Heterogeneous Investor Response to New Risks in Financial Markets: Evidence from Environmental Litigation Risk

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A. Introduction

Climate change can pose risks to companies and it is unclear whether these factors are priced into asset values. I explore whether the financial market is processing climate risks as new information becomes available. I use new environmental lawsuits as a shock to both defendant and competitor litigation risk from climate change. Looking at competitor firms helps get around the selection effect issues of litigation. I then test four possible hypotheses that could be occurring in financial markets.

B. Environmental Litigation

Litigation risk has been increasing over the past few years, especially after the US withdrew from the Paris Agreement in 2017. Litigation was seen as a way to influence firms in the absence of government policies.

C1. Hypothesis 1: No Response

Hypothesis: Environmental litigation risk is not being reflected in asset prices.
Empirical Test: Determine if there is a negative price response after a litigation event using a Fama French 3-factor event study:

Conclusion: I find both a negative price response of around -5% for both defendants and competitors so it seems unlikely that investors aren’t aware of these risks or monitoring them.

C2. Hypothesis 2: Screening

Hypothesis: Some investors are aware of this risk and are selling shares to other investors that aren’t aware of this risk.
Empirical Test: Test whether large investors are selling to smaller investors in the quarter of a lawsuit since large investors would have more resources to process risk information:

Conclusion: I find smaller investors are decreasing holdings and large investors are increasing holdings, so it seems unlikely that there are large information asymmetries with respect to this risk.

C3. Hypothesis 3: Preferences

Hypothesis: Investors redistribute company shares according to their preferences for ESG factors; ESG investors sell firms with high environmental litigation risk to other investors.
Empirical Test: Test if ESG investors decrease holdings in defendant and competitor firms after litigation:

Conclusion: Since ESG investors are increasing holdings, it seems unlikely investors are redistributing based on their preferences for ESG factors.

C4. Hypothesis 4: Engagement

Hypothesis: Investors with a comparative advantage in engagement buy high risk firms, engage with the company and create value by improving environmental performance.
Empirical Test: We already know large and ESG-conscious investors, which likely have a comparative advantage in engagement, are increasing holdings. Is there more engagement in the form of environmental shareholder proposals following a litigation event?:

Conclusion: There are fewer environmental shareholder proposals following a litigation event. There may be substitution from public engagement by smaller firms to private engagement by larger firms.

D. Conclusion

After an environmental lawsuit, I find:
1. A negative price response of around -5%;
2. Large investors increasing holdings by about 100,000 shares;
3. ESG-conscious investors increasing holdings by about 100,000 shares; and
4. A decreased probability of an environmental shareholder proposal by about 2%.

These results may indicate that there is a comparative advantage to engagement; large, ESG-conscious investors may be buying up high risk firms and engaging with them to improve their environmental performance. I find a decrease in public environmental shareholder proposals, so the engagement is likely happening privately.