we do not include these variables in our study.

leverage of the company may be associated with litigation risk. Peng and Röell (2008) provide two reasons why high leverage is associated with high litigation risk. First, high leverage may be associated with higher future operating risk, and thus, a higher probability of a large drop in the stock price. Second, high leverage may indicate a recent history of poor performance, asset write-downs, or forced heavy borrowing, which may cause shareholder dissatisfaction. Johnson et al. (2007) document that variables capturing aggressive accounting choices, such as sales growth and abnormal accruals, are also related to the likelihood of class-action litigation.

In this paper, we proxy the size of private benefits using the block premium in the manner of Barclay and Holderness (1989) (see also, Holderness, 2003; Mikkelson and Regassa, 1991; Nicodano and Sembenelli, 2004; Dyck and Zingales, 2004) to test whether the private benefits of the new blockholder affect the likelihood of litigation.

[Table III]

Table III reports results from a logit regression that examines the determinants of lawsuit filings. In Model 1, we examine all lawsuits where the dependent variable equals one if the company whose block of shares is traded is sued after the block trade, and zero otherwise. The table reports marginal sensitivities. That is, the numbers refer to marginal changes in the probability of litigation that result from unit changes in the explanatory variables, as implied by the estimates of the logit coefficients. The estimated coefficient of the block premium variable is positive but statistically insignificant. This result tells us that in our full sample of block traded firms, the size of private benefits of the new blockholder is not associated with the likelihood that the company will face class-action litigation.

As for control variables, results show that market capitalization and trading volume, which factor into the determination of potential damages, are positively associated with the incidence of lawsuits. This result is consistent with prior literature. The estimated coefficient of the cumulative return is significant and negative. This confirms the finding of previous studies that firms with worse stock performance are more likely to be sued by their shareholders. The coefficient of volatility is also positive and significant. More volatile firms are more likely to experience a large price drop, which leads to damages that are large enough to sustain the cost of bringing a lawsuit. Finally, the coefficient of the market-to-book ratio is negative but statistically insignificant.

As for accounting variables, the leverage of the block traded company marginally affects the likelihood of future class-action lawsuits. Both the sales growth index and total accruals to total assets are not significant determinants of the likelihood of litigation. This is inconsistent with the finding of Johnson et al. (2007), who show that these variables that capture aggressive accounting choices affect the likelihood of class-action litigation.

While the private benefits of the blockholder are not significantly related to the overall probability of future litigation, we cannot be sure that the litigation is brought up after the new blockholder has exerted any influence in the company. For example, there may be lawsuits against the *former* management team of the company in which the blockholder has little or no relevance. Thus, in Model 2, we examine cases of lawsuits that are more likely to have been caused by the wrongdoings of the blockholder. We do this by identifying class-action lawsuits that are filed against the new blockholder (i.e., the case where the new blockholder is named as a defendant in

the lawsuit) or the "new management" of the company. We deem that "new management" has been established after the block trade when either the CEO is replaced or the new blockholder takes part in any management activity of the company. Therefore, in Model 2, the dependent variable takes the value of one only if the litigation satisfies the above criteria.

In Model 2, the coefficient of the block premium variable is positive and significant. This shows that if we consider only those class-action lawsuits in which the new blockholder likely had influence, the greater private benefits of the blockholder seem to make the firm more vulnerable to litigation. This evidence suggests that greater private benefits of control may induce blockholders to use their power in the company to perpetrate fraud. If the controlling stakeholders act rationally, they will knowingly commit fraud only if they have an incentive to do so. Private benefits seem to be one motivation for blockholders to engage in such fraudulent activities.

The results of Model 2 also show that firm size, trading volume, and stock return volatility remain significant determinants of litigation risk. The market-to-book ratio and accounting variables are insignificant, as in Model 1. The coefficient of the cumulative return is no longer significant in Model 2. This suggests that if a new blockholder comes in and possibly exerts influence in the company, previous firm performance is no longer a factor in the likelihood of lawsuits against the new blockholder or the new management team of the company.

4. Distressed vs. non-distressed companies

Maksimovic and Titman (1991) argue that the costs of committing fraud tend to be low for firms that face financial trouble and thus, firms near financial distress are

more likely than other firms to commit fraud. Therefore, the factors that predict litigation may be different for financially distressed firms. In this section, we categorize block traded firms into financially distressed and non-distressed firms and analyze those subsamples separately.

To estimate the degree of financial distress, we use the Z-Score developed by Altman (1968) which is measured in the year prior to the block trade. Begley et al. (1996) show evidence that several coefficients in the Altman Z-Score model have substantially changed from their original values. We, therefore, calculate Z-Scores using the updated coefficients that are estimated by Hillegeist et al. (2004). [6] Since lower Z-Scores indicate higher probabilities of bankruptcy, we deem those firms that are in the lowest quartile of the Z-Scores as being financially distressed.

[Table IV]

Table IV estimates logit models that relate the probability of securities class-action lawsuits to the measure of private benefits and other potential determinants of lawsuits for financially non-distressed firms (Models 1 and 2) and financially distressed firms (Models 3 and 4). In Models 1 and 3, we account for all lawsuits, and thus the dependent variable takes the value of one when there is any lawsuit against the block traded company. In Models 2 and 4, we use the more restrictive case of lawsuits against the new blockholder or the new management of the block traded company, the precise definition of which is explained in the previous section.

[6] Hillegeist et al. (2004) uses a sample of 89,826 firm-year observations, including 762 initial bankruptcies between 1980 and 2000. The dependent variable is a dummy variable for bankruptcy in the 4-to-16 months following the end of the fiscal year. Their updated coefficients are: 0.08 for WC/TA (working capital divided by total assets); -0.04 for RE/TA (retained earnings divided by total assets); 0.10 for EBIT/TA (earnings before interest and taxes divided by total assets); 0.22 for V_E/TL (market value of equity divided by total liabilities); -0.06 for S/TA (sales divided by total assets); and 4.34 for the intercept.

For our sample of financially non-distressed firms, the estimated coefficient of the block premium is positive but insignificant when we consider any lawsuit against the block traded company in Model 1. However, in Model 2 where we consider only those lawsuits for which the blockholder are more likely to have taken part in the wrongdoing, the estimated coefficient of the block premium is positive and significant. Therefore, the general relationship between private benefits and class-action lawsuits which we examined in the previous section applies to our sub-sample of financially non-distressed firms.

As for financially distressed firms, the estimated coefficient of the block premium, although not statistically significant, is in fact *negative* for both Models 3 and 4. In addition, we showed in Table II that even though lawsuit firms have a higher block premium on average than non-lawsuit firms, there are also more instances of block trades that occur at a discount for lawsuit firms than non-lawsuit firms. These results, taken together, suggest that the relationship between block premium and litigation risk differ between financially distressed and non-distressed firms. For financially non-distressed firms, greater private benefits seem to induce controlling stakeholders to engage in self-dealing that triggers class-action litigation. However, for financially distressed firms, the increased likelihood of litigation may be incorporated in the lower block premium or greater block discount.

As for the control variables of future litigation for financially non-distressed firms, the estimated coefficients for the following variables are significantly different from zero: firm size, trading volume, and stock return volatility. These results are generally consistent with the results in Table III, with the exception that the estimated coefficient of the cumulative stock return is not significant. When we analyze the

financially distressed firms, we find that firm size is not a significant determinant of litigation but that the cumulative stock return of the company becomes a significant determinant of the future likelihood of litigation.

5. Private Benefits and Accounting Frauds

Prior studies have shown that companies manage earnings to: increase executive compensation; reduce taxes; prevent violations of debt covenants; and temporarily affect stock prices.[7] However, the consequences of earnings management typically have a negative effect on the company. For example, Christensen et al. (1999) find that ex ante incentives for earnings management impair the informational quality of earnings disclosures. In a subsequent study, Marquardt and Wiedman (2004) show that ex post evidence of earnings management also impairs the informational quality of earnings announcement for firms that issue seasoned equity.

While companies have some discretion in managing earnings within GAAP, some companies may decide to violate GAAP when they have exhausted options to manage earnings within the GAAP boundary. When firms violate GAAP in financial reporting, it also results in a violation of the Securities Act. These illegal practices will occur when firms perceive that the benefit of managing earnings exceeds the expected cost of earnings management. As is the case for class-action lawsuits, a blockholder who has private benefits may have incentives to engage in such earnings manipulation. Or any benefits occurring from managing earnings can be a part of her private benefits. In this section, we analyze how private benefits are associated with a specific case of fraud, namely, accounting fraud or earnings manipulation.

[7] See Healy and Wahlen (1999) for an overview.

To sample firms that have engaged in accounting manipulation, we first filter our sample of class-action lawsuits for cases that are accounting-related. In many cases, plaintiffs make more than one type of allegation, and thus, we deem a case as being accounting-related if any of the allegations relate to accounting problems. We retrieve 31 cases of accounting-related class-action lawsuits. In addition to our sample of class-actions that are related to accounting charges, we include cases where the firm was subject to accounting and auditing enforcement by the SEC. The source of these data is the SEC Accounting and Auditing Enforcement Release (AAER) on LEXIS/NEXIS Accounting Search. The AAER records enforcement actions that are brought forth by the SEC against companies for violating the financial reporting requirements of the Securities Exchange Act of 1934.[8] Feroz et al. (1991) and Dechow et al. (1996) point out that it is safe to assume that firms that face enforcement actions by the SEC have intentionally engaged in earnings manipulation, since the SEC will only pursue cases where it can be demonstrated that the management knew about their accounting problems. By searching AAER, we find 18 additional cases where the company was found to have committed accounting fraud within three years of the block trade. We do not count those cases where the start of the manipulation period, as identified in AAER, is before the date of the block trade.

[Table V]

Table V lists the types of alleged earnings manipulation that are reported in the AAER. It shows that the majority of the firms (i.e., seven out of eighteen firms) that are charged with earnings manipulation are overstating revenues.

[8] In AAER, actions are brought against firms pursuant to Section 13(a) of the Securities Exchange Act of 1934. This section requires firms whose securities are registered with the SEC to file reports as required by the SEC's rules and regulations. The financial statements contained in these filings are required to comply with Regulation S-X, which, in turn, requires conformity with GAAP.

[Table VI]

Table VI shows the results of the logit regression for accounting frauds. In Model 1, the dependent variable takes the value of one when the block traded company is accused of any accounting fraud, through either accounting-related litigation or SEC enforcement actions. In Model 2, the dependent variable takes the value of one only when the accounting fraud involves the new blockholder or the new management team of the company, defined as cases where: the fraud occurs after the top executive is replaced; the blockholder takes part in any management activity of the company; or the blockholder is named as one of the defendants in the lawsuit.

In Model 1, the size of private benefits is not a significant determinant of accounting allegations. However, in Model 2, when we examine only cases of accounting allegations made against the new blockholder or the new management, the results show that the size of private benefits is positively associated with the incidence of accounting fraud of the new blockholder or the new management. This is consistent with previous results where we examined all types of class-action lawsuit. Therefore, greater private benefits increase the likelihood of the new blockholder or the new management's engagement in corporate misconduct, as revealed through either securities class-action lawsuits or accounting enforcement actions by the SEC.

As for the other explanatory variables, the results in Table VI show that large firms and firms whose stock returns are volatile are more likely to commit accounting fraud. These results are generally consistent with our previous results that examine class-action lawsuits, with the exceptions that the estimated coefficient of the cumulative return is not significant and that the estimated coefficient of the sales growth is marginally significant. Thus, the cumulative return of the block traded

company is a significant predictor of class-action lawsuits but not a significant factor in predicting accounting frauds. In contrast, sales growth is not a significant determinant of class-action lawsuits but becomes marginally significant if we examine accounting-related class actions and accounting/auditing SEC enforcements.

6. Conclusion

In this paper, we ask the question of whether private benefits give rise to self-dealing that ultimately triggers class-action lawsuits. For the sample of firms whose blocks of shares are traded, we search for cases of securities class-action lawsuits and SEC accounting/auditing enforcement actions. By examining the relationship between the size of private benefits (measured by block premium) and the incidence of securities litigations or accounting frauds, we find that the size of private benefits are positively related to the likelihood of class-action lawsuits that are charged against the new blockholder or the new management and, to a lesser degree, accounting frauds that are charged against the new blockholder or the new management.

We also find that the relationship between the size of private benefits and the future likelihood of litigation is negative (although statistically insignificant) when we consider only firms that are financially distressed. This suggests that for distressed companies, the threat of litigation becomes an important cost of carrying a block of shares and thus, a greater block discount can be a signal that the block traded company is at a greater risk of litigation.

As shown in studies such as Romano (1991) and Bhagat et al. (1998), a firm's share price drops after shareholder litigation because of the downward revision of the firm's value and the weakening of the firm's credibility. Even with these potential

penalties for perpetrating fraud, our study implies that blockholders with large private benefits seem to risk these penalties for their own private benefits and engage in wrongdoings that triggers class-action lawsuits or enforcement actions by the SEC.

Barbanov et al. (2008) show that the trading activities of institutional investors contain information about the future litigation of the company. Our research also provides another important source of information which can hint about the likelihood of litigation. Our study suggests that investors or regulating agencies should pay special attention to block trades that occur with substantially high premiums (for financially non-distressed firms) or substantially high discounts (for financially troubled companies), as these cases of block trades raise a warning flag about future litigation or earnings management issues.

This study is not without limits. As our study does not track the outcome of the class-action litigation, we cannot be certain whether the accused are in fact guilty of fraud or they become free of any charges. Future research may attempt to refine our empirical research design using the actual outcome of the litigation.

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Table I
Types of Allegation in Securities Class-Action Litigation

This table shows the distribution of allegations in securities class-action lawsuits for block traded firms within five years of the block trade where the class period starts within three years after the block trade. The sample firms are 391 firms for which blocks of shares are traded during 1987-2002. Block trades are identified through the SDC Platinum's Mergers and Acquisitions database. The identification of cases of securities class-action lawsuits is undertaken through LEXIS/NEXIS Business News Search. The numbers do not add up to the total number of firms because many lawsuits cite multiple causes of action.

Type of allegation	Number of cases
False/misleading financial statements or estimates	28
Accounting manipulation	16
Nondisclosure of material information	12
Unfair merger / breach of fiduciary duties during merger	4
Unfair buyout / breach of fiduciary duties during buyout	3
Market manipulation / improper trading practices	3
Unfair treatment during stock issues	2
Insider trading	2
Embezzlement	2
Other frauds	3
Total number of firms with class-action lawsuits	46

Table II
Summary Statistics

This table gives means and medians of several variables for 391 firms whose blocks are traded between 1987 and 2002. Block trades are identified through the SDC Platinum's Mergers and Acquisitions database. A firm belongs to "lawsuits firms" if the company is involved in class-action shareholder lawsuits within five years after the block trade where the class period starts within three years after the block trade. The percentage block premium is defined as 100x{(price per share paid for the block) – (exchange price one day after the announcement of the transaction)} / (exchange price one day after the announcement of the transaction). The percent of shares acquired is the percentage of shares acquired in the block transaction. Volume is the average monthly trading volume divided by the shares outstanding for the year preceding the block trade. Cumulative return is the cumulative daily return for the 12 months before the block trade announcement. Volatility is the standard deviation of daily stock returns for the fiscal year prior to the block trade. Market-to-book (MB) ratio is the ratio of the market value of equity to the book value of equity. Leverage is measured as the book value of long-term debt over the book value of assets. The insider holding variable is the percentage of shares owned by officers and directors and includes those shares owned by individuals who are related to a member of the top management team, employee pension or stock option plans, and trusts for which managers have some voting authority; it also includes any other blocks of shares over which a member of the top-management team has voting authority. Outsider dominated board dummy is a dummy variable that takes a value of one when the board has more than 60% of its directors as outsiders of the company. Top exec is founding family dummy variable is a dummy variable that takes the value of one when the top executive is a member of the founding family. Sales growth is the sales growth index and is measured by the ratio of sales in the fiscal year preceding the block trade to sales in the previous year. Accruals are the ratio of total accruals to total assets and are measured in the fiscal year preceding the block trade. Dollar values are in millions. Significant differences for the two groups are indicated at the 10%, 5%, and 1% levels by *, **, and ***, respectively, according to the t-test.

	Whole sample		Lawsuit firms		Non-lawsuit firms		Difference in mean
	mean	median	mean	median	mean	median	
Block premium (%)	9.42	8.03	10.54	7.85	9.27	8.16	1.27
Firms with positive premium (%)	69.31	-	63.93	-	70.03	-	-6.10
Percent of shares acquired (%)	14.22	10.00	16.82	11.42	13.88	9.73	2.97
Total asset (mil)	744.26	97.58	985.18	142.37	712.11	92.78	273.07*
Volume	60.57	47.21	84.63	62.48	57.36	45.91	27.27**
Cumulative return	0.18	0.11	0.07	0.07	0.19	0.12	-0.13*
Volatility	0.48	0.37	0.66	0.53	0.46	0.34	0.20
MB	3.57	2.36	3.54	2.20	3.57	2.39	-0.03
Leverage	0.23	0.11	0.26	0.15	0.23	0.09	0.03*
Insider holding (%)	5.39	0.22	4.72	0.20	5.48	0.23	-0.76
Institutional ownership (%)	27.43	22.26	25.61	20.43	27.67	22.49	-2.06
Outsider dominated board dummy	0.72	1.00	0.68	1.00	0.73	1.00	-0.05
Top exec is founding family dummy	0.20	0.00	0.17	0.00	0.20	0.00	-0.03
Sales growth	1.17	0.84	1.10	1.07	1.18	0.87	-0.08
Accruals	0.02	0.01	0.03	0.03	0.02	0.02	0.01
Sample size	391		46		345		

Table III
Determinants of Securities Class-Action Lawsuits

This table estimates logit models that relate the probability of securities class-action lawsuits to the measure of private benefits and other potential determinants of lawsuits. In Model 1, the dependent variable is the future litigation dummy, which takes the value of one if the company is involved in class-action shareholder lawsuits within five years after the block trade where the class period starts within three years after the block trade. In Model 2, the dependent variable takes the value of one only if lawsuits are made against the new blockholder or the new management team, which is defined as cases where the announcement of litigation occurs after the top executive is replaced or the blockholder takes part in any management activity of the company following the block trade and cases where the new blockholder is named as one of the defendants in the lawsuit. Market cap is the logarithm of the market value of common equity at the end of the fiscal year preceding the block trade. Volume is the average monthly trading volume divided by the shares outstanding for the year preceding the block trade. Cumulative return is the cumulative daily return for the 12 months before the block-trade announcement. Volatility is the standard deviation of daily stock returns for the fiscal year prior to the block trade. Market-to-book ratio (MB) is the ratio of the market value of equity to the book value of equity. Leverage is measured as the book value of long-term debt over the book value of assets. Sales growth is the sales growth index and is measured by the ratio of sales in the fiscal year preceding the block trade to sales in the previous year. Accruals are the ratio of total accruals to total assets and are measured in the fiscal year preceding the block trade. The block premium is defined as {(price per share paid for the block) – (exchange price one day after the announcement of the transaction)} / (exchange price one day after the announcement of the transaction). Dollar values are in millions. P-values are in parentheses. Significant coefficients are indicated at the 10%, 5%, and 1% levels by *, **, and ***, respectively.

Category of independent variables	Independent variables	Model 1	Model 2
		All lawsuits	Lawsuits against new blockholder or new management
Block premium	Block premium	0.179	0.225**
		(0.24)	(0.04)
Stock market variables	Market cap	0.387**	0.416*
		(0.04)	(0.08)
	Volume	0.004**	0.003**
		(0.03)	(0.04)
	Cumulative return	-0.927*	-0.589
		(0.04)	(0.15)
	Volatility	1.231**	1.368**
		(0.02)	(0.03)
	MB	-0.104	-0.055
		(0.28)	(0.29)
Accounting variables	Leverage	0.447	0.410
		(0.10)	(0.12)
	Sales growth	0.087	-0.012
		(0.44)	(0.43)
	Accruals	-0.005	-0.028
		(0.65)	(0.55)

Table IV
Determinants of Securities Class-Action Lawsuits:
Financially Non-Distressed Firms vs. Financially Distressed Firms

This table estimates logit models that relate the probability of securities class-action lawsuits to the measure of private benefits and other potential determinants of lawsuits. Financially distressed firms are block traded firms with the lowest quartile of Z-Scores according to the updated coefficients of Hillegeist et al. (2004). In Models 1 and 3, the dependent variable is the future litigation dummy, which takes the value of one if the company is involved in class-action shareholder lawsuits within five years after the block trade where the class period starts within three years after the block trade. In Models 2 and 4, the dependent variable takes the value of one only if lawsuits are made against the new blockholder or the new management team, which is defined as cases where the announcement of litigation occurs after the top executive is replaced or the blockholder takes part in any management activity of the company following the block trade and cases where the new blockholder is named as one of the defendants in the lawsuit. Market cap is the logarithm of the market value of common equity at the end of the fiscal year preceding the block trade. Volume is the average monthly trading volume divided by the shares outstanding for the year preceding the block trade. Cumulative return is the cumulative daily return for the 12 months before the block trade announcement. Volatility is the standard deviation of daily stock returns for the fiscal year prior to the block trade. Market-to-book (MB) ratio is the ratio of the market value of equity to the book value of equity. Leverage is measured as the book value of long-term debt over the book value of assets. Sales growth is the sales growth index and is measured by the ratio of sales in the fiscal year preceding the block trade to sales in the previous year. Accruals are the ratio of total accruals to total assets and are measured in the fiscal year preceding the block trade. The block premium is defined as {(price per share paid for the block) – (exchange price one day after the announcement of the transaction)} / (exchange price one day after the announcement of the transaction). Dollar values are in millions. P-values are in parentheses. Significant coefficients are indicated at the 10%, 5%, and 1% levels by *, **, and ***, respectively.

Category of independent variables	Independent variables	financially non-distressed firms		Financially distressed firms	
		Model 1	Model 2	Model 3	Model 4
		All lawsuits	Lawsuits against new blockholder or new management	All lawsuits	Lawsuits against new blockholder or new management
Block premium	Block premium	0.239	0.221**	-0.110	-0.013
		(0.18)	(0.05)	(0.23)	(0.28)
Stock market variables	Market cap	0.463**	0.475**	0.228	0.292
		(0.04)	(0.05)	(0.21)	(0.23)
	Volume	0.002**	0.003**	0.005*	0.008
		(0.05)	(0.04)	(0.09)	(0.10)
	Cumulative return	-0.819	-0.740	-0.857***	-0.934**
		(0.14)	(0.17)	(0.01)	(0.01)
	Volatility	1.258**	1.430**	1.003*	1.219*
		(0.06)	(0.05)	(0.06)	(0.07)
	MB	-0.119	-0.237	-0.010	-0.004
		(0.26)	(0.28)	(0.19)	(0.23)
Accounting variables	Leverage	0.560*	0.467	0.431	0.399
		(0.08)	(0.12)	(0.23)	(0.28)
	Sales growth	0.103	0.089	-0.028	-0.084
		(0.45)	(0.41)	(0.43)	(0.52)
	Accruals	-0.079	-0.061	0.058	-0.004
		(0.44)	(0.64)	(0.52)	(0.41)

Table V
Types of Earnings Manipulation Reported in the AAERs

This table lists the alleged earnings manipulations reported in the SEC Accounting and Auditing Enforcement Release (AAER) for block traded firms within three years of the block trade. Sample firms are 391 firms whose blocks of shares are traded during 1987-2002. Block trades are identified through the SDC Platinum's Mergers and Acquisitions database. The identification of cases of earnings manipulation are undertaken through SEC Accounting and Auditing Enforcement Release (AAER) on LEXIS/NEXIS Accounting Search.

Manipulation type	Number of cases
Overstatement of revenues	7
Combination of overstating revenues and understating expenses	3
Delayed recognition of a loss	2
Overstatement of inventory	1
Understatement of provisions for loan loss reserves	1
Overstatement of marketable securities	1
Disclosure issue	1
Other	2
Total	18

Table VI
Determinants of Accounting Fraud

This table estimates logit models that relate the probability of accounting fraud to the measure of private benefits and other potential determinants. Firms with accounting allegations are (1) firms that face class-action lawsuits that are accounting-related and (2) firms that are subject to accounting and auditing enforcement by the SEC. Panel A shows the results for all block traded firms. Panel B shows the results for financially non-distressed firms, which exclude those firms with the lowest quartile of Z-Scores according to the updated coefficients of Hillegeist et al. (2004). In Model 1, the dependent variable takes the value of one if the company is involved in accounting fraud within five years after the block trade. In Model 2, the dependent variable takes the value of one only if the accounting fraud involves the new blockholder or the new management of the company within five years after the block trade. This includes cases where the announcement of accounting-related litigation or SEC enforcement occurs after the top executive is replaced or the blockholder takes part in any management activity of the company following the block trade and cases where the new blockholder is named as one of the defendants in the lawsuit. Market cap is the logarithm of the market value of common equity at the end of the fiscal year preceding the block trade. Volume is the average monthly trading volume divided by the shares outstanding for the year preceding the block trade. Cumulative return is the cumulative daily return for the 12 months before the block trade announcement. Volatility is the standard deviation of daily stock returns for the fiscal year prior to the block trade. The MB ratio is the ratio of the market value to the book value of equity. Leverage is measured as the book value of long-term debt over the book value of assets. Sales growth is the sales-growth index and is measured by the ratio of sales in the fiscal year preceding the block trade to sales in the previous year. Accruals are the ratio of total accruals to total assets and are measured in the fiscal year preceding the block trade. The block premium is defined as {(price per share paid for the block) – (exchange price one day after the announcement of the transaction)} / (exchange price one day after the announcement of the transaction). Dollar values are in millions. P-values are in parentheses. Significant coefficients are indicated at the 10%, 5%, and 1% levels by *, **, and ***, respectively.

Category of independent variables	Independent variables	Model 1	Model 2
		All accounting allegations	Accounting allegations against new blockholder or new management
Block premium	Block premium	0.169	0.192*
		(0.28)	(0.08)
Stock market variables	Market cap	0.348**	0.440**
		(0.03)	(0.04)
	Volume	0.003*	0.003*
		(0.09)	(0.09)
	Cumulative return	-0.350	-0.080
		(0.58)	(0.71)
	Volatility	1.072**	1.430**
		(0.02)	(0.03)
	MB	-0.052	-0.086
		(0.32)	(0.25)
Accounting variables	Leverage	0.664	0.573
		(0.30)	(0.23)
	Sales growth	0.033*	0.038
		(0.09)	(0.13)
	Accruals	0.086	0.034
		(0.23)	(0.35)