Why legal changes aimed at preventing frivolous litigation motivate firms to avoid recalling products

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Researchers from University of Adelaide and University of Danang have published a new *Journal of Marketing* study that examines Universal Demand laws and the unintended consequence of firms becoming less likely to recall products.

The study is titled "So, Sue Me … If You Can! How Legal Changes Diminishing Managers' Risk of Being Held Liable by Shareholders Affect Firms' Likelihood to Recall Products" and is authored by Arvid O. I. Hoffmann, Chee S. Cheong, Hoàng-Long Phan, and Ralf Zurbruegg.

The lawsuits that followed the discovery of technical problems with Boeing's 737 Max show that managers can be held personally liable by shareholders for neglecting fiduciary duties.

"Known as a shareholder derivative complaint, such legal actions seek to hold company officials responsible for alleged missteps and could result in defendants or their insurers paying monetary damages to a corporation and prompt internal governance changes," according to a report in *The Wall Street Journal*. However, what happens when legal changes aimed at preventing frivolous lawsuits diminish such litigation risk? The new *Journal of Marketing* article documents the unintended consequence of firms becoming less likely to recall products.
At the heart of the study is a legal change called Universal Demand (UD) laws, which different states across the U.S. adopted between 1989 and 2015. UD laws make it more difficult for shareholders to file a derivative lawsuit to hold managers liable for breaching their fiduciary duties. In particular, these laws require shareholders to first demand that the firm's board of directors takes legal action against the wrongdoers. As board members themselves are often defendants in the proposed lawsuit, they typically refuse such requests. Because judges tend to follow the decisions of boards, the case is often dismissed.

UD laws are intended to prevent frivolous derivative litigation from disrupting a firm's normal business operations and to sort cases with merit from those without.

Hoffmann explains that "UD laws are well-intended and linked to some positive consequences such as increased corporate innovation. However, the reduced threat of shareholder litigation as a governance mechanism disciplining a firm's managers could have unintended negative consequences. We examine this notion in the context of managerial decision making around product recalls by combining theoretical insights from agency theory with a business ethics perspective."

**What should managers do?**

Managers of publicly listed firms should ideally strive to safeguard the long-term value of the firm, but in practice, they often face incentives and pressures leading to an overemphasis on short-term goals. Accordingly, managers are motivated to avoid recalls to avert immediate costs such as lost sales, an impaired reputation, and consumer compensation. However, this could lead to even bigger long-term damage to firms' future stock price. Consequently, shareholders might sue managers for neglecting their fiduciary duties.
"UD laws reduce the risk of being held personally liable by shareholders and we explore whether this changes firms' likelihood to recall products," says Cheong.

Analyzing over 30 years' worth of data, the authors find robust evidence that the reduction in shareholder litigation risk caused by UD law adoption leads to a substantial drop in product recall likelihood. Phan states that "firms incorporated in states that have adopted UD laws are almost 30% less likely to announce a product recall. Importantly, the effect holds even when controlling for potential improvements in product quality."

Managers' opportunistic response to UD law adoption is less pronounced when organizational mechanisms mitigate agency conflicts between shareholders and managers.

"In particular," says Zurbruegg, "we find that the negative relationship between UD law adoption and product recall likelihood is less pronounced for more customer-focused firms or those subject to more stringent monitoring by institutional investors."

**A plan of action for legislators, policymakers, and firms**

To alleviate the potentially detrimental effects of UD law adoption on consumer welfare and the future viability of the firm, the study suggests the following action plan for legislators, public policymakers, firm owners, and consumer advocates.

- To enhance **consumer protection** in the near term, legislators need to overhaul UD laws to allow shareholders to claim demand futility when bringing a lawsuit concerning consumer safety. Demand futility enables shareholders to avoid the demand requirement if they can allege with particularity that demand will
be futile because company directors have a conflict of interest.

- Public policymakers need to take a more holistic view when considering and implementing legal changes. That is, legislators tasked with revising corporate law should coordinate with regulators in charge of consumer protection. While doing so, these stakeholders should leverage insights from behavioral economics to anticipate unintended consequences of well-intended laws.

- Shareholders and consumer advocates need to stimulate firms to increase their customer orientation. This is because a more pronounced customer focus reduces the level of managerial opportunism around product recall decisions. Firms can achieve this by appointing (more) marketing executives to the board, such as Chief Marketing Officers.

- Finally, strategizing around the ownership composition of the firm can be beneficial. In particular, initiatives to attract more institutional investors to take a meaningful ownership stake in the firm are likely to pay dividends in terms of reducing managerial opportunism around product recall decisions.


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