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Managerial Ability and Lawsuit Settlement

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1. Introduction

Ever since Demerjian, Lev, and McVay (2012) presented the noteworthy and thorough metric of managerial ability, there has been a rapid increase in its application in recent research. Managerial ability is defined as the ability to convert firm resources into revenue. Theoretically, Demerjian et al. (2012) introduces the concept that higher ability managers understand more about customer trends, industry and market demand, technology, and other competitive factors, vis-à-vis lower ability managers. As a result, these more able managers are affiliated with better company performance and other positive firm-specific outcomes. Previous research assesses and discovers that possessing more capable managers has a positive influence on the firm. As an example, Demerjian, Lev, Levis, and McVay (2013) learn that managerial ability has a positive influence on earnings quality, thus indicating that managers judged more capable issue more precise estimation of financial information. Also, Cornaggia, Krishnan, and Wang (2017) find that companies with high ability managers tend to get higher bond credit ratings while De Franco, Hope, and Lu (2017) show that more capable managers bring lower bank loan prices to their firms. Even more, Hasan (2020) finds that companies with higher ability managers produce annual reports that are more readable and understandable. Taken together, research to date indicates that managerial ability influences company performance and outcomes in a positive manner, thus showing the relevance of having capable managers in a competitive firm.

Despite the surge of attention on managerial ability, there is little empirical research on whether and how managerial ability influences corporate legal outcomes (i.e., lawsuit and lawsuit settlement). The lack of empirical evidence motivates us to examine the impact of managerial ability on legal outcomes. We obtain data on lawsuit settlement from the special items section of an income statement because companies report their lawsuit settlement gain or loss in this section. Our study focuses on lawsuit settlement outcomes because more than 90 percent of lawsuits in the United States settle without going to a trial (Eisenberg and Lanvers, 2009).

The purpose of our study is to investigate the impact of managerial ability on business lawsuit outcomes, measured as the likelihood of lawsuit and the magnitude of lawsuit settlement. To obtain information on lawsuit settlement, we use the account of lawsuit settlement (Compustat Database Item #372; SETP) in the special items section of an income statement, which is reported as a component of other income within income from continuing operations. If a company is a plaintiff (a defendant) in settling a lawsuit, the company often reports a settlement gain (a settlement loss). A large body of research on managerial ability suggests that more capable managers can improve their firm performance (i.e., higher revenues) and more favorable outcomes (i.e., higher bond ratings and more favorable loan contracts) because those managers are more knowledgeable of key factors to a firm's success (Demerjian et al., 2012). Therefore, building on prior research, we posit that firms with higher ability managers are less likely to become involved in a lawsuit, relative to those with lower ability managers. Further, we posit that more capable managers can better handle the settlement process after a lawsuit filed, leading to more favorable settlement outcomes (i.e., larger settlement gain or smaller settlement loss), relative to less capable managers.

In testing our first hypothesis, we examine the relation between managerial ability and the likelihood of lawsuit using a large panel sample of 89,658 firm-year observations from 1996 to 2020. We find a significant negative relation, suggesting that firms with higher ability managers are less likely to become involved in a lawsuit. Using a panel sample consisting of observations with non-zero settlement gain or loss, we document that managerial ability is significantly and positively related to the magnitude of lawsuit settlement, which suggests that more capable managers can better manage

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the lawsuit process to achieve larger settlement gain or smaller settlement loss. Additionally, we find that this relation is largely driven by firms reporting settlement losses. In summary, empirical evidence supports our hypotheses.

We also perform a battery of additional tests to ensure the robustness of our primary findings. For example, we re-estimate our baseline regression model using lagged values of managerial ability in testing the first hypothesis and perform a changes analysis and a two-stage OLS regression analysis (2SLS) in testing the second hypothesis. We still obtain related results, consistent with our primary findings. In addition, we explore the role of corporate cash holdings in the relation between managerial ability and the likelihood of lawsuit. We uncover that the significant negative relation becomes stronger for firms with low cash holdings.

Our study is related to Krishnan, Wang, and Yu (2021), which finds a negative relation between managerial ability and litigation related to financial reporting, suggesting that more capable managers are less likely to engage in opportunistic financial reporting. Our study is different from Krishnan et al. (2021) in the following ways. First, their sample period is from 2003 to 2011, while our sample period ranges from 1996 to 2020. Thereby, we use a bigger sample to examine the relation between managerial ability and litigation outcome. Second, Krishnan et al. (2021) focus on lawsuits related to financial reporting, whereas our sample includes different types of lawsuits.

Our study makes several important contributions. First, our study contributes to the management literature on managerial characteristics and to the financial accounting literature on special items. In particular, the topic of special items is still under research. Thus, our study can lead to a more comprehensive understanding of the components included in the special items section on an income statement. In addition, to the best of our knowledge, this is perhaps the first study that examines the direct link between managerial ability and lawsuit settlement. Second, our study adds to the validity of the Upper Echelons theory, which argues that organizational outcomes are partially influenced by managers' differing background characteristics (Hambrick and Mason, 1984; Tushman and Romanelli, 1985; Hambrick, 2007). In other words, this theory implies that managers matter in firms' decisions and outcomes. Our findings suggest that managers with higher ability play an imporatant role in legal matters and outcomes. Hence, our study contributes to the Upper Echelons theory. Third, prior research (e.g., Huang, Hui, and Li, 2019) has attempted to identify factors that influence litigation risk. Our study shows that managerial ability can mitigate litigation risk. Hence, we contribute to the literature on litigation risk. Fourth, our study has some practical implications. For example, investors may invest in firms with more capable managers because those managers are more knowledgeable and can better handle legal matters. Lastly, our study may also relate to fraud and forensic accounting because forensic accountants not only examine the litigation against the firm but also attempt to identify factors that mitigate the litigation risk.

The remainder of this paper is organized as follows. Section 2 presents related studies on managerial ability and develops hypotheses. Section 3 discusses research design including sample selection, descriptive statistics, empirical specification, and correlation matrices. Section 4 and Section 5 report primary results and additional test results, respectively. Section 6 concludes this study.

2. Literature Review and Hypotheses Development

2.1 Managerial Ability

Recent years have seen a rapidly increasing attention on managerial ability. Indeed, the critical nature of managerial ability has become an important research area to many academic researchers (Andreou, Philip, and Robejsek, 2016). The surge of attention was caused by Demerjian et al. (2012), who successfully develop a comprehensive and robust measure of managerial ability. In Demerjian et al. (2012), the authors define managerial ability as the ability to convert firm resources into revenues and argue that managers with higher ability should generate more revenues, relative to those with lower ability. In addition, more capable managers should also be able to increase their firm operating performance and bring other favorable outcomes. Demerjian et al. (2012) further point out that the improved firm performance and favorable outcomes are caused by more capable managers' ability to fully understand industry trends and technology, reliably forecast customer demand, accurately invest in projects with high return on investment, and effectively manage employees. Collectively, from a theoretical perspective, Demerjian et al. (2012) believe that managers with high ability can have a positive impact on their firms.

There have been many studies which have recently assessed the influence of firms possessing capable managers. For instance, Demerjian et al. (2013) indicates a significant positive impact of managerial ability on earnings quality. As a result, this positive impact suggests that more capable managers are less likely to manipulate earnings and conduct other

behavior in an opportunistic manner. In addition, they find that companies with higher rates of managerial ability were less likely to issue subsequent restatements in earnings. Thus, one can conclude that more capable managers are more knowledgeable about their firms and stakeholders, therefore leading to a better reporting of financial data (Demerjian et al., 2012). Similarly, Koester, Shevlin, and Wangerin (2017) discover that high ability managers are not going to conduct activities associated with tax avoidance, thus further supporting their demonstration of less opportunistic behavior. Also, more able managers are typically going to produce more accurate management earnings forecasts and more readable and understandable annual reports (Baik, Farber, and Lee, 2011; Hasan, 2020). Going further, increased managerial ability has been affiliated with lower bank loan prices as well as corporate social responsibility performance (Baik, Farber, and Lee, 2016; De Franco et al., 2017). This ability suggests that more capable managers can increase both financial and non-financial performance metrics.

Other studies suggest that highly qualified managers can result in lower audit efforts and fees (Krishnan and Wang, 2015), more accurate accounting estimates (Libby and Luft, 1993), higher information environment (Baik, Brockman, Farber, and Lee, 2018), higher innovation productivity (Cho, Halford, Hsu, and Ng, 2013), lower likelihood of insolvency (Leverty and Grace, 2012), more favorable loan contracts (Francis, Hasan, and Yun, 2013), higher corporate bond ratings (Bonsall, Holzman, and Miller, 2017; Cornaggia et al., 2017), improved investment efficiency and lower stock price crash risk (Habib and Hasan, 2017; Andreou, Karasamani, Louca, and Ehrlich, 2017; Gan, 2019), more successful career paths (John, Ravid, and Sunder, 2017), more smoothed earnings (Demerjian, Lewis-Western, and McVay, 2017), higher employee productivity (Ghosh, Huang, and Sun, 2020), lower level of earnings management (Skousen, Sun, and Wu, 2019), improved cost structure (Bradbury and Scott, 2018; Huang and Yan, 2019), improved risk-taking behavior (Yung and Chen, 2018), and lower litigation risk (Krishnan et al., 2021). Taken together, prior research implies that having higher ability managers can have a positive impact on firm performance and outcomes. Due to their higher managerial ability to control and manage firm resources, these managers are less likely to engage in opportunistic behavior. Overall, the empirical evidence on managerial ability is consistent with Demerjian et al. (2012).

2.2 Hypotheses Development

Building on prior research on managerial ability, we posit that firms with more capable managers are less likely to become involved in a lawsuit, relative to less capable managers, for the following reasons. First, prior research (e.g., Demerjian et al., 2012) finds that managers with higher ability are more knowledgeable of internal and external factors such as firm operation, customer demand, supplier capability, technology, and industry and market trends. This research suggests that more capable managers may be better able to foresee or predict some future events such as legal troubles, relative to less capable managers. If this result is the case, more capable managers may take the necessary actions to avoid any upcoming legal troubles. Second, it is documented that more capable managers are less likely to engage in opportunistic behavior including unethical tax avoidance activities and aggressive earnings manipulations (Demerjian et al, 2013; Koester et al., 2017; Krisnan et al., 2021). If the level of such behavior in firms with higher ability managers is lower, we expect that such firms are less likely to become involved in legal troubles, relative to firms with lower ability managers. Third, prior research finds a significant positive association between managerial ability and CSR performance, suggesting that more capable managers engage in more CSR activities (Baik et al., 2016). Valuing and performing CSR activities mean that these companies attempt to take care of their stakeholders' needs and treat all stakeholders such as employees and customers better. If this situation is the case, we argue that firms with CSR performance are less likely to be sued by their stakeholders. Taken together, we posit a negative relation between managerial ability and the likelihood of lawsuit, leading to the following hypothesis.

H1: Managerial ability is negatively related to the likelihood of lawsuit.

In developing our second hypothesis, we posit that more capable managers can bring more favorable settlement outcomes (i.e., larger settlement gain or smaller settlement loss), relative to less capable managers. Demerjian et al. (2012) document that higher ability managers can generate more revenues than lower ability managers can in a firm's normal operation. In addition, more capable managers are more likely to successfully defend litigation against their firms, relative to less capable managers. Intuitively, we expect that more capable managers may generate more gains than less capable managers in the process of managing and settling a lawsuit. We propose the following hypothesis.

H2: Managerial ability is positively related to lawsuit settlement outcome.

3. Research Design

3.1 Measuring Managerial Ability

We follow Demerjian et al. (2012) to develop the managerial ability metric. First, a commonly used decision-making technique in operations management and decision sciences, Data Envelopment Analysis (DEA) is used to fit inputs to an output measure so an efficiency frontier can be formed. Using this technique, we use seven input variables and one output variable. The input variables for the DEA are as follows: cost of goods sold (COGS), selling, general, and administrative expenses (XSGA), property, plant, and equipment (PPE), operating leases (LEASE), research and development expenses (RD), goodwill (GOODWILL), and other intangibles (OTHER). The output variable is revenue. The DEA equation is as follows.

$$max_t Q = \frac{REVENUES}{t_1 COGS + t_2 XSGA + t_3 PPE + t_4 LEASE + t_5 RD + t_6 GOODWILL + t_7 OTHER}$$

Relating to both company- and manager-level factors, Demerjian et al. (2012) state that the DEA scores should be regressed on company-specific variables (such as cash flows, firm size, business operations complexity, market share, firm age, and foreign operations) and the residuals from the regression should be used as the managerial ability measurement. We follow this recommended approach for the managerial ability variable.

This managerial ability metric by Demerjian et al. (2012) is a viable and appropriate measure to contribute to this study in at least three ways. For instance, Demerjian et al. (2012) found via several tests that this variable specifically measures managerial characteristics and is positively associated with market reaction. Also, a considerable number of studies (e.g., Albuquerque, De Franco, and Verdi, 2013; Baik et al., 2011; Banker, Darrough, Huang, and Plehn-Dujowich, 2013) pursue related variables and do not find it is impacted by firm performance. Second, previous literature has measured managerial ability differently (e.g., Baik et al., 2011; Fee and Hadlock, 2003; Rajgopal, Shevlin, and Zamora, 2006). These distinct approaches include industry-adjusted return on assets, industry-adjusted stock return, CEO compensation, and CEO media mentions. For instance, Fee and Hadlock (2003) measure managerial ability using historical stock returns as the basis. Demerjian et al. (2012) state that this measure can be influenced by a multitude of company-specific factors, thus making it unsuitable. Francis et al. (2008) applied CEO media citations as a measure, but since it is difficult to obtain widespread data on this metric, the result is a much smaller sample size than is typically required (Demerjian et al., 2013). Thus, there are many concerns with these distinct applications for measuring managerial ability. As a result, we contend that the approach used by Demerjian et al. (2012) is the better approach for this study's purposes. Lastly, data on managerial ability are available to the public, costless to the researcher, and have been used considerably in the associated literature (Baik et al., 2016, 2018; Bonsall et al., 2016; Cornaggia et al., 2016; Demerjian et al., 2013, 2016; Koester et al., 2016; Krishnan and Wang, 2015).

3.2 Empirical Specifications

To investigate the impact of managerial ability on the likelihood of lawsuit and the magnitude of lawsuit settlement, we use the following equation to test our hypotheses.

$$\begin{aligned} LAWSUIT_{i,t} = {} & \beta_0 + \beta_1 \mathbf{MASCORE}_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 MTB_{i,t} + \beta_4 LEV_{i,t} + \beta_5 ROA_{i,t} + \beta_6 OCF_{i,t} + \beta_7 LOSS_{i,t} + \\ & \beta_8 ZSCORE_{i,t} + \beta_9 TOBINQ_{i,t} + \beta_{10} FIRMAGE_{i,t} + \beta_{11} ASSETAGE_{i,t} + \beta_{12} BUS\_VOL_{i,t} + \\ & \beta_{13} SEPITEM_{i,t} + \beta_{14} BIG4_{i,t} + \beta_{15} HLI\_IND_{i,t} + \text{Industry Indicators} + \text{Year Indicators} + \varepsilon_{i,t} \end{aligned}$$

[Equation 1]

The dependent variable (LAWSUIT) alternatively represents the likelihood of lawsuit (LAWSUIT) and the magnitude of lawsuit settlement (LAWSUIT_GL). Specifically, LAWSUIT is an indicator variable that equals one if a firm is involved in (at least) one lawsuit in a given year and zero otherwise. LAWSUIT_GL is the magnitude of settlement gain or loss, scaled by total firm assets. The primary independent variable of interest (MASCORE) is the managerial score, provided by Professor Demerjian. To the extent that higher ability managers are less likely to be involved in a lawsuit (H1), we expect a negative and significant coefficient on MASCORE. Regarding H2, to the extent that higher ability managers are more likely to receive favorable outcomes in lawsuit settlements, we expect a positive and significant coefficient on MASCORE.

Given that corporate lawsuits may influence the study, we control for their probability and magnitude. More precisely, we use performance-related measures such as total firm assets (SIZE), market-to-book ratio (MTB), leverage ratio (LEV), return on assets (ROA), operating cash flows (OCF), whether a loss is reported by an observation (LOSS),

Altman Z score (ZSCORE), and Tobin's Q (TOBINQ). Since a lawsuit settlement amount is found in special items, we include special items (SEPITEM), as well. Cursory suggestions are that older companies tend to be sued more, vis-à-vis newer companies, so we control for company age (FIRMAGE). We adopt Cochran and Wood's (1984) approach and control for long-term asset age (ASSETAGE) due to the observation that companies with younger assets behave differently vis-à-vis companies with older assets. Other issues we control for include external business risks (BUS_VOL) and industry-specific litigation risks (HLI_IND). HLI_IND is coded as either zero or one, depending on whether the company is in an industry with increased litigation risks (SIC: 2833-2836; 3570-3577; 3600-3674; 7371-7379; or 8731-8734). Each observation found to belong to the aforementioned industries related to high litigation risk were noted with a one, all other companies received a zero. Finally, whether a BIG4 auditing company (BIG4) was used is also indicated.

In testing H1, we use logistic regression because the dependent variable is an indicator variable (LAWSUIT). In testing H2, we use clustered standard errors OLS regression. Consistent with prior research (e.g., Petersen, 2009), we use two-way clustering by firm and year. All continuous variables in Equation 1 are winsorized at the 1 percent and 99 percent percentiles to mitigate influences of outliers. Industry indicators (based on Fama and French 48 industry classification) and year indicators are also included in Equation 1. Please refer to Appendix 1 for detailed variable definitions.

3.3 Sample Selection and Descriptive Statistics

Our sample selection begins with the managerial ability ratings, provided by Professor Demerjian.[1] This dataset consists of 150,714 firm-year observations from 1996 to 2020. We merge this dataset with the Compustat database. Next, we delete 53,189 firm-year observations due to missing data to construct control variables in Equation 1 and then remove 7,867 observations in highly regulated industries (SIC 4000-4999 and 6000-6999). The final sample consists of 89,658 firm-year observations from 1996 to 2020. Of these 89,658 observations, we find that 11,423 observations report either lawsuit settlement gain or loss, and 78,233 report no settlement outcomes. Panel A of Table 1 explains our sample selection process.

Panel B of Table 1 presents the sample distribution by year. Based on the full sample (89,658 observations), the number of observations shows an upward trend from 1996 to 2003 and a downward trend from 2004 to 2020. Based on the lawsuit sample (11,423 observations), the number of observations displays an upward pattern from 1996 to 2005 and a downward pattern from 2006 to 2020. Panel C of Table 1 reports the sample distribution by industry, which is based on the first two digits of the SIC code. In the full sample, the most represented industry is Business Services (SIC = 73; 12,504 observations), followed by Chemicals (SIC = 28; 9,333 observations) and Electronic Equipment (SIC=36; 9,009 observations). In the lawsuit sample, the Chemicals, Business Services, and Electronic Equipment are the most representative industries with 12.33 percent, 10.91 percent, and 10.17 percent of the sample, respectively. [See Table 1, pg. 425]

Panel A of Table 2 reports the full sample descriptive statistics. The mean value of LAWSUIT is 0.127, which suggests that approximately 12.7 percent of the full sample report lawsuit settlement gain or loss. The mean and median value of MASCORE is -0.002 and -0.024, respectively. Panel B of Table 2 presents the mean value of key variables for the lawsuit sample (11,425 observations) and the non-lawsuit sample (78,233 observations), and the significance of the difference in those means. For example, the mean value of MASCORE is -0.005 for the lawsuit sample and -0.002 for the non-lawsuit sample, and the difference between -0.005 and -0.002 is statistically significant (p-value = 0.0017). In other words, this evidence indicates that the average managerial ability of the lawsuit sample is significantly lower than those of the non-lawsuit sample, suggesting that firms with higher managerial ability are less likely to become involved in lawsuits. Panel C of Table 2 displays the sample descriptive statistics for the lawsuit sample. For instance, the mean of the magnitude of lawsuit settlement (LAWSUIT_GL) is -0.005. The mean (median) value of MASCORE is -0.005 (-0.034). [See Table 2, pg. 428]

3.4 Correlation Matrices

Panel A (Panel B) of Table 3 reports the correlations among key variables for the full sample (for the lawsuit sample). In both panels, we report Pearson and Spearman correlation coefficients and related p-values. Panel A shows that the correlation coefficient between MASCORE and LAWSUIT is -0.01 with a p-value of less than 0.01 in Pearson matrix

[1] http://faculty.washington.edu/pdemerj/data.html

and -0.02 with a p-value of less than 0.01 in Spearman matrix, suggesting a significant negative correlation between managerial ability and the likelihood of lawsuit. This evidence indicates that firms with higher managerial ability are less likely to become involved in lawsuits, lending initial support to H1.

Panel B presents that the coefficient on the correlation between managerial ability (MASCORE) and the magnitude of lawsuit settlement outcomes (LAWSUIT_GL) is 0.03 with a p-value of less than 0.01 in Pearson matrix and 0.04 with a p-value of less than 0.01 in Spearman matrix, which suggests that managerial ability is significantly and positively correlated with the magnitude of settlement outcomes (gain or loss). In other words, this evidence suggests that more capable managers may bring more favorable settlement outcomes such as larger settlement gain or smaller settlement loss, lending initial support to H2.

In both panels of Table 3, most correlation coefficients are small, which may suggest that our study is not subject to multicollinearity. Additionally, those p-values show that most correlations are statistically significant, suggesting that we test our hypotheses in a multivariate setting (i.e., we need to include all variables from Equation 1 in the regression analysis). Taken together, the findings of Table 3 seem to support our hypotheses and are in line with the theoretical development. [See Table 3, pg. 430]

4. Primary Findings

Table 4 presents our primary findings. Specifically, Panel A reports the results of testing H1 using the full sample, while Panel B reports the results of testing H2 using the lawsuit sample. In Panel A, the coefficient on MASCORE is -0.465 with a chi-square value of 22.74 in logistic regression, which suggests that MASCORE is significantly and negatively related to LAWSUIT. In other words, firms with more capable managers are less likely to become involved in lawsuits. Thus, our H1 is supported. We check and find that the value of Variance Inflation Factor (VIF) are fairly small, which indicates that this analysis is not subject to multicollinearity issues.

Panel A also shows that the likelihood of lawsuit (LAWSUIT) is positively related to SIZE, MTB, LEV, and FIRMAGE, and negatively related to ZSCORE, ASSETAGE, SEPITEM, and BIG4, consistent with general expectations. For example, the positive relation between LOSS and LAWSUIT indicates that firms with worse operating performance are more likely to become involved in lawsuits. The negative relation between BIG4 and LAWSUIT suggests that firms audited by a BIG4 accounting firm are less likely to get involved in lawsuits, highlighting the importance of using BIG4 auditors. It is also possible that BIG 4 auditors may be less likely to accept and audit higher-risk clients.

Panel B of Table 4 presents the results of estimating Equation 1 for the lawsuit sample using clustered standard errors OLS. Based on 11,423 observations, Column 1 reports a significant positive coefficient on MASCORE (coefficient = 0.006; t-value = 2.42), which suggests that managerial ability is positively related to the magnitude of lawsuit settlement outcomes. This evidence is consistent with H2 that more capable managers can bring more favorable settlement outcomes. We further decompose this sample into two subsamples, namely observations with settlement gain (5,655 observations) and observations with settlement loss (5,744 observations), re-estimate Equation 1 for each subsample, and report results in Column 2 and Column 3, respectively. As shown in Panel B, Column 2 reports an insignificant coefficient on MASCORE for the group with settlement gain and Column 3 shows a significant positive coefficient on MASCORE for the group with settlement loss, which suggests that the significant positive relation between MASCORE and LAWSUIT_GL is largely driven by observations with settlement loss. In other words, managerial ability matters more when companies experience settlement loss, relative to those experience settlement gain, which highlights the ability of capable managers to mitigate the magnitude of settlement loss. [See Table 4, pg. 432]

5. Additional Tests

5.1 Using Lagged Managerial Ability

Corporate or business lawsuits often occur. Disputes over intellectual property, breach of contract, employee injuries and disputes, and product liability are common types of corporate lawsuits. Eisenberg and Lanvers (2009) find that at least 90 percent of lawsuits in the United States settle without going to a trial. Settlement means that both parties (i.e., plaintiff and defendant) compromise their claims in order to resolve the lawsuit and to avoid a long legal process. Anecdotal evidence indicates that the average length of time that it takes a lawsuit to settle ranges from six months to over a year. Thus, a time gap between the date of lawsuit filing and the date of settlement often exists. For instance, a customer

may sue a company in 2018 and could reach a settlement with the company in the same year or in later years (e.g., 2019 or later).

In the primary analysis, we examine the association between MASCORE and LAWSUIT in the year of settlement not the year of lawsuit filing. It is quite likely that the lawsuit could be filed in the previous years. To address this concern, we re-estimate Equation 1 using lagged values of managerial ability, namely Lag1_MASCORE, Lag2_MASCORE, and Lag3_MASCORE, and report results in Table 5. Lag1_MASCORE is the managerial ability score in year t-1, while Lag2_MASCORE (Lag3_MASCORE) is the managerial ability score in year t-2 (year t-3). Using the full sample, Table 5 reports that the coefficient on Lag1_MASCORE, Lag2_MASCORE, and Lag3_MASCORE are all significant and negative, consistent with H1. For instance, the coefficient on Lag3_MASCORE is -0.414 with a t-value of 17.94. Taken together, results of this test not only strengthen our primary findings but also curtail concerns about the time gap between lawsuit filing date and settlement date. [See Table 5, pg. 433]

5.2. Changes Analysis

Our primary analysis depends on a level analysis, which regresses the level of the lawsuit settlement gain or loss on the level of managerial ability and control variables. In addition, although we control for many factors that may influence the settlement outcomes in the baseline regression model, it is possible that some unknown firm characteristics may affect both managerial ability and settlement outcomes, known as omitted correlated variables. Thereby, to curtail any concerns about omitted correlated variables, we employ a changes analysis that regresses the changes in settlement gain or loss on the changes in managerial ability and other control variables. Specifically, we use a bivariate changes analysis by regressing the changes in LAWSUIT_GL from year t-1 to year t (ΔLAWSUIT_GL) on the changes in MASCORE from year t-1 to year t (ΔMASCORE).

Table 6 reports that the coefficient on ΔMASCORE is 0.0024 with a t-value of 1.89, showing a significant positive relation between ΔMASCORE and ΔLAWSUIT_GL. This evidence suggests that an increase (a decrease) in managerial ability can lead to an increase (a decrease) in lawsuit settlement outcomes, consistent with our primary findings. In summary, results of this changes analysis provide compelling evidence to show that the differences in the level of lawsuit settlement outcomes (i.e., gain or loss) can be attributed to the level of managerial ability, and greatly mitigate concerns about omitted correlated variables in our study. [See Table 6, pg. 434]

5.3 Two-stage OLS Analysis (2SLS)

After we address concerns about omitted variables, we perform a two-stage OLS regression analysis (2SLS) to curtail any concerns about reverse causality. For example, it is likely that firms that are involved in lawsuits may seek managers with higher ability to handle lawsuits better, which suggests that lawsuits drive managerial ability. In 2SLS, we first estimate managerial ability score using the average managerial ability score of firms in the same industry based on the first two digits of the SIC code. This estimated managerial ability score (MASCORE_Instrumented) relates to the individual managerial ability score of a given firm but not directly relates to the lawsuit outcomes. Next, we estimate our baseline regression model (Equation 1) using the instrumented managerial ability variable as the primary independent variable of interest. Table 7 reports results of 2SLS. Specifically, Column 1 shows that the coefficient on MASCORE_Mean is 0.832 with a t-value of 75.03 in the first stage. More importantly, Column 2 displays that the coefficient on MASCORE_Instrumented is 0.007 with a t-value of 3.57, suggesting a significant positive relation between MASCORE_Instrumented and LAWSUIT_GL. Thus, the evidence not only is consistent with H2 but also mitigates concerns about reverse causality in our study. [See Table 7, pg. 435]

5.4 High Corporate Cash Holdings vs. Low Corporate Cash Holdings

General expectations and anecdotal evidence suggest that entities with more cash are more likely to be sued. Thus, we expect that the likelihood of lawsuit is higher for firms with more cash. If this is the case, we argue that the low likelihood of lawsuit for firms with low cash holdings may make the relation between MASCORE and LAWSUIT stronger. In other words, we expect this relation to become stronger for firms with less cash because they are less likely to be sued. To verify our expectation, we median split our full sample into two subsamples (observations with high cash holdings and observations with low cash holdings) based on the value of cash holdings, and re-estimate Equation 1 for each subsample.

Table 8 presents that the coefficient on MASCORE is -0.214 with a t-value of 4.05 for firms with high cash holdings in Column 1, and -0.889 with a t-value of 26.67 for firms with low cash holdings in Column 2. The coefficient comparison test reveals that -0.889 is statistically smaller than -0.214, which suggests that the relation between MASCORE and LAWSUIT is much stronger for firms with low cash holdings, consistent with our expectation. In other words, due to the fact that firms with less cash are less likely to be sued, the impact of managerial ability on the likelihood of lawsuit becomes stronger for those firms. [See Table 8, pg. 436]

VI. Conclusion

In this study, we examine the impact of having more capable managers on corporate legal outcomes, measured as the likelihood of lawsuit and the magnitude of lawsuit settlement. We find that firms with more capable managers are less likely to become involved in lawsuits and such managers can better manage the lawsuit settlement process to achieve larger settlement gain or smaller loss, relative to less capable managers. Overall, our results highlight the importance of having managers with higher ability, which is consistent with prior research (e.g., Demerjian et al., 2012).

Our study uses the lawsuit settlement data reported in the special items section of an income statement. Research on the components of special items is still limited. Thus, our study contributes to a more comprehensive understanding of the special items. Furthermore, this is perhaps the first empirical study that examines the link between managerial ability and lawsuit settlement. We believe that our study is important because it not only provides new empirical evidence on the impact of managerial ability on corporate legal matters but also generate new research questions such as “do managers with higher ability strategically settle the lawsuits?”

Similar to other studies, the present one has limitations. First, the sample used is based on large, public companies located in the United States. Future studies may aim to include firms based in other regions such as Europe or Asia. Going further, it is not known whether the findings can be discovered in small or private firms. Second, though the managerial ability metric used for this study is considered robust, there could be a more precise measure which may lead to stronger results. Third, the special items section of the income statement that reports lawsuit settlement amounts is aggregated. As a result, this figure could include many lawsuit settlements of which we do not know the precise nature and topic. Therefore, future research can examine these issues in greater detail.

Appendix 1: Variable Definitions

Variable		Definition
LAWSUIT	=	an indicator variable that equals one if a firm reports lawsuit settlement (SETP) in the special items on an income statement and zero otherwise;
LAWSUIT_GL	=	the magnitude of lawsuit settlement (SETP) scaled by total firm assets (AT);
MASCORE	=	managerial ability scores (Demerjian, Lev, McVay, 2012) from Professor Demerjian's website;
SIZE	=	natural log of total assets (AT);
MTB	=	market value of common shares [(CSHO) × (PRCC_F)] divided by total book value of common shares (CEQ);
LEV	=	long-term liabilities (DLTT) divided by total assets (AT);
ROA	=	income before extraordinary items (IB) scaled by total assets (AT);
OCF	=	cash flows from operating activities (OANCF) scaled by total assets (AT);
LOSS	=	one if a firm reports a loss otherwise zero;
ZSCORE	=	3.3×[net income (NI)/total assets (AT)] + sales (SALE)/total assets (AT) + 0.6×{market value of common shares [(CSHO) × (PRCC_F)]/total liabilities (LT)} + 1.2×working capital [current assets (ACT) – current liabilities (LCT)]/total assets (AT) + 1.4 × retained earnings (RE) / total assets (AT);
TOBINQ	=	total assets (AT) + market value of common shares (CSHO × PRCC_F) – stockholder equity (SEQ) – deferred taxes (TXDB), scaled by total assets (AT);
FIRMAGE	=	natural log of the number of years since a firm was included in the Compustat database;
ASSETAGE	=	the ratio of net property, plant, and equipment (PPENT) to gross property, plant, and equipment (PPEGT);
BUS_VOL	=	five-year rolling sales volatility;
SPE_ITEM	=	the magnitude of special items (SPI) scaled by total assets (AT);
BIG4	=	one if a firm uses a BIG 4 auditor and zero otherwise;
HLI_IND	=	one if a firm is in an industry with high litigation risks (SIC: 2833-2836; 3570-3577; 3600-3674; 7371-7379; or 8731-8734) and zero otherwise;

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Table 1: Managerial Ability and Lawsuit Settlement Sample Selection and Distribution

Panel A: Sample selection process

Full Sample	Observations
Managerial ability data from Professor Demerjian (1996-2020)	150,714
Less: Observations with insufficient data to construct control variables	53,189
Less: Observations in highly regulated industries (SIC 4000-4999 & 6000-6999)	7,867
Number of Observations	89,658

Panel B: Sample distribution by year

	Full Sample		Lawsuit Sample	
Year	Number of Observations	Percentage	Number of Observations	Percentage
1996	3,595	4.01%	92	0.81%
1997	3,764	4.20%	100	0.88%
1998	3,819	4.26%	101	0.88%
1999	4,050	4.52%	107	0.94%
2000	4,357	4.86%	237	2.07%
2001	4,242	4.73%	394	3.45%
2002	4,098	4.57%	509	4.46%
2003	4,273	4.77%	655	5.73%
2004	4,250	4.74%	664	5.81%
2005	4,109	4.58%	670	5.87%
2006	3,945	4.40%	662	5.80%
2007	3,737	4.17%	584	5.11%
2008	3,630	4.05%	545	4.77%
2009	3,534	3.94%	573	5.02%
2010	3,514	3.92%	524	4.59%
2011	3,392	3.78%	537	4.70%
2012	3,295	3.68%	532	4.66%
2013	3,233	3.61%	547	4.79%
2014	3,165	3.53%	525	4.60%
2015	3,034	3.38%	496	4.34%
2016	3,002	3.35%	499	4.37%
2017	3,086	3.44%	514	4.50%
2018	3,046	3.40%	515	4.51%
2019	2,972	3.31%	492	4.31%
2020	2,516	2.81%	349	3.06%
	89,658	100.00%	11,423	100.00%

Table 1: Managerial Ability and Lawsuit Settlement Sample Selection and Distribution
Panel C: Sample distribution by industry

		Full Sample		Lawsuit Sample				Full Sample		Lawsuit Sample	
Industry	Description	Obs.	%	Obs.	%	Industry	Description	Obs.	%	Obs.	%
1	Agricultural Crops	249	0.30%	50	0.44%	36	Electronic Equipment	9,009	10.71%	1,162	10.17%
2	Agricultural Livestock	53	0.06%	7	0.06%	37	Transportation Equipment	2,660	3.16%	369	3.23%
7	Agricultural Services	40	0.05%	2	0.02%	38	Measuring Instruments	6,941	8.25%	951	8.33%
8	Forestry	28	0.03%	2	0.02%	39	Miscellaneous Manufacturing	968	1.15%	97	0.85%
9	Fishing	15	0.02%	1	0.01%	50	Durable Goods Wholesale	2,563	3.05%	239	2.09%
10	Metal Mining	2,163	2.57%	186	1.63%	51	Nondurable Goods Wholesale	1,264	1.50%	203	1.78%
12	Coal Mining	229	0.27%	45	0.39%	52	Building Materials	187	0.22%	10	0.09%
13	Oil & Gas Extraction	5,578	6.63%	661	5.79%	53	General Merchandise Stores	625	0.74%	90	0.79%
14	Mining	325	0.39%	59	0.52%	54	Food Stores	677	0.80%	55	0.48%
15	Building Construction	121	0.14%	16	0.14%	55	Automotive Dealers	482	0.57%	71	0.62%
16	Heavy Construction	474	0.56%	83	0.73%	56	Apparel Stores	1,002	1.19%	138	1.21%
17	Special Construction	218	0.26%	32	0.28%	57	Furniture Stores	413	0.49%	43	0.38%
20	Food	2,925	3.48%	442	3.87%	58	Eating & Drinking Places	1,583	1.88%	231	2.02%
21	Tobacco	125	0.15%	16	0.14%	59	Miscellaneous Retail	1,750	2.08%	221	1.93%
22	Textile Mill	412	0.49%	46	0.40%	70	Hotels	333	0.40%	63	0.55%
23	Apparel	1,004	1.19%	71	0.62%	72	Personal Services	295	0.35%	53	0.46%
24	Lumber	708	0.84%	95	0.83%	73	Business Services	12,504	14.86%	1,246	10.91%
25	Furniture	635	0.75%	73	0.64%	75	Auto Repair Services	182	0.22%	25	0.22%
26	Paper	1,160	1.38%	180	1.58%	76	Miscellaneous Repair	19	0.02%	31	0.27%
27	Printing	1,062	1.26%	89	0.78%	78	Motion Pictures	420	0.50%	46	0.40%
28	Chemicals	9,333	11.09%	1,408	12.33%	79	Amusement	1,156	1.37%	208	1.82%
29	Petroleum Refining	830	0.99%	124	1.09%	80	Health Services	1,947	2.31%	324	2.84%

30	Rubber	1,076	1.28%	141	1.23%	81	Legal Services	41	0.05%	3	0.03%
31	Leather	3,326	3.95%	34	0.30%	82	Educational Services	514	0.61%	58	0.51%
32	Stone Clay Glass	708	0.84%	104	0.91%	83	Social Services	132	0.16%	11	0.10%
33	Primary Metal	1,559	1.85%	249	2.18%	87	Engineering & Accounting	1,866	2.22%	194	1.70%
34	Fabricated Metal	1,594	1.89%	215	1.88%	99	Nonclassified Establishments	1,065	1.27%	137	1.20%
35	Industrial Machinery	6,097	7.25%	746	6.53%			89,658		11,423	

Panel A provides the sample selection process. Panel B reports the sample distribution by fiscal year. Panel C presents the sample distribution by industry (based on the first two digits of the SIC code). The sample consists of 89,658 observations from 1996 to 2020.

Table 2: Managerial Ability and Lawsuit Settlement Sample Descriptive Statistics
Panel A: Full sample

Variable	Observations	Mean	Std Dev	25th Pctl	50th Pctl	75th Pctl
LAWSUIT	89,658	0.127	0.336	0.000	0.000	0.000
MASCORE	89,658	-0.002	0.127	-0.078	-0.024	0.040
SIZE	89,658	5.555	2.479	3.791	5.593	7.307
MTB	89,658	2.686	5.768	0.941	1.803	3.335
LEV	89,658	0.177	0.215	0.001	0.113	0.274
ROA	89,658	-0.092	0.432	-0.072	0.026	0.071
OCF	89,658	0.017	0.253	0.000	0.072	0.128
LOSS	89,658	0.386	0.487	0.000	0.000	1.000
ZSCORE	89,658	1.907	11.290	1.047	2.699	4.745
TOBINQ	89,658	2.225	2.416	1.094	1.506	2.341
FIRMAGE	89,658	2.414	0.917	1.792	2.485	3.091
ASSETAGE	89,658	0.470	0.197	0.336	0.468	0.605
BUS_VOL	89,658	0.893	0.742	0.388	0.678	1.150
SEPITEM	89,658	-0.021	0.088	-0.014	0.000	0.000
BIG4	89,658	0.725	0.447	0.000	1.000	1.000
HLI_IND	89,658	0.255	0.436	0.000	0.000	1.000

Panel B: Observations with lawsuit (Obs. = 11,425) vs. observations with no lawsuit (Obs. =78,233)

Variable	Observations	Mean	Observations		Mean	Difference in Mean (p-value)
MASCORE	11,425	-0.005	78,233		-0.002	0.0017
SIZE	11,425	-0.005	78,233		5.398	<0.0001
MTB	11,425	6.602	78,233		2.68	0.4507
LEV	11,425	2.155	78,233		0.173	<0.0001
ROA	11,425	0.191	78,233		-0.097	<0.0001
OCF	11,425	-0.057	78,233		0.013	<0.0001
LOSS	11,425	0.043	78,233		0.391	<0.0001
ZSCORE	11,425	0.349	78,233		1.915	<0.0001
TOBINQ	11,425	1.614	78,233		2.253	<0.0001
FIRMAGE	11,425	1.847	78,233		2.378	<0.0001
ASSETAGE	11,425	2.658	78,233		0.471	<0.0001
BUS_VOL	11,425	0.465	78,233		0.911	<0.0001
SEPITEM	11,425	0.734	78,233		-0.021	0.0009
BIG4	11,425	-0.028	78,233		0.716	<0.0001
HLI_IND	11,425	0.788	78,233		0.257	0.0021

Table 2: Managerial Ability and Lawsuit Settlement Sample Descriptive Statistics
Panel C: Lawsuit sample (Obs. = 11,425)

Variable	Observations	Mean	Std Dev	25th Pctl	50th Pctl	75th Pctl
LAWSUIT_GL	11,425	-0.005	0.037	-0.005	0.000	0.004
MASCORE	11,425	-0.005	0.138	-0.089	-0.034	0.036
SIZE	11,425	6.602	2.325	5.139	6.773	8.279
MTB	11,425	2.155	4.575	1.078	1.929	3.343
LEV	11,425	0.191	0.180	0.011	0.159	0.305

ROA	11,425	-0.057	0.354	-0.040	0.029	0.070
OCF	11,425	0.043	0.196	0.025	0.078	0.126
LOSS	11,425	0.349	0.477	0.000	0.000	1.000
ZSCORE	11,425	1.614	9.402	1.173	2.576	4.309
TOBINQ	11,425	1.847	1.076	1.137	1.505	2.161
FIRMAGE	11,425	2.658	0.909	2.079	2.708	3.401
ASSETAGE	11,425	0.465	0.173	0.346	0.462	0.586
BUS_VOL	11,425	0.734	0.537	0.332	0.580	0.995
SEPITEM	11,425	-0.028	0.092	-0.026	-0.006	0.002
BIG4	11,425	0.788	0.408	1.000	1.000	1.000
HLI_IND	11,425	0.243	0.429	0.000	0.000	0.000

This table presents the number of observations, pooled means, standard deviations, 25th percentile, median, and 75th percentile of the dependent variables, independent variable of interest, and control variables. Specifically, Panel A reports the descriptive statistics for the full sample with 89,658 observations. Panel B presents the means of variables for two subsamples (observations with lawsuit and observations with no lawsuit) and the statistical significance of the differences in means. Panel C shows the descriptive statistics for the lawsuit sample with 11,425 observations. All continuous variables are winsorized at the 1 percent and 99 percent percentiles. Please refer to Appendix 1 for detailed variable definitions.

Table 3: Managerial Ability and Lawsuit Settlement Correlation Matrix

Panel A: Full sample (Obs. = 89,658)

	LAWSUIT	MASCORE	SIZE	MTB	LEV	ROA	OCF	LOSS	ZSCORE	TOBINQ	FIRMAGE	ASSETAGE	BUS_VOL	SEPITEM
LAWSUIT		-0.02	-0.02	-0.02	0.00	0.04	0.02	-0.03	0.01	-0.02	0.02	0.00	-0.01	0.23
p-value		<.0001	<.0001	<.0001	0.52	<.0001	<.0001	<.0001	0.0159	<.0001	<.0001	0.80	<.0001	<.0001
MASCORE	-0.01		-0.11	0.14	-0.20	0.21	0.14	-0.14	0.19	0.22	0.03	-0.18	-0.02	0.08
p-value	0.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
SIZE	-0.02	0.04		0.19	0.36	0.36	0.37	-0.37	0.18	-0.06	0.30	0.31	-0.21	-0.12
p-value	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
MTB	-0.01	0.09	0.06		-0.06	0.31	0.22	-0.22	0.41	0.65	0.03	0.05	0.00	0.02
p-value	0.0879	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.88	<.0001
LEV	0.00	-0.11	0.17	-0.07		-0.04	0.03	-0.03	-0.35	-0.10	0.12	0.27	-0.08	-0.09
p-value	0.2763	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
ROA	0.04	0.07	0.42	0.08	-0.09		0.67	-0.83	0.61	0.15	0.21	0.13	-0.19	0.28
p-value	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
OCF	0.02	0.08	0.43	0.05	-0.06	0.80		-0.55	0.43	0.09	0.17	0.11	-0.19	0.08
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
LOSS	-0.05	-0.15	-0.37	-0.05	0.07	-0.48	-0.44		-0.48	-0.06	-0.22	-0.13	0.19	-0.25
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
ZSCORE	0.00	0.03	0.31	0.20	-0.22	0.69	0.59	-0.30		0.27	0.12	0.07	-0.10	0.15
p-value	0.4566	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001
TOBINQ	-0.01	0.17	-0.27	0.24	0.04	-0.49	-0.44	0.12	-0.29		-0.06	-0.09	0.12	0.04
p-value	0.0004	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001
FIRMAGE	0.01	0.04	0.30	-0.01	0.05	0.17	0.17	-0.22	0.05	-0.11		-0.12	-0.34	0.00
p-value	0.0191	<.0001	<.0001	0.02	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	0.4366
ASSETAGE	-0.01	-0.12	0.32	0.02	0.16	0.19	0.18	-0.13	0.21	-0.12	-0.12		0.17	0.01
p-value	0.1208	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	0.0010
BUS_VOL	0.00	-0.02	-0.24	0.02	-0.01	-0.26	-0.27	0.21	-0.14	0.21	-0.32	0.17		0.00
p-value	0.1574	<.0001	<.0001	<.0001	0.03	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		0.6870
SEPITEM	0.17	0.03	0.08	0.03	-0.03	0.42	0.16	-0.28	0.17	-0.04	0.08	0.04	-0.08	
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	
BIG4	-0.01	-0.01	0.53	0.05	0.08	0.24	0.23	-0.19	0.22	-0.14	0.05	0.17	-0.14	0.02
p-value	0.0036	0.03	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
HLI_IND	-0.01	0.16	-0.14	0.06	-0.11	-0.12	-0.16	0.14	-0.03	0.16	-0.11	-0.20	0.03	-0.05
p-value	0.0500	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001

This panel reports the Pearson correlations (below the diagonal) and the Spearman correlations (above the diagonal) of the variables for the full sample. Correlation coefficients and related (two-tailed) p-values are provided for each pair of variables. All continuous variables are winsorized at the 1 percent and 99 percent percentiles before the correlation analysis. Please refer to Appendix 1 for detailed variable definitions.

Table 3: Managerial Ability and Lawsuit Settlement Correlation Matrix

Panel B: Lawsuit sample (Obs. = 11,423)

	LAWSUIT_GL	MASCORE	SIZE	MTB	LEV	ROA	OCF	LOSS	ZSCORE	TOBINQ	FIRMAGE	ASSETAGE	BUS_VOL	SEPITE
LAWSUIT_GL		0.04	-0.05	-0.06	-0.01	0.14	0.06	-0.12	0.02	-0.08	0.05	-0.01	-0.03	0.60
p-value		<.0001	<.0001	<.0001	0.28	<.0001	<.0001	<.0001	0.01	<.0001	<.0001	0.1680	0.0014	<.000
MASCORE	0.03		0.02	0.17	-0.19	0.22	0.18	-0.14	0.23	0.23	0.02	-0.16	-0.02	0.02
p-value	0.0003		0.0798	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.0426	<.0001	0.0831	0.009
SIZE	0.08	0.11		0.20	0.37	0.32	0.29	-0.34	0.11	-0.02	0.40	0.28	-0.27	-0.04
p-value	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.0366	<.0001	<.0001	<.0001	<.000
MTB	0.02	0.10	0.11		-0.02	0.36	0.28	-0.26	0.39	0.66	0.05	0.04	-0.05	0.01
p-value	0.0210	<.0001	<.0001		0.0243	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.197
LEV	0.02	-0.13	0.27	-0.10		-0.06	-0.01	-0.01	-0.38	-0.08	0.12	0.27	-0.10	-0.06
p-value	0.0710	<.0001	<.0001	<.0001		<.0001	0.4999	0.5336	<.0001	<.0001	<.0001	<.0001	<.0001	<.000
ROA	0.30	0.08	0.44	0.15	0.00		0.64	-0.81	0.61	0.28	0.21	0.09	-0.19	0.38
p-value	<.0001	<.0001	<.0001	<.0001	0.62		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.000
OCF	0.19	0.10	0.45	0.14	0.00	0.77		-0.50	0.46	0.23	0.12	0.07	-0.17	0.14
p-value	<.0001	<.0001	<.0001	<.0001	0.67	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.000
LOSS	-0.19	-0.15	-0.35	-0.13	0.05	-0.46	-0.41		-0.49	-0.15	-0.22	-0.11	0.20	-0.34
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	<.0001	<.0001	<.0001	<.000
ZSCORE	0.15	0.05	0.34	0.17	-0.13	0.73	0.65	-0.29		0.33	0.11	0.03	-0.09	0.16
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	0.0003	<.0001	<.000
TOBINQ	-0.14	0.22	-0.17	0.20	-0.06	-0.24	-0.20	-0.04	-0.14		-0.05	-0.08	0.05	0.00
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.0002	<.0001		<.0001	<.0001	<.0001	0.813
FIRMAGE	0.07	0.04	0.38	0.03	0.06	0.19	0.17	-0.22	0.11	-0.12		-0.05	-0.32	0.03
p-value	<.0001	<.0001	<.0001	0.0047	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	<.0001	0.000
ASSETAGE	0.03	-0.07	0.31	0.04	0.23	0.17	0.16	-0.11	0.19	-0.09	-0.05		0.11	0.01
p-value	0.0008	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		<.0001	0.114
BUS_VOL	-0.06	-0.02	-0.30	-0.03	-0.05	-0.25	-0.26	0.21	-0.17	0.14	-0.33	0.11		-0.02
p-value	<.0001	0.08	<.0001	0.0068	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001		0.038
SEPITEM	0.51	0.00	0.15	0.07	-0.01	0.55	0.27	-0.34	0.28	-0.08	0.10	0.06	-0.10	
p-value	<.0001	0.80	<.0001	<.0001	0.21	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	
BIG4	0.05	0.04	0.57	0.07	0.14	0.28	0.28	-0.22	0.25	-0.08	0.14	0.16	-0.18	0.07
p-value	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.000
HLI_IND	-0.02	0.18	-0.07	0.03	-0.14	-0.08	-0.10	0.10	-0.05	0.16	-0.10	-0.17	0.01	-0.06
p-value	0.0258	<.0001	<.0001	0.00	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001	0.1370	<.000

This panel reports the Pearson correlations (below the diagonal) and the Spearman correlations (above the diagonal) of the variables for the lawsuit sample. Correlation coefficients and related (two-tailed) p-values are provided for each pair of variables. All continuous variables are winsorized at the 1 percent and 99 percent percentiles before the correlation analysis. Please refer to Appendix 1 for detailed variable definitions.

Table 4: Managerial Ability and Lawsuit Settlement Primary Results
Panel A: Full Sample

	Dependent Variable = LAWSUIT			
	Column 1			Column 2
	Logistic Regression			Ordinary Least Squares Regression
Parameter	Estimate	Chi-Square	Pr > ChiSq	Variance Inflation Factor (VIF)
Intercept	-4.788***	2,361.15	<.0001	
MASCORE	**-0.465*** **	22.74	<.0001	1.138
SIZE	0.232***	1,042.67	<.0001	2.089
MTB	0.004***	3.27	0.059	1.175
LEV	0.107*	3.12	0.064	1.194
ROA	0.009	0.02	0.901	5.433
OCF	0.148	2.60	0.111	3.178
LOSS	0.162***	29.81	<.0001	1.504
ZSCORE	-0.013***	58.77	<.0001	2.275
TOBINQ	0.001	0.02	0.901	1.731
FIRMAGE	0.164***	122.71	<.0001	1.288
ASSETAGE	-0.558***	52.73	<.0001	1.354
BUS_VOL	-0.026	1.73	0.199	1.278
SEPITEM	-0.447***	7.68	<.0001	1.469
BIG4	-0.112***	11.04	<.0001	1.437
HLI_IND	0.033	0.46	0.325	1.132
Industry Indicators	Yes			
Year Indicators	Yes			
Observations	89,658			
Pseudo R^2	0.1451			

This panel presents the results of the baseline regression model using logistic regression. The baseline model is as follows. LAWSUIT = β_0 + β_1×MASCORE + β_x×Control Variables + Industry Indicators + Year Indicators + ε
The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.

Table 4: Corporate Social Responsibility and Lawsuit Settlement Primary Results
Panel B: Lawsuit Sample

	Dependent Variable = LAWSUIT_GL						
	Clustered Standard Errors OLS						
	Column 1			Column 2		Column 3	
	Lawsuit Sample			Settlement Gains		Settlement Losses	
Variable	Estimate	t Value	VIF	Estimate	t Value	Estimate	t Value
Intercept	0.007***	4.17		0.033***	27.74	-0.025***	-8.92
MASCORE	**0.006****	2.42	1.34	0.004	1.44	**0.011*****	3.34

SIZE	-0.001***	-3.23	2.73	-0.003***	-24.69	0.003***	9.71
MTB	0.000***	0.71	1.22	0.000	-1.56	0.000**	2.49
LEV	0.005***	2.92	1.35	-0.002*	-1.93	0.013***	4.65
ROA	-0.004**	-2.29	5.17	-0.004***	-2.87	-0.005*	-1.81
OCF	0.018***	7.01	3.09	0.000	-0.07	0.020***	5.39
LOSS	-0.002**	-2.22	1.53	0.000	-0.05	-0.003***	-3.11
ZSCORE	0.000**	-2.34	2.56	0.000***	-8.22	0.000***	6.19
TOBINQ	-0.003***	-11.00	1.50	0.000*	1.96	-0.006***	-12.00
FIRMAGE	0.000	1.29	1.41	-0.001**	-2.23	0.000	-0.86
ASSETAGE	-0.001	-0.47	1.57	-0.002*	-1.74	0.003	0.99
BUS_VOL	0.001	1.16	1.39	0.001**	2.24	0.002**	2.07
SEPITEM	0.205***	49.70	1.72	0.048***	14.50	0.184***	31.21
BIG4	0.001	1.05	1.63	0.001**	2.35	-0.002*	-1.75
HLI_IND	0.003***	4.25	3.52	0.003***	5.04	0.003***	2.78
Industry Indicators	Yes			Yes		Yes	
Year Indicators	Yes			Yes		Yes	
Observations	11,425			5,655		5,744	
Adjusted R^2	0.2776			0.3269		0.4118	

This panel presents the results of the baseline regression model using clustered standard errors OLS regression (by firm and by year). The baseline model is as follows. LAWSUIT_GL = $\beta_0 + \beta_1 \times$MASCORE + $\beta_x \times$Control Variables + Industry Indicators + Year Indicators + ε
The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.

Table 5: Managerial Ability and Lawsuit Settlement Using Lagged Managerial Ability Measures

	Dependent Variable = LAWSUIT					
	Logistic Regression					
	Column 1		Column 2		Column 3	
Parameter	Estimate	Chi-Square	Estimate	Chi-Square	Estimate	Chi-Square
Intercept	-3.702***	814.00	-3.871***	800.27	-4.135***	852.43
Lag1_MASCORE	**-0.501****	17.82				
Lag2_MASCORE			**-0.522****	18.96		
Lag3_MASCORE					**-0.414****	17.94
SIZE	0.213***	657.56	0.225***	636.69	0.233***	647.58
MTB	0.001	0.14	0.000	0.01	0.000	0.00
LEV	0.034	0.19	0.038	0.20	0.035	0.13
ROA	0.226	2.22	0.236	2.04	0.261	1.91
OCF	0.359**	4.89	0.320*	3.31	0.403**	4.46
LOSS	0.179***	24.40	0.192***	24.32	0.192***	21.79
ZSCORE	-0.017***	37.48	-0.018***	34.84	-0.021***	45.54

TOBINQ	-0.006	0.23	-0.006	0.22	-0.005	0.11
FIRMAGE	0.167***	85.03	0.191***	85.45	0.206***	84.75
ASSETAGE	-0.448***	23.21	-0.471***	22.10	-0.439***	18.03
BUS_VOL	-0.022	0.75	-0.031	1.20	-0.053*	3.13
SEPITEM	-0.867***	10.52	-0.867***	8.89	-0.946***	9.82
BIG4	0.030	0.61	0.033	0.63	0.062	2.06
HLI_IND	0.043	0.58	0.049	0.72	0.070	1.27
Industry Indicators	Yes		Yes		Yes	
Year Indicators	Yes		Yes		Yes	
Observations	77,791		67,447		57,371	
Pseudo R^2	0.1408		0.1201		0.1148	

This table presents the results of the baseline regression models using three lagged managerial ability variables, namely Lag1_MASCORE, Lag2_MASCORE, and Lag3_MASCORE. Specifically, Lag1_MASCORE is the managerial ability score in year t-1. Lag2_MASCORE (Lag3_MASCORE) is the managerial ability score in year t-2 (t-3). The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.

Table 6: Managerial Ability and Lawsuit Settlement Changes Analysis

	Clustered Standard Errors OLS		
	Dependent Variable = ΔLAWSUIT_GL		
	Lawsuit Sample		
Variable	Estimate	t Value	Pr > |t|
Intercept	0.0021**	2.37	0.018
ΔMASCORE	**0.0024***	1.89	0.059
ΔSIZE	-0.0023***	-3.04	0.002
ΔMTB	0.0000	-0.46	0.649
ΔLEV	0.0044**	2.49	0.013
ΔROA	-0.0102***	-6.15	<.0001
ΔCASHFL	0.0105***	6.50	<.0001
ΔLOSS	-0.0011***	-3.52	0.000
ΔZSCORE	0.0000	0.26	0.791
ΔTOBINQ	-0.0003	-1.16	0.247
ΔFIRMAGE	0.0000	-0.02	0.981
ΔASSETAGE	0.0041	1.55	0.122
ΔMGR_ABLITY	0.0010*	2.08	0.038
ΔACCRUAL	0.0575***	23.98	<.0001
ΔSALE_VOL	-0.0008	-0.80	0.422
ΔSPE_ITEM	0.2282***	8.92	<.0001
ΔBIG4	-0.0008	-0.20	0.844
Industry Indicators	Yes		

Year Indicators	Yes
Adj. R^2	0.2036
Observations	9,548

This table presents the results of the changes analysis. The following model is used: $\Delta LAWSUIT\_GL = \beta_0 + \beta_1 \times \Delta MASCORE + \beta_x \times \Delta Control\ Variables + Industry\ Indicators + Year\ Indicators + \varepsilon$.
The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.

Table 7: Managerial Ability and Lawsuit Settlement Two-Stage OLS Regression Analysis

	Dependent Variable = LAWSUIT_GL			
	Lawsuit Sample			
	Column 1		Column 2	
	Stage 1 of 2SLS		Stage 2 of 2SLS	
Variable	Estimate	t Value	Estimate	t Value
Intercept	-0.015***	-6.30	0.001***	6.35
MASCORE_Mean	0.832***	75.03		
MASCORE_Instrumented			**0.007****	3.57
SIZE	0.005***	20.28	-0.001***	-9.97
MTB	0.000	0.91	0.000	1.25
LEV	-0.043***	-21.86	0.002*	1.90
ROA	0.058***	28.27	-0.013***	-12.31
OCF	0.039***	14.41	0.013***	9.10
LOSS	-0.028***	-28.58	-0.004***	-7.07
ZSCORE	-0.001***	-22.91	0.000	-0.34
TOBINQ	0.013***	60.93	-0.001***	-8.71
FIRMAGE	0.002***	3.44	0.000*	1.92
ASSETAGE	-0.064***	-27.83	0.000	-0.40
BUS_VOL	0.007***	12.01	0.001*	1.81
SEPITEM	-0.079***	-14.74	0.131***	48.03
BIG4	-0.017***	-16.29	0.001***	2.68
HLI_IND	0.022***	23.17	0.001*	1.76
Industry Indicators	Yes		Yes	
Year Indicators	Yes		Yes	
Observations	11,423		11,423	
Adjusted R^2	0.2985		0.3169	

This table presents the results of the two-stage OLS analysis (2SLS). The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.

Table 8: Managerial Ability and Lawsuit Settlement High Cash Holdings vs. Low Cash Holdings

	Dependent Variable = LAWSUIT			
	Full Sample			
	Logistic Regression			
	Column 1		Column 2	
	High Cash Holdings		Low Cash Holdings	
Variable	Estimate	t Value	Estimate	t Value
Intercept	-4.213***	1,130.21	-6.239***	1,204.63
MASCORE	**-0.214****	4.05	**-0.889*****	26.67
SIZE	0.226***	606.01	0.275***	440.60
MTB	0.003	0.83	0.010**	4.70
LEV	0.110	1.78	0.250**	5.59
ROA	0.043	0.28	-0.026	0.04
OCF	0.167	2.44	-0.254	1.72
LOSS	0.139***	13.22	0.221***	17.30
ZSCORE	-0.014***	55.52	-0.010***	4.91
TOBINQ	-0.004	0.27	0.002	0.02
FIRMAGE	0.131***	44.20	0.242***	86.36
ASSETAGE	-0.485***	25.54	-0.737***	25.73
BUS_VOL	-0.051**	4.30	0.006	0.03
SEPITEM	-0.283	2.09	-0.694**	5.14
BIG4	-0.127***	9.61	-0.096	2.17
HLI_IND	0.007	0.02	-0.087	0.55
Industry Indicators	Yes			Yes
Year Indicators	Yes			Yes
Pseudo R^2	0.1756			0.2003
Observations	44,829			44,829
	Coefficient Comparison Test Coefficient of MASCORE (-0.214) for Observations with High Cash Holdings vs. Coefficient of MASCORE (-0.889) for Observations with Low Cash Holdings F-stat. = 17.22; p-value < 0.0001			

This table presents the results of the baseline regression model using logistic regression for observations with high cash holdings and observations with low cash holdings. The baseline model is as follows. LAWSUIT = $\beta_0 + \beta_1 \times$MASCORE + $\beta_x \times$Control Variables + Industry Indicators + Year Indicators + ε
The continuous variables in the baseline regression model are winsorized at the 1 percent and 99 percent percentiles each year before entering the regression analysis. *, **, and *** denote significance at the 10, 5 and 1 percent (two-tailed) confidence levels, respectively. Detailed variable definitions are provided in Appendix 1.