WORKPLACE ENVIRONMENT AND PAYOUT POLICY

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ABSTRACT

Firms that encounter lawsuits are subject to unforeseen costs when a case is ruled in favor of the plaintiff. We examine the impact of lawsuits brought against firms and whether this affects the firms' dividend policy, using unique hand-collected datasets of employee litigations and disputes that include court settlements for employee dispute cases in the U.S. We find that lawsuits lower a firm's payout ratio, and an increase in lawsuits for a firm lowers the likelihood of the firm to pay out dividends. The payout ratio also declines for firms following a litigation year: this effect of a lower payout ratio is more pronounced for smaller firms. These findings provide evidence that firms adjust their dividend policy when facing employee lawsuits.

Keywords: Lawsuit, Employee Treatment, Dividend Policy

INTRODUCTION

Finance literature has examined the factors that affect a firm's payout policy, spanning from taxation, signaling, agency costs, management compensation, to legal implications, one of these major legal implications being corporate lawsuits. Corporate lawsuits have become a major source of risk for firms, with a drastic increase in firms paying out court settlements. Firms that face lawsuits suffer from significant direct costs, which include settlement payments, legal fees, and indirect costs, such as damage to brand image and reputation [2], with corporate reputation being linked to firm financial performance [29].

One of the main types of corporate litigation that firms are subject to is employee disputes. There are several types of employee disputes that firms face, which include discrimination, labor law disputes, injury and death, management negligence, and employee disputes that are more firm-specific. We examine the impact of lawsuits brought against firms and whether this affects the firms' dividend policy, using unique hand-collected datasets of employee litigations, allegations, violations, and disputes that also include court settlements and awards for employee dispute cases in the United States. Our findings support [9], who find that firms who face cash flow uncertainty will be less likely to issue dividends. Employee lawsuits can bring cash flow uncertainty to firms, because facing these lawsuits can lead to losses in consumers and stakeholders, which can affect cash flow uncertainty and, in turn, firms will be hesitant to issue dividends.

Working with 2,809 unique firms between 2000 and 2014, we first examine the relationship between lawsuits and payout probability and find that an increase in lawsuits for a firm lowers the likelihood of the firm to pay out dividends. Next, we examine the case duration and payout ratio. Our results indicate that the payout ratio declines for firms following a litigation year. Then, we examine how this affects firms with different characteristics and we find that this effect of a lower payout ratio is more pronounced for smaller firms. Afterward, we examine a firm's total payout ratio and find that lawsuits lower a firm's total payout policy. We finally examine alternative channels and examine lawsuits and cash holdings. From this, we document that firms react to lawsuits by increasing cash holdings and that firms hold more cash following a lawsuit. We hand-collect unique datasets of employee lawsuits, allegations, violations, and complaints which also include court cases brought against firms, with their subsequent awards and settlements. This allows us to show the direct impact an employee lawsuit has on the defendant firm and how that affects the firm's payout policy. Our findings contribute to the payout literature by helping to explain specific factors that affect a firm's payout policy. Employee lawsuits as a factor of payout policy are quite relevant with the drastic increase of employee lawsuits stemming from labor and wage issues, sexual harassment, and discrimination. The results have implications for investors, management, and stakeholders.

LITERATURE REVIEW

Several studies examine what affects a firm's payout policy. [16] provide a survey of corporate payout policy. [5] discover that firm officers from multiple industries (utilities, manufacturing, and wholesale/retail) agree that continuous dividends are vital and that dividend policy influences share value, and that these officers are familiar with dividend signaling. Firms may use payout flexibility as a means of operational hedging in order to avoid financial distress [7].

[19] study how managerial incentives affect payout policy and find that there is a strongly negative relationship between dividends and management stock options. [28] find a positive relationship between share repurchases and managerial stock options. The findings from both of these papers support the argument that the rise of managerial stock options may explain the increase of share repurchases.

Motivated by those studies, we also investigate the underlying factors of firms' payout policy. Briefly, we examine how a firm's relationship with its major stakeholders, employees, influence dividend behavior. [14] [15] state that firms may cut dividends when negotiating collective bargaining with labor unions. [33] finds a negative relationship between union power and dividend policy, but the results are not significant. When examining union power at the industry-level, firms that are very profitable tend to have higher payouts than firms that are not profitable [11]. When studying higher employee protection and firing costs, firms will engage in share buybacks to prevent transfer of shareholder wealth to workers [13]. Ahmad, Our study contributes to the literature on examining how labor-related lawsuits, as well as employee treatment, affects firm-level policies.

HYPOTHESIS DEVELOPMENT

There has been a rising trend of firms facing employee lawsuits, which has resulted in numerous settlements. Litigation under labor laws has drastically risen since 2000 [18]. There were over 7,000 collective actions regarding wage and hour violations filed with federal courts in 2011, which is an approximate 400 percent increase from 2000 [37][1]. Over 3,500 federal civil lawsuits related to harassment were filed in 2017, an increase from 3,288 in 2016 and such lawsuits are at their highest level since 2012 [29]. The ten largest worker treatment class-action suits were up to $2.72 billion in 2017, from $1.75 billion in 2016 [31].

Cost of Litigation and Potential Impact on Payout Policy

We believe that the cost factor associated with labor litigations can cause a severe threat to the business. For example, ten former employees filed a civil rights lawsuit in the U.S. District Court of Virginia against McDonald's for racism, sexual harassment, and wrongful termination, alleging that the firm fired a dozen black employees that "didn't fit the profile" they wanted [26].

[22] found that firms facing legal liability risk from workers being exposed to carcinogens tended to acquire firms that had high operating cash flows. This is a means for management to diversify their risk as well as protect their personal exposure to the negative returns from these adverse shocks to the share price. This strategy of holding cash to remedy declines in share price may also hold true for when firms face other types of employee lawsuits. Given the negative impact corporate lawsuits have on firm value and performance, we hypothesize that lawsuits lower a firm's payout ratio due to the firm preparing to cover for costs associated with the lawsuit, which includes legal fees, court awards and/or settlements and the losses from consumers and stakeholders. [4] examine litigation risk and find that firms store cash to cover anticipated litigation costs by decreasing capital expenditures. This leads us to our regression model below:

$$\text{Payout Ratio} = \text{Lawsuit} + \Sigma\ \text{Controls} \quad (1)$$

In this model, we regress the payout ratio on the log transformation of the total number of lawsuits, such as *Log(Lawsuit)*, by controlling a set of firm-level control variables. For other variables, we mostly follow [20]. First, we create *Treat * Post Years* to measure how firms adjust their dividend policy after they face

[1] A collective action is a type of class action lawsuit that is brought by a group of employees under the Fair Labor and Standards Act (which sets the levels for minimum-wage and overtime pay) who were not paid what was owed due to being misclassified, from being exempt from overtime, or were properly classified but not paid the time they worked.

litigations. *Treat* is a binary variable and equal to one if the firm is facing an employee allegation, zero otherwise. *Post Years* is equal to one for all the years after the firm is charged in an employee dispute. Our control variables include three sets. The first set is firm-level control variables, namely, market-to-book ratio, asset growth, ROA, firm size, retained earnings to total capital, idiosyncratic risk, and cash holding. The second set is labor and employment-related variables, specifically: percentage of industry unionization, percentage of unionization at the state level, percentage of unionization growth at an industry, personnel intensity, property, plants, and equipment. The last set includes corporate governance-related variables, i.e., leverage, investment ratio, tax, institutional holding, and takeover index (to conserve space, we report those variables as GOV. Controls in our regressions). In each regression, we first control for firm- and labor-related control variables. We then add governance-related variables, following [20] to reduce any omitted variable bias. Detailed definitions of the variables are in the appendix. We perform year and industry fixed effects, year and state (location) fixed effects, year and firm fixed effects to eliminate any unobserved heterogeneity. We also cluster standard errors at the firm level.

DATA

We use the S&P Capital IQ database to collect the financial information of US publicly traded firms between 2000 and 2014. Our sample has 10,042 unique firms after excluding financial firms and utility firms. Our lawsuit data is gathered from two sources. First, we hand-collect labor- and employment-related lawsuits from the National Labor Relations Board database. We obtain 34,955 unique cases, along with charging parties and case outcomes.[2] For robustness of our results, we also introduce different work-related disputes that proxy for litigation. We obtain unique hand-collected labor enforcement datasets from the US Department of Labor.[3] Those datasets include Occupational Safety and Health Administration (OSHA) enforcement data, Wage and Hour Compliance Action Data, and Employee Benefits and Security Enforcement Data. Finally, we also collect, from S&P Capital IQ, data on discrimination lawsuits that are filed against firms by employees, lawsuit announcements and news releases, which include settlement amounts, legal fees, and attorney fees.

FINDINGS

Summary Statistics

We show that firms can face as many as 224 lawsuits in a year, while cases can take up to 3,461 days to conclude. Charging Party data indicates that 67% of the cases are filed by labor unions, while 33% are filed by individual employees. The 'treat' variable documents that 20% of the firms in our sample are facing at least one lawsuit.

Employee Lawsuits and Payout Ratio

We examine the relationship between lawsuit and payout ratio. Our results indicate that lawsuits lower payout ratios. We find that the increase in the number of litigations lowers a firm's dividend payments. [4] find that firms who face litigation hold more cash and reduce capital expenditures. Our findings support that firms hold cash to cover future litigation costs, but they reduce their payout ratio instead.

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[2] https://www.nlrb.gov/news-outreach/graphs-data/recent-filings
[3] US Department of Labor Enforcement Data: http://ogesdw.dol.gov/views/data_catalogs.php

Employee Lawsuits and Payout Probability

We measure the relationship between lawsuit and payout probability. 'Payout likelihood' is a binary variable and equal to one if the firm is paying dividends, and zero otherwise. We find that an increase in lawsuits lowers the likelihood of a firm paying dividends.

Case Duration and Payout Ratio

There is a possibility that our results are capturing pre-existing trends in a firm's dividend policy. To address this, we examine the case duration and payout ratio. We find that an increase in case duration (case closure date minus case opening date) lowers the payout ratio. We include *charging party* in the empirical model. *Charging party* is equal to one if the case is filed by a union, and zero otherwise. These results show that union filed cases lower dividends more than individual employee-filed cases. This finding is important, because it adds to the literature on the relationship between union activities and firm performance [8] [12][39]. Labor unions can impact a firm's cash holdings [27]. Our results build upon the findings in [24], who state that unionization lowers a firm's dividend ratio.
We perform a difference-in-difference test. 'Treat' is a binary variable, equal to one if the firm is being sued. We create 'lawsuit_before', which is years before (-1, -2) and years after (+1, +2) a lawsuit. We show that the firms' payout ratio goes down following the litigation year. If prior trends in a firm's dividend policy are present, then 'lawsuit_before' should be both negative and significant. These results provide support that our initial findings are not endogenous and do not stem from a firm's previous trends of dividend policy.

Corporate Governance Characteristics

We also examine whether smaller firms are more affected by employee lawsuits. Smaller firms have smaller workforces and less access to capital so that these firms may be impacted more by employee lawsuits. We show our measurements of the firm's corporate governance characteristics. 'Treat' is a binary variable for lawsuit firms. 'Post Years' is all of the years after a firm is sued. 'Small firm' is a binary variable which indicates whether the firm size is smaller than the sample median. We document that the effect of lowered payout ratio is more pronounced for smaller firms. This is consistent with our hypothesis that firms reduce their payout policy to reserve capital to cover impending litigation costs. This would be more pronounced for smaller firms, who are more limited in raising capital and hence need to safeguard capital even more than larger firms, thus reducing their payout policy more than larger firms.

Employee Lawsuits and Total Payout Ratio

[23] state that firms may have gradually transitioned from dividend issues to share repurchases over time, while [16] state that the supply of dividends is concentrated in a small number of firms. Thus, the decline in dividend issues may stem from firms replacing dividend issues with share repurchases. To address this matter of whether employee lawsuits influence a firm's payout policy, we examine a firm's "total payout ratio" which is the sum of dividend and share repurchases to earnings. Our results reflect that lawsuits lower the total payout ratio.

We use the dependent variable, *Payout Through Repurchases*, which reflects the fraction of the total payout that is paid out through share repurchases. Specifically, we test whether employee lawsuits may influence managers' preference for share repurchases rather than dividend payments. The results of this calculation provide further support for our initial findings: employee lawsuits decrease managers' incentive for paying dividends and operating share repurchase programs. Our results are consistent with [36].

We test how employee litigations affect dividend forecast "ERROR". We follow [23], who posit that dividend policy is a function of targeted payout policy and the speed of adjustment of current dividends.

$$ERROR_{i,t} = \frac{\left[\Delta\, DIV_{i,t} - \left(\beta_{1,i} + \beta_{2,i}\, EARN_{i,t} + \beta_{3,i}\, DIV_{i.t-1}\right)\right]}{VM_{i,t-1}} \quad (2)$$

In this equation, $\Delta\, DIV_{i,t}$ is the change in the dividend, $EARN_{i,t}$ is the earnings of the firm, and $VM_{i,t-1}$ is the market value of equity of the firm. We regress ERROR on share repurchases as well as the employee lawsuit binary variable interacted with share repurchases. We find a negative correlation between share repurchases and ERROR, which indicates that share repurchases and dividend payments are substitute payout methods. Overall, the results suggest that employee lawsuits do not moderate the relationship between dividends and share repurchases. Costly allegations can weaken the substitution effect.

Employee Lawsuits and Free Cash Flow

An issue may arise where firms increase dividends before a court filing, to appease shareholders who are focused on a short-time horizon and then, after the case, cut dividends. In order to address this, we separate our sample into two subsamples and use a proxy for the severity of the free cash flow problem. We reference [20] and use an interaction term *Treat*Post Case* and the dummy variable *Low Free Cash Flow Problem*, where the variable is equal to 1 if the firm is above the Market-to-Book Ratio sample median value and below the *Cash Flow* sample median value in the specified year and 0 otherwise. These variables are incorporated into the regression. The coefficient of the interaction term is negative and significant, which suggests that the regression coefficients of Treat*Lawsuit are significantly different across these two subsamples. From this, we can conclude that lawsuits have a more significant effect on cash distributions, particularly dividends, when there is a more severe cash flow problem. It is less probable that the firms were reducing investment before the lawsuit. Therefore, our results suggest that firms did not cut dividends to satisfy shareholders.

Employee Lawsuits and Cash Holdings

Firms hold more cash in order to prepare for covering the imminent costs associated with an employee lawsuit. This may be especially true after the lawsuit, because the firm will need to pay settlement costs to the plaintiff and legal costs to the lawyers representing the firm. [38] states that "Corporations hold cash for several important reasons: (1) to pay for a firm's obligations, (2) to take immediate advantage of business opportunities [6], and (3) to provide for self-insurance against unknown hazards." Firms who have leaner cash holdings tend to generate higher returns, especially for firms with negative earnings growth and loss firms [38]. This corresponds with our finding that, typically, it is not in a firm's best interest to hold cash. This occurs because of the need to cover the costs associated with employee lawsuits. Firms hold cash in order to cover anticipated settlements and costs associated with securities class action litigation [3]. [34] add to this and find that, following a securities class action lawsuit, firms decrease payouts and increase cash holdings, as well as increase leverage and firm-specific risk. Our results reflect

that firms similarly hold cash for employee lawsuits. Our results support [32], who find that increases in litigation risk lead to increases in a firm's cash holdings and find a positive relationship between cash holdings and labor violations.

We repeat our main regression by considering the leverage ratios of the firm. This is important, given the fact that firms may be constrained in issuing dividends due to debt covenants [35]. To address this, we use the control variable 'Leverage' in all our regressions. However, firms may be borrowing money to cover legal allegations which could alter their dividend payout ratios. To alleviate that concern, we repeat the main regression, but use firms that have below median debt ratios, which are less susceptible to this debt covenant effect.

Robustness Checks

In this section of our study, we run further tests to confirm our initial findings. First, we re-run our main regressions by creating a matched sample. We match each lawsuit firm to a non-lawsuit firm based on 'size (total assets)' and 'booktomarket'. We find that litigation lowers payout ratios. Also, firms have a lower payout ratio in the years following litigation. We match our sample based on the number of employees and book-to-market. Consistent with expectations, we document that employee lawsuits are negatively related to the dividend payout ratio.

Next, we use alternative dividend payout definitions, measured as, a) dividend as a percentage of the book value of total assets, and b)the ratio of dividends to the market value of assets, as an additional robustness check. We show that a specific payout ratio definition does not bias our results. Afterward, we use other employee disputes that proxy for litigations. We use the log transformation of total wage-related cases, log transformation of total penalties for wage-related allegations, log transformation of total OSHA inspections, log transformation of discrimination cases, log transformation of total settlement amounts, and log transformation of total attorney fees. They all lower payout ratios. Legal violations can affect firm value, as seen with OSHA citations in [21], as well as labor violations. Equal Employment Opportunity violations lead to losses in equity value that exceed the amounts of the settlement costs of the violation, which may stem from the added costs of the firms in altering their employment practices or the publicity of firm management exposed by the court case [25]. We document that the number of wage-related cases and wage-related penalties lower firms' payout ratio. We also show that OSHA inspections and discrimination cases are negatively and significantly related to dividend payout ratios. Finally, we find that the direct cost of lawsuits (settlement costs and attorney costs) yield lower levels of dividends. Our results are robust to alternative employee disputes, violations, complaints, and allegations.

Additionally, there may be state-level factors that influence a firm's dividend policy. An example is state laws that require a minimum asset-to-debt ratio in order to issue a payout [35]. To address any time-variant state-level effects, we incorporate a state incorporation dummy variable into the regression. We perform state and year fixed effects based on the state of incorporation (some states may have better laws for employee protections, so states should be checked individually). We perform year and fixed effects to eliminate any unobserved heterogeneity. Our results remain relatively constant; firms tend to reduce the number of payouts as they face employee allegations.

CONCLUSION

In this paper, we examine whether employee lawsuits affect a firm's dividend policy. We use a series of unique datasets, which are NLRB lawsuits, the U.S. Department of Labor work-related allegations, and S&P Capital IQ discrimination lawsuits and news releases that contain lawsuits and court settlements for U.S. firms over a time span of 15 years from 2000 to 2016. Our results indicate that lawsuits lower a firm's

payout ratio; an increase in lawsuits for a firm lowers the likelihood of the firm paying out dividends; and the firm's payout ratio declines following a litigation year. This act of lowering the firm's payout ratio is more pronounced for smaller firms. Also, we find that firms increase their cash holdings when faced with a lawsuit and hold more cash following the lawsuit. Our findings contribute to the current literature by examining whether firms adjust their payout policy when facing employee lawsuits.

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