Political Connection and Corporate Litigation: Evidence from a Quasi-Natural Experiment

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Abstract

This paper studies the causal impacts of political connection on corporate litigation. Specifically, by exploiting the enforcement of an unanticipated depoliticization regulation—the Chinese Communist Party's Rule 18 which forces politically connected directors to resign from public firms, we investigate how acquired favoritism and protection from political connection impair the effectiveness and fairness of the judicial system. We show that the weakening of political connection results in higher likelihood of and larger monetary amounts involved in lawsuits against connected firms. The effects are more pronounced for non-state-owned enterprises, financially distressed firms, and firms in regions with weak legal institutions. Furthermore, we find that cases with high information asymmetry largely drive the effects. Overall, our paper demonstrates that constraining board political connection can mitigate the bias in corporate litigation and level the playing field for litigants.

Motivation

■ An effective and fair judicial system is essential for the security of property and enforcement of contracts in the commercial realm.

↪ Firms and individuals rely on courts to resolve property and contractual disputes.

■ However, it may be undermined by political interference and corruption. Firms have incentives to distort the judicial proceedings because once they are sued:

- Negative market reactions and reputation damage: (Karpoff and Lott, 1993; Bhagat et al., 1998; Fich & Shivdasani, 2007; Karpoff et al., 2008 Murphy et al., 2009; Haslem et al., 2017).

↪ Emerging but still scarce literature: analyze some aspects of corporate litigation (Ducharme et al., 2004; Field et al., 2005; Lerner, 2010; Hutton, et al., 2015).

■ Extant descriptive and correlation-based studies on corporate litigation show that political connection may result in bias and favoritism:

- Chinese evidence: Firth et al. (2011) on stock market reactions; Lu et al., (2015) on court outcomes → State ownership first-order impact, board connection mild.

■ Potential concerns from a causal perspective:

1. Ambiguous relationship between Political Connection and Litigation:
   i.) Loss of political connection and resultant reduction in business corruption may lead to less lawsuits filed.
   ii.) Less corrupt judiciary may encourage people to use the courts and lead to correct decisions and fair judgments.
2. Reverse Causality and Omitted Variables:
   i.) Build-up of political tie may stem from increased (expected) litigation risk.
   ii.) Measures of Political Connectedness are endogenous variables.

⇒ Therefore, we exploit an exogenous negative shock to board political connection to quantify its causal effect on corporate litigation, and show that it has a first-order impact on both the incidence and outcomes of corporate litigation.

Institutional Background: Rule 18

On 19 Oct 2013, the Chinese Communist Party announced Rule 18: all government and party officials, including both incumbent officials and those who retired within 3 years, should resign from firms as independent directors within a short period after the announcement.

Table 1: Sample Construction

All non-financial firms listed on the Shanghai and Shenzhen Stock Exchanges with independent director resignations from Oct 2013 to Dec 2016 (from CSMAR Database)	2,131
Less: Resignations from firms that went public after 2014	175
Less: Voluntary resignations (out of e.g., personal, health, or career reasons) of directors without political connection	949
Less: Resignations citing Rule 18 with directors from universities, publicly funded organizations and SOEs	467
⇒ Politically connected independent directors' mandatory resignations influenced by Rule No. 18	540
⇒ Firms with resigned official directors	368
Less: firms with missing value of variables or no matched control firms	32
⇒ Treatment firms	336

Identification Strategy

- Strategy: Compare incidence and outcomes of lawsuits of the treatment firms that experienced at least one incident of official director resignation due to Rule 18 to those of the control firms that did not
- Design: Propensity Score Matching (PSM) (same 1:1 industry nearest neighbor matching w/o replacement) + DID in a 10-year panel with the specification:

$$y_{it} = \beta \times RULE_i \times POST_t + \Gamma' \times CONTROLS_{it-1} + \gamma_i + \theta_{kt} + \mu_{pt} + u_{it}$$

- y_{it}: 1) An indicator which takes one if a firm is sued at least once in a year and zero otherwise; 2) Total number of cases in a year, 3) Total monetary amount involved in lawsuits in a year.

Main Results

Table 2: Firm-level DID Regression

Variables	Sued	# Litigation	Amount Involved
Rule 18*Post	0.103***	0.113***	0.002***
	(6.36)	(6.53)	(3.99)
Controls	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes
Province*Year FE	Yes	Yes	Yes
Observations	5,785	5,785	5,785
Adjusted R^2	0.180	0.228	0.176

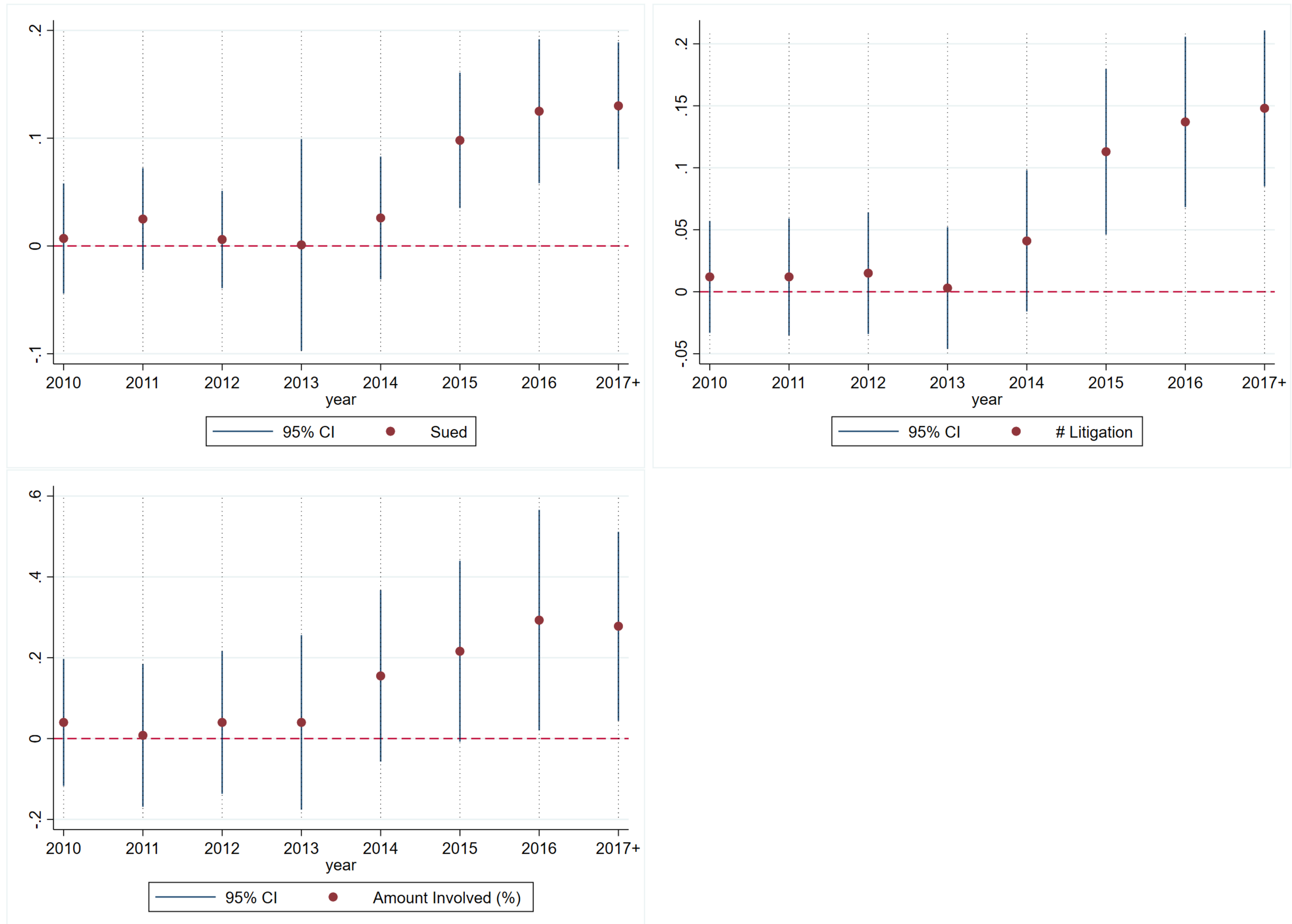

Figure 1: Dynamic Effects

Further Analyses

- **Cross-sectional tests (DDD)**: Effects are more pronounced for non-state owned, financially distressed, and regions with weak legal protection.
- **Type of cases**: Based on Regulation of Reasons for Civil Lawsuits.
  – Higher likelihood of lawsuits for: contract disputes, company disputes, labor disputes, intellectual property disputes, and unfair competition disputes.
- **Additional tests: Case level**
  – Monetary Amount Involved ↑ and Plaintiff Monetary Awards ↑ in each case.
- **Robustness checks**: Related parties, placebo tests, controlling for potential confounding events, short-window estimations, and alternative matching procedures.

Table 3: Alternative Matching Procedures

Matching Procedures	Sued	# Litigation	Amount Involved
PSM 1:1 w/ replacement	0.117***	0.129***	0.003***
	(7.11)	(7.23)	(4.30)
Normalised Euclidean Distance 1:1 w/ replacement	0.122***	0.121***	0.002***
	(7.67)	(7.43)	(5.12)
Industry + Size 1:1 w/ replacement	0.106***	0.117***	0.002***
	(6.54)	(6.95)	(5.59)
All other public firms as control firms	0.113***	0.113***	0.002***
	(8.49)	(8.58)	(6.23)

Concluding Remarks

- Rich evidence on the causal relationship between political connection and corporate litigation: higher likelihood and worse outcomes of litigation subsequent to the weakening of political ties.
- Like state ownership, board political connection also has a significant impact on corporate litigation: implications for non-stated-owned firms and for creating a level playing field for unconnected litigants.
- Add to a growing literature on the economic analysis of litigation (Priest & Klein, 1984; Bhattacharya et al, 2007; Firth et al., 2011; Hutton et al., 2015; Lu et al., 2015; Arnold et al, 2018; Cassella & Rizzo, 2020; Gormley et al, 2020).
  – New and strong evidence on the bias rooted in the judiciary.
  – Policy implication for other economies: mitigation of judicial bias.
- Extend our understanding of the value of corporate political connection.