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Investors punish for social irresponsibility depending on proportion of company execs with law degrees

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Vamsi Kanuri. Credit: University of Notre Dame

Corporate social irresponsibility (CSI) and other questionable business practices that ultimately harm stakeholders occur frequently, drawing vastly different reactions from investors.

And, the extent to which investors punish firms for CSI—or corporate events that may have a negative impact on stakeholders or the environment—is associated with the proportion of top management executives in a firm who have a law degree, according to new research from the University of Notre Dame.

"Firms behaving badly? Investor reactions to corporate social irresponsibility" appears in the current issue of *Business and Society Review* from Vamsi Kanuri, assistant professor of marketing in Notre Dame's Mendoza College of Business, along with Michelle Andrews from Emory University and Reza Houston of Ball State University.

"A lot of attention has been paid to how investors react when firms 'do good,' Kanuri said. "Less attention has been paid to how and why investors react when firm actions may not be so good. Our research shows how investors react to news of CSI, including violations of environmental regulations and workforce reductions. We find if the percentage of top management with law degrees is too small or too large, punishment is more severe, while an average proportion with law degrees is associated with less or even no punishment. In our sample, we notice firms that had a proportion ranging from 6 percent to 9 percent realized the highest abnormal stock returns, whereas firms that had a proportion of less than 6 percent realized the lowest abnormal returns."

The team also finds this association depends on the size of the firm, amount of volatility in a firm's returns and competitiveness of a firm's industry of operation.

They collected data on the difference between actual and expected

returns for 308 publicly traded S&P 500 firms shortly after the announcements of 629 CSI events. They also tracked the number of top management team (TMT) executives in each firm who had a law degree at the time of the announcement, comparing the proportion of executives with a law degree with how investors reacted to the announcement in terms of abnormal returns—the difference between actual and expected returns.

"We hypothesize the proportion of board members and TMT executives with law degrees affects investor perceptions of firm foresight, and in turn, their judgment of blame and consequent punishment," Kanuri said, "and we show investors may punish firms based on whether they believe firms understood the potential ramifications of their actions."

For example, in early 2009, the study states, aircraft manufacturer Boeing announced plans to reduce its workforce by 4,500, representing cuts of more than 5 percent. Weeks later, construction equipment maker Caterpillar revealed plans to cut 20,000 workers, a slash equaling a tenth of its workforce. In the days following these announcements, Boeing incurred negative 3.8 percent cumulative abnormal returns, while Caterpillar accumulated 1.9 percent in positive returns. Varied investor reactions to reports of similar corporate events are not limited to such internal business concerns, but also manifest for external environmental concerns. For example, revelations in 2008 that confectioner Hershey's allegedly violated environmental regulations drew negative 1.2 percent cumulative abnormal returns, yet news that automotive parts manufacturer Johnson Controls paid environmental regulation fines yielded positive returns of 4.8 percent.

"We hypothesize and empirically illustrate that such findings can be explained by the proportion of top management executives in a firm who have a law degree," Kanuri said.

While it may not be surprising that the educational background of company executives can be associated with investor reactions to firm events, Kanuri is surprised to find that the proportion of corporate chiefs with a legal background matters. Investors naturally look to justify why unwelcome events occur and may scrutinize the experience of top management, including educational background, which can shape how decision-makers approach their decisions.

"Having the right proportion of law-trained executives on the senior leadership team can help," Kanuri said. "A law education can train business leaders to approach strategic decisions with a different lens and can signal to investors the extent to which firm leaders are capable of considering the ramifications of their actions.

"Our findings underscore how law degrees make an impact beyond the legal field and politics, and that proportion matters," he continued. "It's not just about having leaders with law degrees, but having the right balance. One way firms can reduce the likelihood of investor punishment is to assemble that right balance."

More information: Vamsi K. Kanuri et al, Firms behaving badly? Investor reactions to corporate social irresponsibility, *Business and Society Review* (2020). DOI: 10.1111/basr.12193

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