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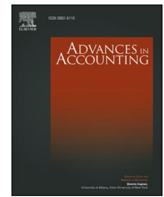

Consequences of state-level regulations in accounting, finance, and corporate governance: A review☆

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ABSTRACT

We review the literature on the consequences of U.S. state-level local regulations for various corporate outcomes in the accounting, finance, and corporate governance domain. We argue that state-level regulations might affect corporate outcomes through at least two channels. First, the state intervention channel that includes state regulations pertinent to auditor liability, director-liability, and shareholder litigation rights. Second, the dispute resolution channel as reflected in circuit court rulings. Our review shows that these regulatory and legal effects have had profound implications for various corporate outcomes.

1. Introduction

We review the growing body of literature that investigates whether and how state-level regulations affect various corporate outcomes. The enactment of state level regulations is considered exogenous to the individual firm's decisions and, hence, provides identification strategies superior to the endogenous decisions made by managers (Huang, Roychowdhury, & Sletten, 2020; Johnson, Kasznik, & Nelson, 2001). We interpret state-level regulation as encapsulating the state-level legal environment (litigation regime), the adoption of state-level laws and regulations (law creation), and court decisions (dispute resolution).

Such regulations might affect corporate outcomes through at least two channels. First, the "state intervention channel," which includes the state-level legal environment and the adoption of state-level regulations, and which can be explained through various regulatory theories including the Public Interest, the Institutional and the Political and Economic theories (see Section 2). Some of the regulations pertinent to this category include the state-level auditor liability regime, the director-liability-reduction law, and the universal demand law. These state-level regulations have profound implications for decision-making by various stakeholders. For example, Anantharaman, Pittman, and Wans (2016) finds that auditors are more likely to issue going concern audit opinions to firms headquartered in states with high auditor liability exposure. Basu and Liang (2019) finds that firms reduce their accounting conservatism after the enactment of director-liability-reduction regulation. Nguyen, Phan, and Sun (2018) and Appel (2019) show that the number of cases related to derivative lawsuits declined after universal demand laws, suggesting that the adoption of these laws weakened shareholders' litigation rights.

The second channel through which state-level regulations might affect corporate outcomes is the "dispute resolution channel," whereby differences related to the federal appeals circuit courts affect corporate outcomes. For example, the Ninth Circuit (Fourth Circuit) rulings have traditionally been described as liberal (conservative) rulings, following

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the appointment of more Democratic (Republican) judges who are likely to make more anti (pro)-business rulings. Broscheid (2011) notes that "Different circuits 'house' different judges with different political predispositions; circuits set their own precedent, only rarely overturned by the Supreme Court; different circuits can be expected to develop different political and jurisprudential cultures" (p. 172). However, one Ninth Circuit Ruling, the 1999 *Silicon Graphics Inc* ruling, made it more difficult for shareholders to bring lawsuits against companies. This ruling also increased the risk courts will dismiss meritorious suits as well. Hopkins (2018) finds that firms located in the Ninth Circuit have a higher probability of restating financial statements after a decline in litigation risk, relative to firms that are located elsewhere. Ninth Circuit rulings have often been criticized by conservatives.[1] Fig. 1 summarizes our approach to reviewing the consequences of state-level regulations following these two broad channels.

We choose a systematic literature review approach for our study. Systematic review is a "replicable, scientific, and transparent process that enables the researcher to provide an audit trail, justifying his/her conclusions" (Tranfield, Denyer, & Smart, 2003, p. 218). A strand of literature examining the consequences of state antitakeover law in the finance discipline started appearing from the early 1980s (e.g, DeAngelo & Rice, 1983; Linn & McConnell, 1983). We did not survey this literature as Straska and Waller (2014) and Catan and Kahan (2016) provide excellent reviews.[2] Beginning in the mid 90's a stream of analytical research modelling auditing under different legal regimes appeared, and we begin our literature review in 1994, the year in which Narayanan (1994) paper appeared. This stream of literature can help us more clearly understand the testable research propositions related to auditor liability regime. The study of Kobeissi, Sun, and Wang (2010) appears to be the first study outside of the state antitakeover regulation area that uses empirical archival data to investigate the effects of local regulation, and specifically, noncompetition agreements on merger and acquisition decisions. We use a keyword search that includes "regulation," "state-level," "state level," "litigation," "shareholder litigation," "auditor liability," "third party liability," "third-party liability," "Universal Demand," "UD law," "noncompetition agreements," "constituency statutes," "inevitable disclosure," "wrongful discharge laws," and "circuit court ruling." We also follow the "cited by" option for each paper, to ensure that relevant papers are not missed.

We focus on the U.S. setting alone, because of the availability of various state-level regulatory data that enable researchers to explore the consequences of such regulations on various outcomes. Furthermore, the Common-law origin of the U.S. places great value on deciding cases according to consistent rules, yields similar and predictable outcomes, and therefore, enables researchers to explore various corporate outcomes stemming from such judicial precedents. In this review, we include a total of 67 published papers and 1 working paper dealing with the consequences of U.S. state-level regulations on accounting, finance, and corporate governance outcomes. An overwhelming majority (84%) of the reviewed papers have been published only since 2018. We only include those papers that use regulation as the main variable of interest. We include papers published in journals in the business discipline, and accounting and finance journals in particular. We acknowledge that *excluding* articles published in law and economics journals from this review is a limitation of the study (for example, Houston, Lin, & Xie, 2018). Table 1 provides a breakdown of the publication outlets of the reviewed papers.

Our review will be useful to researchers who intend to extend this stream of research to incorporate hitherto unexplored consequences. Effective enforcement of state-level regulation can be welfare-enhancing and, therefore, it is imperative to understand how state-level regulation affects corporate decision-making, because corporations are the primary catalyst of economic development.[3]

The remainder of the paper is organized as follows. In the following section we provide an overview of the theoretical framework for the key regulatory theories, and a brief description of the U.S. judicial system. Section 3 reviews the literature that adopts "state intervention" as the channel through which regulation affects corporate outcomes. Section 4 reviews the literature on the "dispute resolution channel" of regulation. Section 5 provides a brief discussion about some open issues. Section 6 concludes the paper.

2. Theoretical framework

2.1. Theories about the emergence of regulation or law creation

Debates regarding the pros and cons of regulatory interventions are ongoing. The opponents of regulatory intervention believe that market forces operate efficiently in the best interests of society and, hence, can make appropriate resource allocation choices in the absence of regulatory mandates. The proponents, however, believe that regulatory intervention is necessary to protect the public interest and, in particular, to minimize the adverse consequences stemming from market failures.

However, there is much less agreement on how to define and measure the construct of public interest (Willmott, 1990). The public interest theory (PIT) assumes that regulation aims to achieve beneficial outcomes for the public that the market per se would not be able to deliver. In other words, the public interest underpins the economic and political impacts on law and regulation (Posner, 1974). Briloff (1970) asserts that the accounting and finance profession serves and protects the public interest by establishing strong internal control and a high level of corporate transparency. However, the literature also observes that the enforcement of the profession's disciplinary mechanisms prioritizes private interests over the public interest (Bédard, 2001; Canning & O'Dwyer, 2001). For example, on one hand, the code of ethics can be seen as one of the early main concepts that has been applied by professional accounting organizations to work in the public interest. On the other hand, ethical codes "fulfil a 'profession protection' as opposed to a 'society protection' role aimed at insulating the profession from inspection and assessment from outside parties" (Canning & O'Dwyer, 2001, p.725).

Another theoretical framework pertaining to regulatory intervention that emerged in the accounting and finance literature is based on institutional arrangements and rules (Baldwin & Cave, 1999). The

[1] "Commentator Bill O'Reilly calls it the 'wild bunch' (2002); Senator Orrin Hatch blames it for 'judicial activism and overreaching' and claims that it is 'out of the mainstream of both American law and culture' (2002); lawyer Bruce Fein, Washington Times, accuses the court of 'manipulative judging at its worst' (2006, p. A16); and on it goes." Cited from Broscheid (2011).

[2] Karpoff and Wittry (2018) identifies at least 81 published and working papers on the consequences of business combination and other antitakeover laws on corporate outcomes since 1999.

[3] An understanding of the implications of state-level regulations is also important because the promulgation and enforcement of regulations in the U.S. is costly. In 2018 about 25,800 regulatory sanctions were imposed (e.g., tax-related sanctions, sanctions related to breaches of working conditions, and so on). In addition, "The government's internal estimates show that between 1971 and 2018, compliance with paperwork regulations required a total of 2.03 trillion responses and 269 billion hours of work" (Kalmanovitz, 2020, p. 19–20). The Securities and Exchange Commission (SEC) states that about 14.2 million hours were used to prepare and file 8137 annual financial statements (10−*K*) (Kalmanovitz, 2020). McLaughlin and Sherouse (2019) develops a State-level "RegData" project aimed at gathering and analyzing the regulations of 46 states. The authors used text analysis and machine learning algorithms to quantify how many words and regulatory restrictions each state's regulations contain. They find, for instance, California has the highest regulatory restrictions with 396,000 words, followed by New York with over 300,000 words (https://www.mercatus.org/system/files/figure_1._state-level_regulatory_restrictions_-_v11.pdf).

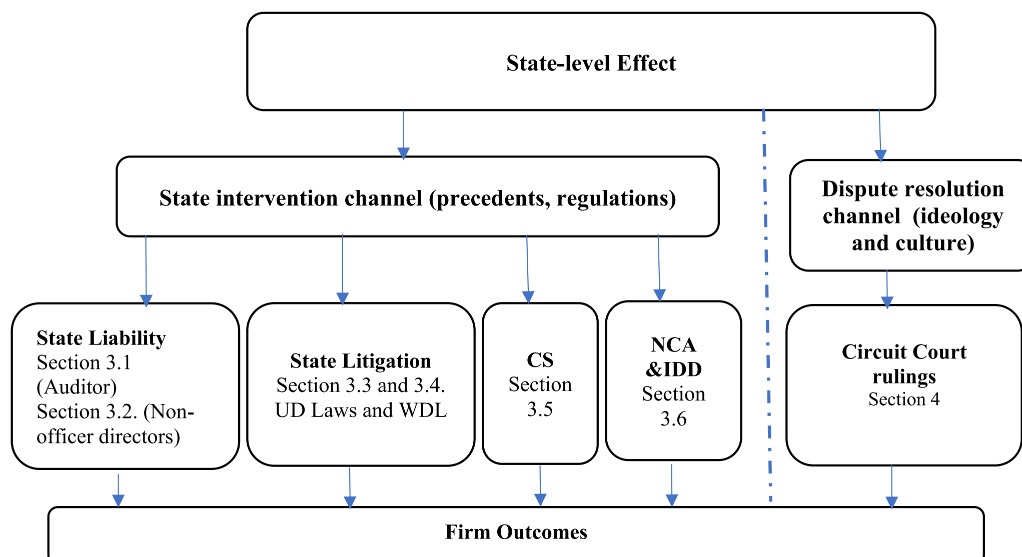

Fig. 1. Framework of State-level regulatory effects on corporate outcomes.
Note: This figure illustrates the organization of our literature review, with references to sections of the paper. UD is universal demand law; WDL is wrongful discharge law; CS is constituency statutes; NCA is non-compete agreements; and IDD is inevitable disclosure doctrine.

institutional theory of agency (ITA) posits that firms are usually influenced by institutional practices related to financial reporting, corporate governance, and management control systems (Seal, 2006). Large numbers of studies and literature reviews have used ITA to address the theoretical explanations and deficiencies in, for instance, corporate governance (e.g., Armstrong, Guay, & Weber, 2010), and accounting (e.g., Dillard, Rigsby, & Goodman, 2004). Cooper and Keim (1983) shows how two studies that use the same economic doctrine can present opposite findings. Tinker (1984) believes that the misperceptions about regulation proposed by Cooper and Keim (1983) cannot be resolved by the conventional theory of economic regulation. Tinker (1984) identifies flaws in the neoclassical viewpoint by arguing that "…the economic reductionism…and the political voluntarism…create sufficiently serious difficulties as to justify a radical change in the theory of disclosure regulation." (p. 61).

The political economic theory of regulation is grounded on the belief that capitalism is a complex interaction among the political, social and economics realms (Tinker, 1984). This is in contrast to the neoclassical theory where the political realm is assumed to shape the economic interests. Thus, Tinker (1984) argues that regulation will balance the inequalities among social classes in the marketplace. This debate in fact goes back to Berle and Means (1932) and Dodd (1932), as to whether the responsibility of the firm should be directed toward its shareholders exclusively or to social and public purposes. This debate has been gradually enhanced and developed into stakeholder management theories, as manifested in the adoption of non-shareholder constituency statutes (Karpoff & Wittry, 2018). Taken together, regulation is expected to protect the interests of capital providers and influence social responsibilities and ethical behavior.

2.2. Overview of the U.S. judicial system

The United States of America has a federal judicial system with a central federal government and individual governments in each of the 50 states. Differences between the federal and state regulations are significant, but both share some common characteristics. For instance, both the federal and state courts prescribe procedures in writing on how court cases will be conducted, and both courts handle civil and criminal cases.[4] Also, the courts cannot be called upon to make laws: a function of the legislative branch. Nor can the courts be expected to enforce and execute laws: a function of the executive branch. Federal laws apply throughout the U.S., e.g., Securities and Exchange Commission (SEC) regulations, while state laws are administered by the state courts. In most states the law is based on the "common law" of England, except for Louisiana, which has a "civil law" origin (Olson, 1999). There are also local laws for counties, cities, municipalities, and towns, such as building codes and local safety regulations. Federal courts function following the constitution of 1789, adopted by the thirteen states. Article III of the U.S. Constitution establishes the Supreme Court and authorizes Congress to establish lower courts. There are thirteen Courts of Appeal or Circuit Courts that mediate the appellate courts of the U.S. federal judiciary.[5] In addition, all other courts, both federal and state, have to follow any precedent set by the Supreme Court. Hart (1954) proposes that there are two principal ways in which the relationship between federal law and state law can be broadly depicted. Federal law can regulate the exercise of state authority without imposing strict federal control, although in certain situations federal law could prohibit state action (e.g., protecting the individual against abusive state actions). Alternatively, federal law could become the dominant regulatory authority, marginalizing the role of state law.

2.3. Litigation environment[6]

Legal scholars posit that some of the important functions performed by the legal system include regulation of behavior (deterrence function), resolution of conflict, and damage recovery (Simpson, 1988; Vago, 1988). The success of securities litigation in deterring managerial fraudulent behavior and compensating aggrieved shareholders has been an issue of intense debate in the U.S. (Laux & Stocken, 2012). Managers often view liability thresholds as being too low, subjecting them to frivolous suits that result in unnecessary waste of time and resources.

[4] https://legalbeagle.com/6809739-federal-state-court-similarities.html.

[5] The district, appellate, and Supreme courts are all authorized under Article III of the U.S. Constitution, giving them the exclusive functions as constitutional courts.

[6] This discussion relies heavily on Section 2 of Habib, Jiang, Bhuiyan, and Islam (2014).

Table 1
State-level regulation and corporate outcomes: publication outlets.

	Auditor liability	Topic	Journal
1.	Narayanan (1994)	Auditor liability rules	*Journal of Accounting Research*
2.	Willekens et al. (1996)	Audit standards and auditor liability	*Accounting and Business Research*
3.	Radhakrishnan (1999)	Auditor liability rules	*The Accounting Review*
4.	Liu and Wang (2006)	Auditor liability and business investment	*Contemporary Accounting Research*
5.	Gaver et al. (2012)	Conservative financial reporting	*Auditing: A Journal of Practice & Theory*
6.	Gimbar et al. (2016)	Critical audit matters	*Current Issues in Auditing*
7.	Anantharaman et al. (2016)	Audit opinion	*The Accounting Review*
8.	Chy et al. (2021)	Bank financing	*Journal of Accounting & Economics*
9.	Chy and Hope (2021)	Corporate innovation	*Review of Accounting Studies*
	Director & officer liability regulation	Topic	Journal
1.	Basu and Liang (2019)	Accounting conservatism	*Journal of Accounting Research*
2.	Guan et al. (2021)	Innovation	*Journal of Corporate Finance*
	Universal demand law	Topic	Journal
1.	Bourveau et al. (2018)	Corporate disclosure	*Journal of Accounting Research*
2.	Ni and Yin (2018)	Cost of debt	*Journal of Corporate Finance*
3.	Nguyen et al. (2018)	Cash holding	*Journal of Corporate Finance*
4.	Appel (2019)	Corporate governance	*Working paper*
5.	Nguyen et al. (2020)	Capital structure	*Journal of Corporate Finance*
6.	Le et al. (2020)	Stock price informativeness	*Journal of Financial Markets*
7	Huang, Li, et al. (2020)	Management earnings disclosure	*Journal of Accounting Research*
8.	Obaydin et al. (2021)	Stock price crash	*Journal of Corporate Finance*
9.	Huang, Li, et al. (2020)	Corporate disclosures	*Journal of Accounting Research*
10.	Chen et al. (2021)	Accounting conservatism	*Journal of Business Finance & Accounting*
11.	Chu and Zhao (2021)	Corporate takeovers	*Financial Management*
12.	Lin et al. (2021)	Corporate innovation	*Management Science*
13.	Manchiraju et al. (2021)	Accounting conservatism	*The Accounting Review*
14.	Do and Le (2022)	Labor investment efficiency	*Finance Research Letter*
15.	Freund et al. (2022)	Corporate social responsibility (CSR)	*Journal of Financial and Quantitative Analysis*
16.	Huang et al. (2022)	External growth (M&A and alliances)	*Journal of Financial and Quantitative Analysis*
	Wrongful discharge law	Topic	Journal
1.	Acharya et al. (2014)	Corporate Innovation	*The Review of Financial Studies*
2.	Serfling (2016)	Capital structure	*Journal of Finance*
3.	Bai et al. (2020)	Investment	*Review of Financial Studies*
4.	Fairhurst et al. (2020)	Tax avoidance	*Journal of Banking & Finance*
5.	Kim et al. (2020)	Labor adjustment cost	*Journal of Law, Finance, and Accounting*
6.	Dang et al. (2021)	Share Payouts	*Journal of Corporate Finance*
	Non-shareholder constituency statues	Topic	Journal
1.	Flammer and Kacperczyk (2016)	Corporate innovation	*Management Science*
2.	Leung et al. (2019)	Financial stability	*Journal of Corporate Finance*
3.	Ni (2020)	Earning management	*Journal of Corporate Finance*
4.	Ni et al. (2020)	Payout policy	*Journal of Banking & Finance*
5.	Gao et al. (2021)	Cost of debt	*Journal of Financial and Quantitative Analysis*
	Non-competition agreements	Topic	Journal
1.	Kobeissi et al. (2010)	M&A	*Journal of Business Research*
2.	Ertimur et al. (2018)	Chief executive officer promotion gaps	*Journal of Accounting Research*
3.	Aobdia (2018)	Corporate disclosures	*Review of Accounting Studies*
4.	Chen et al. (2018)	Financial reporting and investment	*Journal of Accounting & Economics*
5.	He (2018)	Cash holdings	*Journal of Corporate Finance*
6.	Tang et al. (2021)	Disclosure of management forecasts	*Contemporary Accounting Research*
7.	Cici et al. (2021)	Employee's behavior in mutual funds	*Journal of Banking & Finance*
8.	Hrazdil et al. (2021)	CSR Performance	*Review of Financial Economics*
	Inevitable disclosure doctrines	Topic	Journal
1.	Klasa et al. (2018)	Capital structure	*Journal of Financial Economics*
2.	Gao et al. (2018)	Earning Management	*Review of Accounting Studies*
3.	Li et al. (2018)	Variation in proprietary cost of disclosures	*Journal of Accounting Research*
4.	Ali et al. (2019)	Good versus bad news disclosures	*The Accounting Review*
5.	Flammer and Kacperczyk (2019)	CSR	*Strategic Management Journal*
6.	Na (2020)	Performance evaluation	*Journal of Financial Economics*
7.	Callen et al. (2020)	Financial reporting opacity	*Journal of Corporate Finance*
8.	Li and Li (2020)	Disclosure of forward-looking information	*Journal of Business Finance and Accounting*
9.	Ding et al. (2021)	Tax avoidance	*Journal of Business Research*
10.	Kim et al. (2021)	Stock price synchronicity	*The Accounting Review*
11.	Li et al. (2022)	Tax avoidance	*Contemporary Accounting Research*

(*continued on next page*)

Table 1 (*continued*)

	Auditor liability	Topic	Journal
	Circuit 9 rulings	Topic	Journal
1.	Chu (2017)	Cost of banks loans	*Journal of Corporate Finance*
2.	Crane and Koch (2018)	Ownership structure and performance	*Management Science*
3.	Hopkins (2018)	Financial restatements	*Contemporary Accounting Research*
4.	Bliss et al. (2018)	Information bundling	*Journal of Accounting & Economics*
5.	Dong and Zhang (2019)	Voluntary disclosures	*European Accounting Review*
6.	Huang et al. (2019)	Securities class action lawsuits	*Journal of Accounting Research*
7.	Houston et al. (2019)	Voluntary disclosures	*The Accounting Review*
8.	Arena et al. (2019)	Corporate tax avoidance	*Journal of Corporate Finance*
9.	Chung et al. (2020)	M&A decisions	*Journal of Corporate Finance*
10.	Huang, Roychowdhury, and Sletten (2020)	Real earning management	*The Accounting Review*
11.	Hassan et al. (2021)	Corporate innovation	*Journal of Corporate Finance*

However, if the liability threshold is too high, then officers and directors will not be subject to the discipline of valid suits and, therefore, will get away with low punishment. This imposes additional agency costs on shareholders, as officers and directors are tempted to extract private benefits from the firm at shareholder expense.

The U.S. Congress enacted the Securities Exchange Acts of 1933 and 1934 to promote full disclosure of securities offerings. In Section 4 of the 1934 Act, Congress created the SEC with the authority for the civil enforcement of these new statutes, and in section 10(b), Congress authorized the Commission to enact regulations banning manipulation or deception in connection with the purchase or sale of securities. In 1942, the SEC enacted Rule 10b-5 prohibiting individuals or companies from buying securities if they engaged in fraudulent purchases; previously enacted rules prohibited only the fraudulent sale of securities. Rule 10b-5 was designed as a public enforcement mechanism to deter securities fraud in order to promote society's collective interest in the integrity and efficiency of capital markets. This rule allows the SEC to exercise a number of remedies, including civil money penalties, officer and director bars; injunctive relief; cease and desist orders; and orders requiring corrective disclosures and corporate governance changes (Rose, 2008, p. 1310).

The class action lawsuits concept, which emerged in 1966, was made applicable to securities cases by the fraud-on-the-market presumption of reliance.[7] This presumption, available in rule 10b-5, allowed plaintiffs to sue against corporate defendants, so long as the plaintiffs purchased the shares from an efficient market. This is a much less onerous requirement for litigation than for common law fraud cases, where plaintiffs must prove that they actually read and relied upon the allegedly misleading disclosures for investment decision-making. This lighter requirement for securities litigation inevitably resulted in class actions brought on behalf of thousands of investors. While class actions are a potentially useful mechanism to discipline opportunistic managers and controlling shareholders, such a mechanism is also plagued with the problem of non-meritorious lawsuits. To protect managers from frivolous lawsuits, Congress enacted the Private Securities Litigation Reform Act (hereafter PSLRA) of 1995.[8] The subsequent passage of the Sarbanes–Oxley Act of 2002, was believed by some to herald an increase in litigation risk for corporate officers and external auditors. In contrast to class action lawsuits, in a derivative lawsuit, shareholders sue directors or officers on behalf of the corporation, but the compensation, if any, is paid to the corporation, instead of to the shareholders who initiated the derivative lawsuits. The primary motivation for shareholders to initiate derivative lawsuits is to strengthen the governance landscape so that the officers or directors do not violate their fiduciary duties (Ferris, Jandik, Lawless, & Makhija, 2007).

2.4. *Dispute resolution*

Litigation plays an important role in resolving disputes arising within organizations, as well as between organizations and their external stakeholders. However, resolving disputes out-of-court is more common in the legal system in the United States. Out-of-court settlements are an alternative to litigation: the latter, although quite useful, is a formal, expensive, time-consuming and complicated process for disputing parties (Nosyreva, 2001). However, we focus on litigation as a mechanism for dispute resolution. (Menkel-Meadow, 2000, p. 6) notes that: "… Working with both individual and social conflicts helps articulate and test what norms and rules should be applied to a situation and successful 'negotiation' through conflict makes both individuals and groups stronger by demonstrating survival and flexibility skills and permitting continuity." Dispute resolution is not a neutral process: instead it is influenced by court administrators or government. Social order provides a basic structure of empowering laws, thereby, enabling institutions to develop substantive rules (Menkel-Meadow, 2000). Importantly, dominant regulatory ideologies, such as might be expressed in circuit court decisions, will shape and develop the boundaries of business and economic activities in society. Studies in both legal and political science document that 'ideology' is among the most important of judges' personal attributes influencing lawsuit outcomes (George, 1998). For example, judges appointed by Democratic presidents are more liberal on the bench than those appointed by Republican presidents, as is manifested in lawsuit outcomes that are antibusiness (Huang, Hui, & Li, 2019). This theoretical perspective, therefore, predicts differential outcomes for lawsuits filed in different circuit courts. For example, the Ninth Circuit, with more Democratic appointees, are likely to make more liberal rulings. The Ninth Circuit covers the Pacific West and some of the Western Mountain states. There is a perception that different circuits represent different political/legal cultures, and these may be related to their geographic locations (Broscheid, 2011). As the West Coast is Democratic- (liberal-)leaning, and insofar as Democrats generally consider regulation of corporations necessary, and hence are perceived as anti-business, Ninth Circuit rulings are expected to be shareholder-friendly. However, there are instances when this has not been the case. One such widely-known ruling is *Silicon Graphics Inc*, which is related to class action lawsuits and is discussed below.

Prior to 1995, all types of class action litigation were governed by the same rule (Rule 23, Federal Rules of Civil Procedure). In 1995 Congress passed the PSLRA which established pleading standards: conditions that must be satisfied for owners to legally form a class. On July 2, 1999, the Ninth Circuit Court of Appeals issued a ruling on Silicon Graphics that interpreted the pleading standard more strictly than all other circuits. Specifically, the ruling requires plaintiffs to establish that the defendant acted with "*deliberate* not *mere* recklessness," otherwise, owners are not legally allowed to form a class. Shareholders of firms in the Ninth Circuit must have evidence of managerial intent of defrauding the litigants prior to establishing a class: a condition that is onerous and, unsurprisingly therefore, class action lawsuits against the Ninth Circuit firms dropped

[7] For a detailed discussion on how securities class action lawsuits are filed in the federal judicial system in the U.S., see Section 3.2. of Huang et al. (2019).

[8] See Perino (2003) for an early assessment of the effectiveness of PSLRA.

significantly after 1999 (Crane & Koch, 2018, p. 7).

3. State intervention channel

3.1. Auditor liability regulations

3.1.1. Conceptual underpinnings and measurement

The legal system, including both statutory law and common law, influences the auditor's behavior and audit quality through the standard of care: a standard with which auditors must legally comply to avoid potential litigation stemming from defective audits (DeFond & Francis, 2005; Gaver, Paterson, & Pacini, 2012). The auditor's common law liability to third parties is based on court cases and legal precedents applicable at the state level alone.

There are three basic state liability standards for auditors: Privity, Restatement, or Foreseeability. "In Privity, only the parties to the contract can sue the auditor for ordinary negligence. In Restatement, auditors are liable to known third parties (including creditors). In Foreseeability, all foreseeable parties can sue auditors for failure to exercise due diligence" (Gaver et al., 2012, p. 100). Privity (foreseeability) implies the lowest (highest) auditor liability. Pacini, Hillison, and Sinason (2000) uses a 9-point scale that measures the expansiveness of the third-party liability standard in each state and the third-party legal and statutory law by state, and ranks states along this index. Subsequent studies use this or similar measures. Anantharaman et al. (2016) includes a dummy variable coded 1 for states with expansiveness scores ≥ 4 to proxy for restatement or foreseeability standards, and zero otherwise. Chy, De Franco, and Su (2021) uses a dummy variable coded 1 when an auditor's third-party liability in a state increases from "Privity to Restatement" or increases from "Privity to Foreseeability", and zero otherwise. The second measure of third-party legal liability is based on joint-and-several liability reforms compiled by the American Tort Reform Association and the American Bar Association (Anantharaman et al., 2016). A state receives 1 point, 0.5 point, and 0 points, if it follows full "joint-several" liability sharing, "modified joint-several" liability sharing, and "proportionate" liability sharing, respectively.

3.1.2. Evidence on auditor liability regulations

Narayanan (1994) develops a model of auditor litigation incorporating audit quality under the "joint and several" liability regime versus the proposed "proportionate" liability regime. Narayanan (1994) shows that adopting the "proportionate" liability regime would increase audit quality, although experts' testimony before the Senate suggested the opposite. Narayanan (1994) argues that under the "proportionate" liability regime, the auditor's litigation cost will be more sensitive to his/her efforts than it is under alternative liability regimes and, hence, will affect audit quality positively. Radhakrishnan (1999) extends Narayanan (1994) by modelling the interactions among liability regimes, auditor effort, auditor penalties, and investor welfare. An investor will sue auditors when losses occur, but the outcome of the litigation will depend on firm types and liability regimes, namely, the "due care" regime and the "strict liability" regime. Under both regimes, auditors will be liable for investor losses caused by reporting failures.

Using insights from the economics and law literature, Willekens, Steele, and Miltz (1996) shows analytically that a large uncertainty about the legal standard of care affects the audit production level. That paper proposes that compliance with accounting standards and laws by auditors will not be sufficient to defend themselves against the allegation of negligence. The paper therefore concludes that "A surprising insight is that a large uncertainty about the legal standard of care can reduce rather than increase the quality of audit work supplied and increase the insurance component [of audit fees]. Relying on insurance premiums can be more effective than direct expenditure in reducing risk." (p. 249). However, (Liu & Wang, 2006, p.1055) finds that "the variance of the legal error affects the relative magnitudes of audit effort levels under the two liability regimes [and also finds] that the firm owner gets a higher expected benefit, and the auditor earns a higher audit fee under strict liability than under negligence liability."

Gimbar, Hansen, and Ozlanski (2016) uses an experimental study to examine the effects of imprecise standards, or Critical Audit Matter Paragraphs (CAMs), on auditor liability. The paper finds that subjects participating in the experiments have a lower propensity to hold auditors liable when the client's lease accounting practices comply with a precise standard, as opposed to an imprecise standard. This finding from 234 subjects suggests that audit quality increases when auditors face greater liability exposure. However, the enactment of the PSLRA eliminated the joint and several liability provision (Lee & Mande, 2003), thereby relieving audit firms from litigation threats significantly. Research on the consequences of auditor liability using state-level data took some time to appear, because the settlement information in private suits in state courts is often sealed: a restriction that made historical information unavailable to researchers (Talley, 2006).

Gaver et al. (2012) study was the first to appear, using a sample of private insurance firms. The paper hypothesizes that auditors would require more conservative reporting from clients located in states with strict standards for third-party claims against auditor negligence. Using a sample of 3107 observations from loss reserve spanning 1993 to 2004, the paper finds that financially struggling insurers tend to under-reserve if their auditor is expected to face expensive litigation costs. They used the 9-point scale from Pacini et al. (2000) to measure the strictness of litigation. Using a sample of 14,925 firm-year observations for the period 2001–2009, Anantharaman et al. (2016) finds that auditors are more likely to issue a modified going concern (GC) opinion to financially distressed clients domiciled in high litigation states. This positive relation is more pronounced for clients of Big four accounting firms. Firms in higher litigation states are 2.5% more likely to receive a GC opinion, than firms located in lower litigation states.

Previous studies also examine the impact of auditor liability on creditors, arguing that an increased risk of litigation from auditors would improve the quality of financial reporting: a tool that would help creditors select clients, and evaluate debt performance (Chy et al., 2021). Chy et al. (2021) examines whether a higher risk of audit litigation improves corporate clients' access to bank finance. Using a sample of 56,402 observations spanning 1982 to 1998, the paper finds that an exogenous increase in the risk of auditor litigation increases both the likelihood that clients will receive credit, and the average amount of the bank loans that they receive. Companies that are exposed to an increased risk of auditor litigation are 12% more likely to receive bank loans than a comparable control company. The increased litigation risk also leads to lower accounting accruals, an improved ability of the accrual to predict future cash flows, a higher possibility of issuing GC reports, and a reduction in the possibility of restating financial statements.

Chy and Hope (2021) hypothesizes that increased litigation threats against auditors will make them more conservative and might be manifested as constraining clients from making income-increasing accounting choices. This, in turn, will motivate managers to sacrifice long-term value-creating innovation projects in order to meet short-term earnings targets. Using a sample of 63,976 firm-year observations from 1970 to 1998, the paper finds support for this hypothesis. Economically, the treatment firms (firms exposed to more litigation threats) reduce R&D expenditures by 6%, on average, relative to control firms. Results are more pronounced in firms that receive greater analyst and debt market pressures.

3.2. Director and officer (D & O) legal liability regulations

In the Smith v. Van Gorkom (TransUnion) case (1985), the Delaware Supreme Court found TransUnion's directors guilty of violating their 'duty of care' by accepting a merger proposal without giving due consideration to its effect on firm value (Fischel, 2002). The outcome of this case reshaped the concept of 'duty of care' and exacerbated the

Director/Officer Insurance Crisis. Subsequently, all 50 U.S. states modified corporate laws to limit the legal liability of nonofficer, but not officer, directors.

Basu and Liang (2019) empirically investigates the effects of such liability-reduction laws on accounting conservatism. Using a sample of 32,418 firm-year observations from 1976 to 2002, the paper documents that conditional conservatism decreased after the staggered enactments of the laws. Three plausible reasons for this decrease have been proposed by the authors. First, "when accounting policies are being selected ex ante, a lower litigation risk will likely reduce nonofficer directors' incentives to monitor and, hence, will encourage managers to adopt aggressive accounting policies" (p.894). Also, a reduction in liability law decreases the probability of the nonofficer directors being sued: an outcome that reduces their predicted legal and reputational costs (Adams & Ferreira, 2007; Laux, 2008). Second, since nonofficer directors can reduce managerial opportunism by monitoring managers ex post, a reduction in liability law reduces such efficient monitoring. Finally, a reduction in nonofficer director liability may increase the supply of less competent directors, thereby, compromising the reporting quality. Using a sample of 2333 firm-year observations from 1998 to 2007, Guan, Zhang, Zheng, and Zou (2021) finds that firms incorporated in Nevada exhibit an increase in innovative outputs, including more explorative innovation, after the adoption in 2001 of corporate law changes that significantly reduced the litigation exposure for D & O in Nevada. This finding suggests that a reduction in litigation threat encourages managers to engage in more and better innovation: a finding supportive of the costly litigation hypothesis.

3.3. Universal demand (UD) laws

3.3.1. Conceptual underpinning and measurement

As is well known, the directors and officers of a firm are required to practice 'duty of care' and abstain from self-serving behavior. If directors breach their fiduciary duty, shareholders can protect their interests through direct action lawsuits, such as derivative lawsuits. Such lawsuits can enhance the corporate governance practices in the firm (Erickson, 2010). However, the adoption of UD laws effectively raises procedural hurdles for shareholders to pursue derivative lawsuits. Because of UD laws, shareholders find it nearly impossible to use derivative suits to enforce fiduciary duties by directors and managers (Appel, 2019). (Nguyen et al., 2018, p.193) explains the procedure for commencing a derivative lawsuit and its associated challenges as follows:

> To commence a derivative lawsuit, shareholders first need to demand that the board of directors take actions to deal with the challenged misconduct. While this process, known as the "demand requirement", is designed to provide boards of directors an opportunity to decide whether they would reject or bring any remedies and litigation against the wrongdoers, the boards usually reject such demand because the named defendants in these lawsuits often include board members. Once a board rejects the demand, shareholders can file the derivative lawsuit in court and plead that the board of directors wrongfully refuses the demand. However, the court usually sides with the boards and dismisses the lawsuits following the business judgment rule, which is based on the presumption that directors make business decisions on an informed basis, with good faith, and in the honest belief that their decisions are in the best interest of the company.

But shareholders have an alternative option to pursue a derivative lawsuit by claiming a futility exception, which allows the plaintiff shareholders to "bypass" the demand requirement and file a derivative lawsuit in the court directly. The subsequent court inquiry will focus primarily on determining whether the demand requirement would indeed have been futile. Given that the courts' decision to allow a derivative lawsuit to continue can make managers concerned about negative publicity and, hence, they will prefer to settle at some point, the futility exception has become a preferred option for plaintiff shareholders in derivative lawsuits (Manchiraju, Pandey, & Subramanyam, 2021, p.394). 23 states adopted the UD law between 1989 and 2005.

3.3.2. Empirical evidence on UD laws

Bourveau, Lou, and Wang (2018) examines the effect of UD laws on corporate disclosures. The authors hypothesize that a reduction in derivative litigation risk, due to UD laws, is likely to affect disclosure strategies through changes in expected costs and benefits related to potential derivative lawsuits, and also because of the governance role performed by derivative lawsuits. Using 30,055 firm-year observations from 1995 to 2007, the authors find that the adoption of UD laws increases the disclosure frequencies of both good and bad news, and both optimistic and pessimistic news. In term of economic magnitude, the passage of UD laws, for example, leads to a 28.59% increase in the raw number of earnings forecasts. The finding is consistent with reduced litigation risk stemming from the adoption of UD laws, encouraging managers to be more forthcoming with their disclosures. The results are more pronounced for companies having high litigation risk (Kim & Skinner, 2012) and for firms facing high operating uncertainty. Huang, Li, Yu, and Zhou (2020) examines the association between managerial litigation risk and management disclosure of earnings warnings, using the adoption of UD laws as an exogenous event.[9] The main benefit of earnings warnings is that they reduce the litigation and reputation costs related to withholding bad news. Litigation costs decrease because managers possess relatively precise information about earnings in the short period prior to the earnings announcement (Skinner, 1994). Using 938 firm-quarters for the period 1995 to 2010, and employing the DiD approach, the paper finds that the adoption of UD laws decreases managers' issuance of earnings warnings, especially among firms facing a higher litigation risk prior to the adoption.

Manchiraju et al. (2021) examines the effects of UD laws on accounting conservatism in 23 U.S. states between 1986 and 2008. A reduction in litigation risk stemming from the passage of UD laws, induces less conservative accounting choices from managers by reducing the marginal benefits of conservative accounting. Manchiraju et al. (2021) hypothesizes that because of reduced litigation threats, shareholders may demand *greater* conservative accounting to compensate for the diminution of the disciplining role they formerly had. Using 16,463 firm-year observations, the paper finds that firms increase their conservative reporting after the adoption of UD laws. This increase in conservative accounting is more pronounced for firms considering equity issuance, with higher institutional investors, and high overall governance quality. It is less pronounced for firms with abnormal insider trading, firms more likely to breach debt covenants, firms with weaker governance, and firms with high *ex ante* litigation risk.

Chen, Li, and Xu (2021), on the other hand, examines the similar research question but finds a significant *reduction* in accounting conservatism after the adoption of UD laws. The sample in that paper consists of 65,272 observations from 1986 to 2007. Economically, conservatism decreases by approximately 22% after the enactment of UD laws. The finding is consistent with reduced litigation threat entrenching managers and weakening the supply of conservative financial statements. The evidence in Manchiraju et al. (2021) is also inconsistent with the findings in Basu and Liang (2019), which documents that the staggered enactment of the director liability-reduction laws reduces conditional conservatism. However, Manchiraju et al. (2021) focuses on the effect of derivative litigation, in contrast to the changes in director liability examined by Basu and Liang (2019).

Nguyen et al. (2018) examines the effects of the staggered adoption

[9] "Earnings warnings are managers' voluntary disclosure of significant bad earnings news shortly before announcements of earnings, especially large negative earnings surprises" (Huang, Li, et al., 2020, p.1162).

of UD laws on corporate cash holdings. Competing arguments exist for the association between the adoption of UD laws and corporate cash holdings. On one hand, a reduction in shareholder litigation rights due to the adoption of UD laws accentuates managerial self-serving behaviors, including retaining cash for personal use rather than distributing cash as dividends to shareholders. On the other hand, a reduction in litigation rights may encourage managers to invest more in value-enhancing projects, by reducing the precautionary cash reserves. Using 74,842 firm-year observations from 1985 to 2010, Nguyen et al. (2018) finds that the adoption of UD laws reduced cash holdings but increased the value of cash. Economically, companies decreased their cash-to-assets ratio by about 2.2 to 4.5 percentage points after the adoption of UD laws. The market valuation of cash result suggests a dollar of incremental cash is valued $0.17 to $0.25 higher to shareholders after the adoption of UD laws. Lin, Liu, and Manso (2021) shows that the reduction in the threat of derivative lawsuits due to adoption of UD laws, increased innovation. The authors used a matched sample of 19,096 firm-year observations between 1976 and 2006, whereby the treated firms were matched with a group of control firms headquartered in the same state as the corresponding treated firms but incorporated in states not adopting UD laws. The authors find that treated firms invest more in innovation inputs (R&D investment), generate more explorative innovation, hold more impact patents (proxied by number of patent citations) and achieve higher patent value. Economically, the treated firms, on average, invest about 0.3% more in R&D than firms incorporated in states without UD laws. The findings generally suggest that the threat of litigation deterred innovation, and the adoption of UD laws, by alleviating managerial concerns about derivative lawsuits, increased innovation efficiency.

Ni and Yin (2018) considers staggered adoption of UD laws as exogenous shocks in examining the relation between shareholder litigation rights and the cost of debt. As discussed above, shareholder litigation rights strengthen the corporate governance environment, and hence, will reduce the cost of debt. Furthermore, the threat of forced replacement and reputational damage stemming from shareholder litigation can discipline managers by curtailing their risk-appetite, and hence, can reduce the cost of debt. But the adoption of UD laws will weaken such a disciplining role of shareholder litigation and increase the cost of debt. Using 22,175 firm-year observations from 1985 to 2009, the paper finds that the passage of UD law increases the cost of debt significantly. The corporate governance, information asymmetry, and managerial risk-taking channels all had a moderating effect on the positive relationship. The adoption of UD laws increased interest spreads by 9.4%.

Nevertheless, using a sample of about 100,000 firm-year observations for the period 1985–2009, Nguyen, Phan, and Lee (2020) finds that firms increase debt financing after the adoption of UD laws. This finding is consistent with the notion that firms choose to increase debt financing as an alternative disciplining mechanism to mitigate weaker shareholder litigation rights stemming from the passage of UD laws. Economically, corporate leverage increases by 5.37 to 6.34% after the adoption of UD laws compared with a control sample of firms headquartered in states that did not adopt UD laws. This impact is more pronounced for firms subject to greater shareholder litigation risk "ex-ante", and for firms in financial distress.

Le, Nguyen, and Sila (2020) finds that the adoption of UD laws negatively affected the information environment, as proxied by idiosyncratic volatility. The paper explores three non-mutually exclusive channels through which UD laws can adversely affect the corporate information environment: (1) an increase in earnings opacity; (2) a reduction in voluntary disclosures; and (3) changes in corporate investment. The paper fails to find any evidence in support of (1) or (2). Instead, the results provide support for the third channel. The passage of UD laws relieves managers of litigation pressure and thereby allows them to invest in long-term projects that are potentially more difficult to value. Consistent with this explanation, the paper reports that UD laws result in a 10.6% increase in research and development (R&D) expenditures. Overall, despite causing a deterioration in the firm's information environment, the reduction in litigation risk does not appear to harm shareholder wealth. Additional tests fail to document any evidence of the passage of UD laws affecting stock price crash risk. Obaydin, Zurbruegg, Hossain, Adhikari, and Elnahas (2021) also finds no evidence that the adoption of the UD laws increases stock price crash risk, using a sample of 38,471firm-year observations.

As the adoption of UD laws weakened shareholder litigation rights, and thereby increases managerial entrenchment, it is likely that such entrenchment could be manifested in inefficient labor investment. Labor, an important factor of production, is instrumental for economic growth, and inefficient labor investment can be detrimental for firm value. Do and Le (2022) uses a sample of 60,841 firm-year observations from 1984 to 2010 and finds that the adoption of UD laws decreases labor investment efficiency. The coefficient on UD suggests that the adoption of UD laws increases firm abnormal net hiring by 0.009–0.011, which is equivalent to 5.84%–7.14% of the sample mean.

Using 50,044 firm-year observations from 1984 to 2010 with 820 cases of derivative lawsuits, Appel (2019) finds that the likelihood of derivative litigation decreased following the passage of UD laws. The reported coefficient suggests that the adoption of UD laws is associated with a drop of 0.6 percentage points in the likelihood of derivative litigation: an effect that is quite substantial given the mean derivative lawsuits of 1.4%. Appel (2019) further shows that the reduced threat of litigation stemming from UD laws, increased poor governance as measured by the *E*-index developed by Bebchuk, Cohen, and Ferrell (2009). The increase in poor governance is related to underperformance of operations, especially for companies without block shareholdings.

Freund, Nguyen, and Phan (2022) examines the changes in shareholder litigation rights and corporate social responsibility (hereafter CSR) activities. Managers could increase CSR activities for their private benefit instead of catering to stakeholder demand in the event of weakened shareholder litigation rights stemming from the adoption of UD laws. Using 11,969 firm-year observations from 1995 to 2009, the paper finds, however, that after the passage of UD laws, firms reduced their CSR activities. The coefficients on *UD law* indicate that the adoption of UD laws is associated with a decrease of 0.029 to 0.047 in the CSR score, which is equivalent to 16% to 26% of the absolute value of the sample mean CSR score. This finding is consistent with weakened litigation rights discouraging managers from investing in CSR to build reputational capital and withstand litigation risk. The authors further document that the UD law-induced reduction in CSR activities increased firm value.

Huang, Ozkan, and Xu (2022) examines whether shareholder litigation risk, proxied by UD laws, influences firms' decisions about external growth strategies, and specifically, decisions to engage in alliances and acquisitions. Although alliances involve litigation risk, such "risks are relatively lower than M&A related risks as the scope for shareholder wealth destruction is generally much lower in alliances … In contrast to M&As, alliances allow firms to put less capital at risk and rely on partners' financial and knowledge capital …" (Huang et al., 2022, p. 4–5). Using a sample of 39,386 firm year-observations from 1984 to 2010, the paper finds that following the adoption of UD laws, firms are likely to choose acquisition over alliances, which is consistent with the notion that reduced litigation threat stemming from the passage of UD laws encourages managers to pursue risky growth options and M&As rather than alliances. The coefficient estimates on UD laws suggest that the adoption of UD laws increases the number of acquisitions and alliance activities by approximately 35.5% and 15.3%, respectively. In a related study Chu and Zhao (2021) finds that the adoption of UD laws improves takeover efficiency for a sample of 1638 observations for the period 1989 and 2005. The paper finds that the acquirers experience higher announcement returns and better post-merger operating performance after the adoption of UD laws. Economically, the adoption of UD laws is associated with 2.0%–3.6% higher acquirer cumulative

abnormal returns.

To summarize, the surveyed literature provides direct causal evidence of the adoption of UD laws on various firm-level outcomes, using information asymmetry and agency theory as the main theoretical frameworks. UD laws increase managerial earnings disclosures (Huang, Li, et al., 2020) and reduce stock price informativeness (Le et al., 2020), thus supporting the information asymmetry argument. The evidence on the effects of UD laws on accounting conservatism remains ambiguous (Chen et al., 2021; Manchiraju et al., 2021). UD laws reduce cash holdings (Nguyen et al., 2018) and affect capital structure decisions (Nguyen et al., 2020; Ni & Yin, 2018): evidence supporting the corporate governance effects of UD laws. Empirically, almost all the reviewed studies have included various sensitivity and endogeneity tests, such as the moderating effects of corporate governance. However, none of them have attempted to test the mediating effects of corporate governance. Furthermore, consistent with Huang, Li, et al. (2020), we observe that UD litigation effects are related to corporate disclosures. In fact, Erickson (2010) finds that about 90% of derivative lawsuits are related to corporate disclosures. Finally, to rule out the possibility that the adoption of concurrent laws could confound the main findings, researchers control for the passage of many such laws.[10] Although the threat and the actual filing of shareholder lawsuits are costly to firms, the adoption of UD laws weakened shareholder litigation rights and, therefore, motivated firms to pursue risk-increasing policies.

3.4. Wrongful discharge laws (WDL)

3.4.1. Conceptual underpinnings and measurement

The traditional employment "at-will" rule in the U.S., enables employers to end any employee services without prior warning and for any reason. Therefore, to protect employees from unfair dismissal practices, many state courts started to recognize exceptions to the "terminate at-will" rule, known as wrongful discharge laws (WDL), beginning from the 1970s. These were relevant for workers not protected by explicit contractual agreements or by federal legislation. The three main exceptions of the WDL are the "good faith," "implied contract," and "public policy" exceptions. State courts have the discretion to adopt none, any, or all three of these exceptions.

> The good faith exception requires that employers treat workers in a fair manner. In its broadest sense, this law protects employees from termination for any reason other than for a "just cause." The implied contract exception protects employees from termination when the employer has implicitly promised the employee not to discharge the worker without good cause. Finally, the public policy exception protects employees from termination for refusing to violate an established public policy or commit an illegal act. Of the three exceptions, the good faith exception is arguably the most far reaching, as it represents the largest deviation from at-will employment. (Bai, Fairhurst, & Serfling, 2020, p. 652).

The recognition of WDL by state courts was aimed at assuring legally binding policy principles, addressing the changing nature of labor relations, and assuring the consistency with contract principles.

3.4.2. Empirical evidence on WDL

Acharya, Baghai, and Subramanian (2014) investigates the association between WDLs and corporate innovation. Using a sample of 48,433 firm-year observations for the period 1971 to 1999 the authors document a positive relationship between the adoption of WDL and innovation intensity. Economically, the adoption of the good faith exception increases the annual number of patents and citations by 12.2% and 18.8%, respectively. This finding suggests that the legal protection offered by WDL alleviates the concern that innovative employees will be exploited by their employers *ex post* and, thereby, encourages employees to engage in innovation activities. Given the incomplete nature of labor contracts, WDL serves a very useful role by imposing the burden of proof on the employer should the employer terminate employees.

Using a sample of 88,997 firm-year observations over the period 1967 to 1995, Serfling (2016) finds that book and market leverage decrease by 6.1% and 3.6% respectively, compared with their respective sample means, following the adoption of the WDL. This finding is consistent with the notion that greater employment protection increases financial risk, and hence, lowers optimal leverage ratios. Cross sectional tests report this impact as being significant for firms operating in industries and for firms in states having more employee discharges, volatile earnings, full-time workers, or nonunionized workers.

Using a sample of 115,432 firm-years observations over the period 1969–2003, Bai et al. (2020) explores the effect of staggered adoption of the "good faith exception" provision of the WDL by deploying a DiD research design. The paper documents a 6.5% reduction in capital expenditures as a fraction of lagged book assets for the treatment group (firms in states that adopted the exception) compared with the control group. The results hold after controlling for firm-, state-, and industry-year-fixed effects. Furthermore, investment-price sensitivity declined after the adoption of the "good faith exception," confirming that since greater employment protection increases the cost of terminating workers, firms may be reluctant to invest in all profitable projects.

In a sample of 57,467 firm-year observations between 1970 and 2000, Fairhurst, Liu, and Ni (2020) documents a decrease in tax aggressiveness in the order of 9.8% relative to the sample standard deviation, following adoption of the "good faith exception" provision. The finding is consistent with greater employment protection increasing firms' operating leverage (more rigid labor costs), increasing distress risk, and dis-incentivizing firms from investing in aggressive tax avoidance strategies. Cross sectional tests reveal that the negative relationship between the adoption of the "good faith provision" and tax aggressiveness is more pronounced for firms with greater distress risk (proxied by Altman's *Z*-Score, expected default frequency, the proportion of short-term debt, and industry cash flow volatility).

Using a sample of 121,728 firm-year observations, Kim, Li, and Park (2020) finds that the adoption of WDLs increases asymmetric cost behavior. The adoption of WDL increases downward labor adjustment costs, as layoffs become more difficult, and hence, require managers to incur labor-related costs even when sales decrease. The adoption of WDL may also decrease cost sensitivity to sales increases, if managers are more reluctant to hire additional workers in response to sales increases when potential future lay-off costs are greater. Economically, cost stickiness increases by 6.9% after the passage of the good-faith exception.

Dang, De Cesari, and Phan (2021) uses a quasi-natural experiment to investigate the relationship between WDL and stock repurchases. Using a sample of 58,088 firm-year observations for the period 1971 to 1995, the authors document a positive relationship between the adoption of WDL and stock repurchases. Economically, the estimated coefficient on WDL suggests a 26% increase in stock repurchases relative to the sample mean of repurchases. The finding is consistent with the 'rent extraction' theory, which posits that the adoption of WDL will "… encourage workers to bring more wrongful termination lawsuits … while increasing employees' shirking and lowering firm productivity …, ultimately leading to employees' rent extraction behavior. This incentive problem occurs separately from the typical agency conflict between shareholders and managers and has the potential to lower shareholder wealth" (p. 4). Therefore, firms have incentives to increase payouts and choose to repurchase over cash dividends as the former is a more flexible mode of payout.

To summarize, empirical evidence on WDL reveals that firms

[10] Some such laws include the business combination laws (e.g., poison pill legislation (1985–1997), PSLRA (1995), Ninth Circuit states, State of Pennsylvania (mandatory adoption after Cuker v. Mikalauska 1970), share acquisition laws, fair price laws, and directors' duties laws.

headquartered in states that have adopted WDL reduce capital investment (Bai et al., 2020), reduce leverage and, therefore, distress risk (Serfling, 2016), reduce tax avoidance (Fairhurst et al., 2020), but increase cost stickiness (Kim, Su, Wang, & Wu, 2021) and stock repurchases (Dang et al., 2021). These studies explored primarily the effect of staggered adoption of the "good faith exception" provision of the WDL in their empirical tests. The empirical evidence generally appears to reveal a negative side of WDL, in that employers, worried about potential lawsuits, cut back on investments in capital expenditures and tax strategies (the latter preferred by shareholders because it conserves cash for them). However, a positive but perhaps unintended consequence of WDL has been an increase in innovative activities.

3.5. Non-shareholder constituency regulations (CS)

3.5.1. Conceptual underpinning and measurement

Constituency statutes (hereafter CS) give firms the freedom to consider different stakeholders' interests. CS allows corporate leaders, for example the directors, a legally enforceable mechanism for considering stakeholder interests without violating their fiduciary duties to shareholders (Orts, 1992; Stout, 2012). The CS are premised on the notion that a corporation should conduct its actions for a wider stakeholder group than just shareholders. Although the statutes are permissive in nature, they are legally enforceable, and made an important shift away from the shareholder primacy principle. By the year 2010, a total of 35 states in the U.S. had adopted CS (Ni, Song, & Yao, 2020).

3.5.2. Empirical evidence on CS

Accounting and finance researchers have investigated the effects of CS on corporate outcomes beginning with Flammer and Kacperczyk (2016). Using a sample of 159,558 firm-year observations between 1976 and 2006, the paper documents a significant positive impact (about 6.8% increase in patent citations) of CS on corporate innovation. The finding supports the view that fulfilling non-financial stakeholder demands might encourage employees to engage in more innovative activities, despite the uncertain nature of such activities. This also boosts customer loyalty and the willingness to tolerate innovation uncertainties associated with the development of new product (p. 1984). The paper also finds that the enactment of the statutes leads to more innovation in the tails of the distribution, as well as more novel and somewhat more general innovation, and in innovative productivity. Results also show that the positive impact is larger for firms in consumer-focused industries and in high-polluting industries. Finally, evidence suggests a marginal increase in long-term firm performance post-enactment, and that "…without a legal tool such as a constituency statute, market pressure may prevent shareholder-oriented companies from becoming more stakeholder friendly in the first place" (p. 1983).

Leung, Song, and Chen (2019) uses a sample of 9348 firm-year observations from 1986 to 2012 and finds that the staggered enactment of the CS reduces banks' total, idiosyncratic, and distress risk. Results are consistent using different robustness checks (e.g., clustering standard error by state, controlling for state-fixed effects, and excluding seven states that had statutes enacted in different years). As an additional test, they find that banks in states that had enacted CS performed better during the Global Financial Crisis (GFC) regime.

Ni (2020) employs a sample of 84,460 firm-year observations spanning 1980 through 2007 to exploit the enactment of the statutes, and documents that firms headquartered in states adopting the CS reported significantly lower discretionary accruals (about 5.2%) compared with firms in states that did not adopt them. Ni (2020) also finds the result to be more pronounced for firms with *ex ante* conflicts between shareholders and non-shareholder stakeholders (proxied by financial distress and dividend payouts) and higher information acquisition costs (proxied by idiosyncratic volatility and analyst earnings forecast error) for the board. Finally, the author finds that the earnings smoothing by more stakeholder-oriented firms is more value-relevant and leads to higher market valuations.

Ni (2020) uses a sample of 86,032 firm year observations and documents a negative and significant relationship between the enactment of CS and total payout and share repurchases. Economically, the reported coefficient implies a 21% ($2.99 million) reduction in share repurchases and a 9.7% ($1.104 million) reduction in cash dividends following the enactment of CS. Additional analysis shows that this negative relationship is more pronounced for firms with financial distress or default, and for firms that are more consumer-orientated and work in more polluting industries.

Gao, Li, and Ma (2021) uses a sample of 36,519 firm year observations from 1987 to 2012 and finds a significant decrease in loan spreads for firms located in states that adopted CS statutes. Gao et al. (2021) hypothesizes "that a state's adoption of such statutes could reduce the cost of debt for firms incorporated in that state, because these statutes help (i) mitigate conflicts of interest between residual claimants (mostly shareholders) and fixed claimants (mostly other stakeholders); (ii) mitigate conflicts of interest between holders of liquid claims (also mostly shareholders) and holders of largely illiquid claims (also mostly other stakeholders); (iii) limit legal risk; and (iv) lower takeover threats" (p.1). Economically, enactment of CS reduces loan spread by $1.2 million annually, on average.

In this section, we surveyed studies examining the consequences of the adoption of constituency statutes. The theoretical assumption underpinning these studies embraces "public interest theory" and "institutional theory" (see Section 2). Historically, the debate about the purpose of the corporation originated in Berle (1931), which argued that a corporation is formed to protect shareholder interests, while Dodd (1932) suggested that corporations should look beyond shareholder interests alone, and hence, regulation should consider wider stakeholder interests. For example, traditionally, corporate governance is established to protect shareholder interests (Section 2), while protecting non-shareholder interests is costly for the shareholders (Leung et al., 2019; Ni, 2020). The enactment of CS provides an ideal exogenous shock to revisit the corporation's purpose and generally supports the notion that the adoption of CS makes corporations take actions that benefit wider stakeholders.

3.6. Noncompetition agreements (NCA) and inevitable disclosure doctrine (IDD)

3.6.1. Conceptual underpinning and measurement

A noncompetition agreement is a contract that forbids employees or workers to work for competitors for a certain period of time (Office of Economic Policy, 2020). Once enforced, this agreement allows current employers to protect their interests by stopping employees from competing with them in their next position, whether working in a close industry or starting up a new business. In fact, this can assist the current business to retain their valuable key people, secret information, and customers, and stop unfair competition. Accounting and finance researchers have studied noncompetition agreements from two aspects: the enforcement aspect and the Inevitable Disclosure Doctrine (IDD) aspect. Azevedo, Pereira, and Rodrigues (2018) develops a dynamic model to assess the noncompete covenants and garden leave[11] under uncertainty situations and embargo periods, as well as reimbursement and severance payments resulting from violation of the noncompete agreement. The paper finds that the noncompetition agreement is more effective than garden leave for firms wishing to retain their employees, particularly when industry uncertainty is low, the embargo period is long, and the manager's salary is low.

[11] Garden leave "…has a similar restriction regarding working for a competitor as the NCA, and may even prevent a manager from working at all, but during the embargo period, the manager is paid a given compensation package by the ex-employer" (Azevedo et al., 2018, p. 204).

Malsberger (2004) in his "Covenants not to compete: A state-by-state survey," discusses noncompetition law in the 50 U.S. states. Garmaise (2011) used the 12 questions used by Malsberger (2004) for each jurisdiction to consider noncompetition status. In particular, Garmaise (2011) developed a threshold for each question: states exceeding that threshold will be assigned a value of 1 for the enforcement in that state, and zero otherwise. Thus, the maximum expected score for each jurisdiction is 12. For example, the index considers the variations in the types of contracts permitted in states. In some states (e.g., New Hampshire), a firm can restrict an employee from future independent dealings with customers with whom the employee had direct contact but cannot prevent the employee from conducting business with other customers once the employee leaves the firm. In other states (e.g., Georgia), a noncompetition agreement can ban an employee from dealing with any current clients of the firm, even if the employee had no contact with the client (Garmaise, 2011, p. 389). Malsberger (2004) and Garmaise (2011) also consider geographic and time restrictions in the index. Pentelovitch (2003) and Malsberger (2004) observe that the enforcement of noncompetition agreements is regulated by employment law, rather than by corporate law. Ertimur, Rawson, Rogers, and Zechman (2018) extended this index to cover the period from 1980 to 2013.

Inevitable Disclosure Doctrine is a common law premise stemming from the concept of "threatened misappropriation," which occurs when an employee who has knowledge of a firm's trade secrets goes to work for a direct competitor in a similar position. In states that consider the IDD, former employees of a company can be prevented from working for its competitors. The adoption of the IDD, therefore, enhances the protection of trade secrets by reducing the risk that departing employees having knowledge about their firm's trade secrets will disclose them to rival companies in any state (Klasa, Ortiz-Molina, Serfling, & Srinivasan, 2018). The IDD provides significant leeway for firms exposed to losing trade secrets for obtaining an injunction by requiring them only to show the presence of a mere threat of irreparable harm, rather than establishing actual wrongdoing. Employment contracts also include nondisclosure agreements (NDA) and/or covenants not to compete (CNC): tools that allow the firm to strengthen its case in the employees' contracts. Since managerial labor-market uncertainty works as a disciplining tool for corporate managers (Fama, 1980), the legal enforcement of NCA can be a good tool to measure the strength of such a disciplinary mechanism in the managerial labor market (Chen, Zhang, & Zhou, 2018). Na (2020) summarizes the main differences between IDD, NDA and CNC, as follows (also see Klasa et al., 2018; and Callen, Fang, & Zhang, 2020):

> First, the IDD does not have geographic restrictions and can be enforced even if a CEO's new employer is headquartered in another state that has not rejected the IDD … NDA and CNC, in contrast, are typically enforceable only within a specified geographic area, for example, within a 50-mile radius of the employer's place of business. Second, the IDD also allows state courts to prevent a CEO from working in another firm if this would inevitably lead to a future violation of NDA. Third, courts can grant an injunction under the IDD even if the employment contract does not have NDA and CNC. (Na, 2020, p. 683).

PepsiCo Inc. v. Redmond, 54 F.3rd 1262 (7th Cir, 1995) is considered the main case in the IDD. Redmond, who worked for PepsiCo for ten years moved to a similar job at Quaker. The Seventh Circuit affirmed the ruling that the defendant's new employment would inevitably disclose the plaintiff's trade secrets. After that case, eighteen state courts recognized the IDD. Thus, from 1995, many state courts follow the decision of the PepsiCo case. Klasa et al. (2018) provides a summary of all "precedent-setting cases" in Table 1 of their paper. New York was the first state to adopt IDD in 1919 and 20 other states followed, with Kansas the last state adopting IDD in 2006. However, three states (Florida in 2001, Michigan in 2002, and Texas in 2003) rejected the IDD after recognizing it in previous years. Na (2020) updates the list and shows that by the end of 2016, a total of 16 states had rejected the IDD.

3.6.2. Empirical evidence on NCA

Kobeissi et al. (2010) documents that firms use less stock in takeover transactions, and pay lower premiums for targets, in states with noncompetition laws, using a sample of 10,507 firm-year observations for the period 1999–2003. The paper also finds that a noncompetition agreement mitigates agency problems, as evidenced in higher abnormal returns during the takeover announcements. Findings are consistent with noncompetition agreement regulation restricting managerial labor market mobility, and hence, motivating employees to maximize the value of their current employer.

Ertimur et al. (2018) hand-collects data on 5095 CEOs to measure the time taken to become a CEO from their previous position for the period 1992 to 2014. Ertimur et al. (2018) hypothesizes that executive skillsets and frictions in the labor market will contribute to the time-to-promotion from the individual's prior executive position to the CEO rank. The paper finds that specialist CEOs,[12] or executives located in strong noncompetition states, are more likely to sign a noncompetition agreement, thereby lessening the CEO promotion gap, than are generalist CEOs.

Based on an assessment of firm and rival information dynamics, Aobdia (2018) assumes that employee mobility results in information transfer from one rival to another. Such information transfer increases proprietary costs in a competitive environment. Therefore, firms have strong incentives to reduce information transfer emanating from employee mobility. Using a sample of 25,529 firm-year observations from 1980 to 2013, and using Garmaise (2011) measure for noncompetition agreements, the paper finds a negative association between firms located in states adopting noncompetition agreements and the extent of corporate disclosures, which is consistent with the proprietary cost of disclosure hypothesis. The results are stronger for firms with more complex operations and greater incentives to withhold information.

Since the adoption of noncompetition agreements reduces executives' job market mobility and exposes them to career risk, Chen et al. (2018) posits that managers have incentives to adopt reporting practices that boost short-term performance. Using 27,964 firm-year observations from 1992 to 2004, Chen et al. (2018) finds that firms headquartered in states with strong noncompetition agreements increase short-term performance by reducing discretionary expenditures. The results are more pronounced for firms with less able CEOs, CEOs with shorter tenures, firms with high growth opportunities, and firms operating in localized industries. As additional analysis, the paper finds that firms in these states curtail R&D, advertising, and other selling, general and administrative expenses.

He (2018) investigates the association between noncompetition enforceability and corporate cash holdings. The paper hypothesizes that firms usually are motivated to increase their reported cash holdings:

> … a high cash balance may signal the firm's ability to retaliate aggressively by engaging in "predatory poaching" if attacked, thereby, distorting competitors' incentives to launch talent raids … A stronger balance sheet helps attract talent, because skilled workers prefer to work for a financially healthy employer to avoid costly job loss [and] … as employee departures can damage firms, the 'indescribable contingencies' … in a more competitive labor market

[12] Ertimur et al. (2018) uses a measure of CEO specialization developed by Custódio, Ferreira, and Matos (2013). Custódio et al. (2013) uses five characteristics, namely, the number of positions, the number of firms, the number of industries, CEO experience, and conglomerate experience, to define generalist versus specialist CEOs. The index is calculated using Factor Component Analysis.

increase future cash flow uncertainty, leading to a stronger precautionary motive to hold cash. (pp. 213–214).

Using 34,956 firm-year observations from 1992 to 2004, He (2018) finds that lower non-competition enforceability increases the cash holdings of treated firms compared to a control group by about 0.7% points.

Cici, Hendriock, and Kempf (2021) uses noncompetition clauses in employment contracts to examine their effects on employee behavior in the mutual fund industry.

> First, NCAs impose additional costs when employees are fired, because they have to stay unemployed for a certain period of time. Second, NCAs reduce the outside options of employees in the external labor market, which makes it hard for them to exploit external promotion opportunities. Thus, increased NCA enforceability should have an impact on employee behavior and output. An increase in the costs associated with being fired should incentivize employees to increase their effort and, consequently, their output in order to avoid termination. (p. 2).

The authors identify three states, Texas, Florida, and Louisiana, where the first noncompeting enforcement agreement was introduced by state governments or Supreme Court rulings. Using a sample of 2344 firm-year observations between 1992 and 2004, the paper finds that increased enforceability of noncompeting clauses leads to significantly better fund performance of at least 84 basis points per year. The paper further finds that stricter enforceability of noncompeting clauses causes fund managers to reduce portfolio risk and herd more, in particular in stocks in which they are unlikely to have an information advantage.

Hrazdil, Kim, and Li (2021) examines the association between CSR practices and employee retention using NCAs as an exogenous shock. Firms usually increase CSR performance to retain their employees: a policy that enables firms to protect their knowledge from being passed on to competitors (knowledge spill-over). Using 29,214 firm-year observations from 1992 to 2013, the paper documents a negative association between the adoption of NCA and CSR performance, which reveals the unintended consequences of NCA regulation and is consistent with the notion that firms engage in CSR practices strategically in order to retain employees.

Tang, Wang, and Zhou (2021) finds a positive relationship between the increased enforceability of noncompetition agreements and expectations management, measured as analysts' downward forecast revisions within a quarter. The paper's finding suggests that lack of job market mobility incentivizes managers to provide more disclosures. In terms of economic magnitude, an increase in noncompete enforceability (Garmaise, 2011) is associated with a 58% increase in expectations management. Additional analysis finds that this association is more pronounced for CEOs lacking general skills, CEOs with shorter tenures, firms with more independent boards, and for firms operating in more homogenous industries.

3.6.3. Empirical evidence on IDD

3.6.3.1. Proprietary cost theory and IDD studies. Corporate disclosure is relevant to investors and is highly regulated. Current and potential rivals can observe these disclosures. Firms therefore decide strategically how, when, and what information about a firm's products, investment, customers, segments, and expected cash flows will be disclosed. This creates a tradeoff between increasing disclosures to reduce the information asymmetry and divulging proprietary information to competitors.

Some of the IDD studies use this proprietary cost of disclosures theory to explain their findings. Klasa et al. (2018) investigates the recognition of the IDD by U.S. state courts and corporate capital structure decisions. Using a sample of 125,895 firm-year observations spanning the period 1977–2011, the authors find that firms in states adopting the IDD increased their leverage relative to unaffected rivals. Economically, the treatment firms report an increase in the ratio of net book and market leverage of about 14% and 19% compared with control firms. The effect is stronger for firms with more potential to lose key employees to rivals that do not adopt the IDD. In addition, this impact is also greater for firms facing financially stronger rivals, and for firms operating in industries where competition is more intense. The finding is consistent with the notion that unused debt capacity "credibly signals to rivals that the firm has the financial ability to respond to the appropriation of its trade secrets which, in turn, reduces rivals' incentives to obtain these secrets" (p.267). Li, Lin, and Zhang (2018) documents that IDD adoption leads to a reduction in the disclosure of customer identities, which is information that if divulged, would be detrimental for firms. Li et al. (2018) argues that after IDD, firms' public disclosure becomes a more important source for competitors to obtain customer identity information, and firms will incur higher proprietary costs if they continue to disclose this information. Using 28,547 firm year-observations from 1994 to 2010, the paper finds that firms headquartered in IDD states reduce their level of disclosure about their customers' identities. The likelihood of concealing customer identities increases by 7.12% after the adoption of IDD.

Gao, Zhang, and Zhang (2018) hypothesizes that insofar as IDD limits the power of employees to disclose sensitive trade secrets to competitors, the managers of the IDD-adopting firms will have less pressure to manipulate earnings. As IDD restricts employees' outside opportunities, they become less sensitive to their employer's financial performance, thereby, attenuating their employer's incentives to manipulate earnings upwards (p. 125). Using a sample of 94,912 firm-year observations from 1987 to 201, Gao et al. (2018) finds that this is indeed the case, as firms headquartered in IDD-adopting states experience a 0.9 percentage point reduction in discretionary accruals, on average.

Callen et al. (2020) uses a sample of 45,313 firm year observations from 1987 to 2010 and finds that firms headquartered in IDD states are characterized by more opaque reporting. The paper uses the absolute value of discretionary accruals and the probability of accounting manipulation (F-score measure developed by Dechow, Ge, Larson, and Sloan (2011)). The positive association is more pronounced for firms with weak external monitoring. Economically, the treatment group experiences an increase in financial reporting opacity of 0.0046 for discretionary accruals (a percentage increase of 7.23% relative to the sample mean) and 0.0641 for the *F*-score (a percentage increase of 5.80% relative to the sample mean). The finding supports the IDD-induced proprietary cost hypothesis.

Li and Li (2020), however, suggests that the adoption of IDD will increase the disclosure of forward-looking information. The paper develops the following arguments in support of their hypothesis:

> First, the adoption of the IDD can reduce the risk that competitors obtain trade secrets …, thus, lowering the proprietary costs of disclosing forward-looking financial information …. Second, adoption of the IDD could affect firms' competitive position indirectly by reducing the agency costs between shareholders and managers. As IDD adoption could reduce managers' outside opportunities and managers are bonded with their firms to a greater extent…, managers tend to focus on long-term performance rather than short-term myopic behavior … and on strengthening their firms' competitive position. (p. 398).

Using 40,532 firm year observations from 1998 to 2011, the paper finds a positive and significant relationship between IDD and management forecast frequency, and forecast horizons, in states that adopted IDD. Economically, the management forecast frequency of IDD firms is 6% higher than that of non-IDD firms. The corresponding increase for the forecast horizon is 14%.

Kim et al. (2021) examines whether the staggered adoption of the

IDD affects stock price synchronicity and documents a positive relationship. This is consistent with IDD increasing the proprietary cost of disclosure and with stock prices incorporating less firm-specific information (higher synchronicity). Therefore, managers could resort to nonproprietary information disclosure to reduce information asymmetry. Investors, thus, are willing to accept this alternative type of disclosure, to the extent that such information can still be useful to them in predicting the amount and timing of future cash flows. However, for rivals, the nonproprietary information is unlikely to be a substitute for the proprietary information that would enable them to gain advantages in the product market. Using, 27,471 firm-year observations, Kim et al. (2021) finds a significant decline in R&D activity disclosures, and a significant increase in confidential information redaction in 10-K reports for firms headquartered in IDD states, supporting the argument that the IDD reduces disclosures of proprietary information.

Li, Shevlin, and Zhang (2022) hypothesizes that IDD recognition may increase the risk of job loss for managers, and hence, motivate them to engage in tax avoidance in order to show improved firm performance. Using 63,530 firm year observations from 1977 to 2011, they find a positive and significant association between IDD and tax avoidance. Economically, GAAP and cash effective tax rates decrease by 0.9 and 1.6 points, respectively, after a firm's headquarter state recognizes the IDD. Ding, Sainani, and Zhang (2021) assumes that IDD adoption reduces information transparency by increasing the benefit of nondisclosure, and hence, creates greater opportunities for firms to engage in more aggressive tax avoidance. This evidence supports Li et al. (2022).

3.6.3.2. Employee mobility arguments and IDD studies. Some studies on the consequences of the IDD use the "employee mobility" argument as their theoretical framework. Ali, Li, and Zhang (2019) hypothesizes that managers at high-risk career points and in states with restrictive job mobility (i.e., states with the IDD), will withhold bad news, while managers looking for promotional opportunities (proxied by managerial ability score) in external markets in such states, will be more forthcoming in disclosing bad news in a timely manner. Using 13,692 firm-year observations from 1995 to 2010, the paper finds that adoption of the IDD increases this asymmetric withholding of bad news. Flammer and Kacperczyk (2019) shows that, owing to the increased risk of losing knowledge workers, the rejection of the IDD leads firms to increase CSR activities that aim at enhancing employee loyalty, improving employer reputation for fostering innovative activities, and encouraging the social and environmental engagement of employees. Using a sample of 30,216 firm-year observations from 1991 to 2013, the paper documents that CSR increases 13–19% after rejection of the IDD. Na (2020) uses a sample of 33,574 firm-year observations from 1992 to 2016 and observes a significant increase in CEO pay and systematic performance-sensitivity, or a decrease in relative performance evaluation (RPE) in states that rejected the IDD. In other words, reverse association between CEO outside opportunities and RPE can be explained, because the contracting environment may drive executive compensation. (Na, 2020, p. 686) concludes that this result "provides strong support for the labor market opportunities-based explanation for linking CEO pay to general market conditions, namely, that an increase in the sensitivity of CEOs' reservation utilities to aggregate shocks should lead to a stronger relation between CEO compensation and systematic performance." An important advantage of using rejection of the IDD as a setting is that the sixteen states that rejected the IDD, as noted by Na (2020), enable the researchers to use multiple shocks at different times, lessening the risk that alternative explanations drive the results. Na (2020) also finds this increase is more pronounced for CEOs that have more labor market mobility and in industries characterized by more proprietary information.

Although most studies on the enforceability of NCA use the enforceability index developed by Malsberger (2004) and adopted by Garmaise (2011), Cici et al. (2021) employs legal changes in non-compete enforceability in Florida, Louisiana, and Texas during the period 1992–2004. A useful feature is that these changes have opposite effects on the enforceability of NCAs, i.e., increased enforceability for Florida and decreased enforceability for Texas. Tang et al. (2021) identified eight more changes based on state court rulings and two more based on state legislation from 2004 to 2010.

In summary, we document that studies of the Inevitable Disclosure Doctrine consider two main types of theoretical arguments. The first set of studies (e.g., Callen et al., 2020; Ding et al., 2021; Gao et al., 2018; Kim et al., 2021; Klasa et al., 2018; Li et al., 2022 and Li & Li, 2020) link their findings to the theory of proprietary cost of disclosures. The second stream of research relates the IDD to the employee mobility argument (e.g., Ali et al., 2019; Flammer & Kacperczyk, 2019; Na, 2020).

4. Dispute resolution channel and corporate outcomes

4.1. Conceptual underpinning and measurement

As discussed in Section 2.4, circuit court rulings are considered an important mechanism for dispute resolutions. For example, the Ninth Circuit is considered very liberal compared with its Fourth Circuit counterpart. However, Broscheid (2011) argues that such differences are not necessarily bad for the U.S. judicial system, and merely reflect the socioeconomic and political cultures of the regions. Following the footsteps of the political scientists and legal scholars, accounting and finance researchers have also put considerable effort into understanding the effects of these ideological differences among circuit courts on firms' financial outcomes.

4.2. Empirical evidence for circuit court rulings and corporate outcomes

Shareholder litigation may help shareholders extract wealth from creditors, if such litigation results in financial distress or bankruptcy. Chu (2017) posits three channels through which the threat of shareholder litigation can affect the cost of bank loans:

> … the threat of shareholder litigation can increase the cost of bank loans because shareholder litigation helps shareholders extract wealth from lenders… the bankruptcy distribution channel. Shareholder litigation can also increase the cost of bank loans via the traditional value destruction channel, i.e., shareholder litigation leads to wealth extractions by lawyers …, worsening performance …, or reputational loss…, all of which reduce firm value. Finally, the threat of shareholder litigation can also decrease the cost of bank loans because the threat of shareholder litigation can help discipline managers and thereby increase firm value…. the discipline channel. (p. 319).

Using a sample of 8398 firm-year observations from 1995 to 2003, Chu (2017) finds that reduced litigation threat stemming from the Ninth Circuit Court's Silicon Graphics ruling decreases the cost of bank loans. The effect is stronger for firms with higher institutional ownership but weaker for firms with stronger creditor protection in bankruptcy.

Hopkins (2018) examines whether a court ruling that made it easier for public corporations to defend against securities class actions had any effect on corporate misreporting. The main independent variables used in Hopkins (2018) are an indicator variable for firms located in the Ninth Circuit (Circuit 9),[13] and POST, coded 1 if firms issued the quarterly report after the Silicon Graphics decision on July 2, 1999.[14] Using a sample of 35,519 firm-year observations for the period, Hopkins (2018)

[13] The Ninth Circuit includes the states of Washington, Oregon, Idaho, Montana, Nevada, California, Arizona, and Alaska.

[14] This decision heightened a key procedural hurdle for plaintiffs, which reduced the likelihood of litigation in the Ninth Circuit, and increased the likelihood of dismissal of the cases filed (Pritchard & Sale, 2005).

finds that firms headquartered in the Ninth Circuit were more likely to restate financial statements following the decrease in litigation risk against firms, relative to firms headquartered elsewhere. Economically, the rate of restatements rose by 1.24% relative to a 1.0% increase prior to the 1999 decision, for firms affected by the decision.

Bliss, Partnoy, and Furchtgott (2018) investigates the relation between information bundling and securities litigation, exploiting the exogenous shock of a 2005 U.S. Supreme Court decision on "securities class action loss causation" requirements. Shareholder plaintiffs usually face difficulties establishing loss causation. This is because of the restrictive nature of loss causation which arises from 1) identifying corrective disclosures, 2) showing that stock price dropped soon after the corrective disclosure, and 3) eliminating other possible explanations for this price drop. Before 2005 it was much easier to establish loss causation, with the court ruling in *Dura Pharmaceutical* vs *Broudo* (Eighth and Ninth Circuits) permitting plaintiffs to establish loss causation merely by establishing that a firm's stock price was inflated at the time of the alleged misstatements or omissions.[15] The paper uses this U.S. Supreme Court decision as an exogenous shock for a sample of 1562 restatement firms and finds that bundling of good news offsets price declines and results in less litigation, while noise bundling magnifies price declines. In terms of economic impact, the paper finds that non-bundled restatements are 5.94 times more likely to result in litigation, while bundled restatements have 8.17 times higher dismissal rates, and $21.17 to $23.45 million lower settlement amounts.

Crane and Koch (2018) examines changes in ownership structure in response to the Silicon Graphics ruling. The paper finds support for a substitution effect between litigation and governance in that institutional ownership increases on average by five percentage points among firms headquartered in the Ninth Circuit, relative to control firms, after the ruling. The paper further documents that the increase in institutional ownership is driven largely by independent institutions and among firms whose owners relied more heavily on class action for monitoring. The paper's sample consists of 26,832 firm-year observations from 1989 to 2009.

Huang et al. (2019) assumes that *ideology* is one of the most important personality traits of judges that affect court decisions. The paper proposes and validates federal judge ideology as a new measure of ex ante litigation risk. Using 91,698 firm-year observations from 1996 to 2014, Huang et al. (2019) finds that firms in liberal circuits are 33.5% more likely to be sued in securities class action lawsuits than those in conservative circuits. The paper measures judge ideology based on the political affiliation of the appointing president and biographical data of circuit court judges. The judge ideology is measured at the circuit court level, as circuit and district court judges are usually the final arbiters of securities class action lawsuits, and circuit court decisions are binding on district courts within their jurisdictions (Huang et al., 2019, p. 434). The findings of Huang et al. (2019) are generally consistent with Ninth Circuit Court rulings being liberal, although as discussed above, *Silicon Graphics* is an exception.

Houston, Lin, Liu, and Wei (2019) examines the effect of Ninth Circuit rulings on management earnings forecast decisions. They assume that the mixed evidence reported in the litigation and the voluntary disclosures literature can be solved by exploiting the exogenous shock of the Ninth Circuit ruling. Using a sample of 838 firms between 1995 and 2003, the authors find that firms experiencing reduced litigation threats because of the Ninth Circuit ruling issued fewer management earnings forecasts. Economically, compared to the firms unaffected by the ruling, the treated firms, on average, are 6% less likely to make a management earnings forecast, and issue 0.57 fewer earnings forecasts (the average number of management earnings forecasts for the full sample is 1.30). However, they find little evidence that firms changed the way they provide earnings forecasts. These results are robust to controlling for state-level factors, excluding high-tech firms and consistent forecasters, and after using quarterly samples with shorter windows. Dong and Zhang (2019) also finds robust evidence that firms in the Ninth Circuit have lower quantity and quality of voluntary disclosure, compared with control firms for a sample of 6382 firm-year observations.

Arena, Wang, and Yang (2019) documents a positive relationship between the Ninth Circuit Court of Appeals and corporate tax avoidance for a sample of 23,914 firm-year observations from 1994 to 2004. This is consistent with the notion that reduced litigation threat encourages managers to engage more in tax avoidance activities. The paper also finds that shareholder litigation risk can enhance value-enhancing tax cash saving. These results are moderated by analyst coverage and institutional ownership, and constrained by labor unions, because labor unions are more risk-averse than managers, and hence, constrain managers' ability to participate in aggressive tax strategies (Chyz, 2013).

Using a sample of 15,000 firm-year observations spanning four years before and four years after the 1999 ruling that reduced litigation risk for Ninth Circuit firms, Huang, Roychowdhury, and Sletten (2020) finds significant post-ruling increases in real earnings management (REM) for these firms, relative to firms located in other circuits. The increase in REM is more pronounced for firms issuing more optimistic disclosures. The findings are consistent with a reduction in litigation stemming from Ninth Circuit ruling, thereby encouraging managers to issue optimistic but misleading disclosures manifested in increased REM behavior. They also document that an increase in REM, in response to a decline in litigation risk, is more pronounced when managers have higher incentives to manipulate earnings, and when governance mechanisms are weaker.

Chung, Kim, Rabarison, To, and Wu (2020) uses a sample of 2549 firm-year observations, and documents that managers in the Ninth Circuit states began acquiring larger firms after the passage of the ruling that made class action lawsuits difficult. The authors also find that bidders in the Ninth Circuit states began including greater proportions of equity payments using overvalued equity, which suggests empire-building. The threat of litigation has a greater effect on acquirer returns in firms with weaker corporate governance (proxied by the *E*-index), few block-holders, low CEO ownership, or CEO duality. In terms of economic significance, the coefficient estimate indicates that after the ruling, bidders in the Ninth Circuit states experienced announcement returns that were 1.32% points lower than bidders located in other states.

It is well documented that Ninth Circuit rulings reduced class action lawsuits, and this reduced threat of litigation is expected to motivate managers to innovate more. Hassan, Houston, and Karim (2021) finds support for this proposition using a sample of 16,616 firm-year observations for the period 1995–2003. The magnitude of the coefficient suggests that firms in the Ninth Circuit jurisdiction receive about 16% more patents than firms elsewhere. The corresponding increase in patent value is 35.3% and about 20% more patent citations than other firms. These results are consistent with Lin et al. (2021), which documents that a reduction in derivative lawsuits also increases innovation. Despite Appel (2019) suggesting that derivate lawsuits and class action lawsuits capture different constructs, the findings documented by Lin et al. (2021) and Hassan et al. (2021) suggest that the risk of litigation, in general, deters innovation.

We summarize this section as follows. First, all studies in this section have employed Silicon Graphics Inc. Securities Litigation, 183 f. 3d 970 in the Ninth Circuit as an exogenous shock in their empirical specifications, except for Bliss et al. (2018), which combined both the Ninth Circuit and the Silicon Graphics ruling. Further, a majority of studies use firm-level corporate governance variables to examine their moderating effect on the relation between the Ninth Circuit ruling and outcome variables (Arena et al., 2019; Bliss et al., 2018; Chu, 2017; Chung et al., 2020). Most studies that used Silicon Graphics Inc. Securities Litigation,

[15] But courts outside the Eighth and Ninth Circuits disagreed and ruled that a claim of price inflation was insufficient to establish loss causation. This case, therefore, imposed a higher standard in both the Eighth and Ninth Circuits for establishing loss causation.

argue that the previous litigation risk measure was often measured imperfectly (e.g., using PSLRA), as the measures were backward-looking, time-varying, and captured other firm aspects. Therefore, the Ninth Circuit ruling provides a strong setting to test the causal effect of litigation on firm outcomes.

5. Open issues

5.1. Research design issues

We observe that a majority of the reviewed studies have employed the DiD design. The use of this approach is prevalent in accounting, finance and legal research, owing to a strong belief that such a design mitigates the trend bias and confounding effects stemming from other concurrent treatments (Baker, Larcker, & Wang, 2022). However, there is a lot of debate around the validity of a DiD estimate and, in particular, the endogeneity concern (Athey & Imbens, 2006; Besley & Case, 2000). We suggest that researchers intending to use DiD consider these concerns in their research design.

It is also important to note that the use of state-level regulations as an exogenous shock to shareholder litigation risk may not be truly exogenous, as the process of debating and adopting these laws would take significant time, thereby allowing firms to be proactive in their operational decisions. Moreover, firms could lobby state legislators to adopt these laws after weighing the costs and benefits of the laws, hence further raising concerns about the exogeneity of their adoption (Freund et al., 2022). In case of UD laws, researchers have used the adoption of UD law by the Supreme Court of Pennsylvania, which is in line with judicial precedent, and hence, is less susceptible to corporate lobbying.

Since research on the consequences of state-level regulation requires researchers to accurately identify firms' headquarter locations, it is important to remember that a well-known limitation of Compustat data is that it provides only the latest headquarters locations, and hence, creates a backfilling problem. Jennings, Kim, Lee, and Taylor (2022) measures the extent to which this backfilling introduces measurement error in the historical state of headquarters. The paper benchmarks Compustat data against the true state of corporate headquarters listed on the firm's annual 10-K filing on EDGAR, and finds that error rates on the 2019 Compustat file exceed 10% and approach 20% as one goes back further in time. To mitigate this problem, some researchers supplement Compustat HQ data with the actual state of headquarters extracted from electronic 10-K filings on the SEC's EDGAR website, using the programming language PHP (e.g., Brushwood, Dhaliwal, Fairhurst, & Serfling, 2016), or else use historical state of incorporation data from firms' 10-K reports on EDGAR, which is available on Bill McDonald's website: https://sraf.nd.edu/data/augmented-10-x-header-data/. However, a strong rationale for choosing one over another is not provided in existing research. So, concerns remain when firms are headquartered in state A, but fully/partially operate in state B. Which state laws should be applicable for such firms?

5.2. Auditor liability regime

Overall, the literature has made significant progress in understanding the effect of auditor liability regimes across states. In particular, few studies suggest that auditors apply different audit strategies to reduce their litigation exposure (see Section 3.1 for relevant review). Future research can investigate the interplay between director liability reduction law and auditor third party liability regimes, as both these parties are entrusted with the responsibility of protecting shareholder interests.

5.3. Interpretation of contradictory findings

We also observe that in some cases researchers use the same regulatory event but provide opposite results. For example, Chen et al. (2021) provides evidence that accounting conservatism *decreased* after the adoption of the UD laws whereas Manchiraju et al. (2021) finds the opposite. These opposing findings could be attributed to research design issues, although both studies use Basu (1997) conditional conservatism measure. Chen et al. (2021) also controlled for the passage of the several concurrent laws (see Table 6 of Chen et al. (2021)) and finds that the passage of the UD laws is the main driver of reduced conservatism, whereas the previously documented finding by Basu and Liang (2019) that a reduction in D&O liability reduced conservatism is found to have no effect. It, therefore, appears that more research is warranted to reconcile these contradictory findings. As there is very little evidence that these regulations were a product of corporate lobbying, researchers may have to develop more powerful techniques to credibly measure the outcome variable. As another example, Houston et al. (2019) shows that the frequency of voluntary disclosure *decreases* after the Ninth Circuit Court's Silicon Graphics Inc. ruling, whereas Bourveau et al. (2018) documents an increase in the frequency of voluntary disclosure after the adoption of the UD laws.

5.4. Local social norms, state-level regulations and corporate outcomes

A growing body of literature has explored the effects of local social norms on accounting and finance outcomes (see Habib, Costa, & Al-Hadi, 2022 for a review). Some such examples include state-level social capital, religiosity and gambling norms, and local corruption. The state-level regulation literature and the local social norm literature appear to have developed independently, despite the observation that managerial actions are affected by both social norms and local regulations. For example, Guiso, Sapienza, and Zingales (2004) notes that people's trust, which is a significant component of social capital, can be a product of social capital present in their community, as well as effective law enforcement. The extent to which findings documented in the local regulation literature are affected by local social norms has not been adequately explored.

6. Conclusion

In this paper we have reviewed the consequences of U.S. state-level regulations on corporate outcomes. To organize the review, we develop a framework whereby we categorize the studies examining the effects of local regulations on corporate outcomes through two main channels: the state's intervention channel; and the dispute resolution channel. We neither assume that this framework is complete, nor that the channels are mutually exclusive or exhaustive. However, this allows us to classify the literature in a more meaningful manner. The state-intervention channel is represented by several state regulation and court case precedents. Some relevant regulations in this category include auditor legal liability, Universal Demand law, Wrongful Discharge law, non-shareholder constituency regulations, noncompetition agreements and Inevitable Disclosure Doctrine. We surveyed the relevant literature that examines the effects of these regulations on audit, accounting and other corporate outcomes. The dispute resolution channel includes regulations pertinent to U.S. circuit court law, such as Eighth Circuit and Ninth Circuit rulings. The regulations affect auditors, corporate directors, non-shareholder corporate stakeholders, and employees. The corporate outcomes affected by such regulations include the audit, financial reporting quality, financing decisions, innovation, and

corporate tax avoidance.

We expect our review to be useful to researchers who intend to extend this stream of research by empirically examining hitherto unexplored consequences of state-level regulation. We have identified some open issues that will assist researchers in developing testable research questions. Although we have included the available literature on the consequences of state-level regulation, the review is confined to papers published in journals in the business discipline, and accounting and finance journals in particular. We have deliberately excluded articles published in law and economics journals to keep our review manageable, but acknowledge this as a shortcoming of this review.

Declaration of Competing Interest

I have no conflict of interest with any people in Advances of Accounting journal.

Data availability

No data was used for the research described in the article.

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