Litigation Risk And Employment: Evidence from The Universal Demand Laws

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December 28, 2021

Abstract

This paper examines the effect of shareholder litigation rights on firm-level employment. I rely on the staggered passage of Universal Demand (UD) laws to establish a causal effect. The adoption of UD laws enacts procedural hurdles for derivative lawsuits and reduces managers' litigation risk. I find that employment increases significantly following the UD adoption. This increase can be explained by managers' risk-taking behaviors as well as firms' increasing demand for high-skilled labor. Although part of the employment growth is driven by innovation, evidence suggests that the overall workforce expansion is inefficient in the way that firms are over-investing in labor.

JEL Classification: G34, G38, J21, K22

Keywords: Litigation risk, Universal Demand laws, Employment growth

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1 Introduction

Apart from "voice" and "exit", shareholder litigation is often used as a third approach to mitigate agency conflicts introduced by the separation of ownership and control. By conducting a legal proceeding, shareholder litigation helps enforce the fiduciary duties of directors and officers and protects shareholders' interests. While existing literature has documented abundant evidence on how litigation affects firms' shareholders and debtholders (e.g., Houston, Lin, and Xie (2018); Ni and Yin (2018)), there is limited knowledge regarding its effect on other stakeholders such as labor. This paper aims to fill the gap by investigating how a reduction in shareholder litigation rights affects the size and structure of a firm's labor force.

Existing studies suggest that weakened shareholder litigation rights cause a deterioration in corporate governance (Ferris, Jandik, Lawless, and Makhija (2007); Appel (2019)). This may lead managers to act against shareholders' best interests through shirking or self-dealing behaviors. On the one hand, managers have the incentive to live a "quiet life" (Bertrand and Mullainathan (2003)), where they are reluctant to invest in new projects and also avoid laying off unproductive workers. These two contradicting effects may cancel out and yield zero net effect on workforce. On the other hand, managers may pursue private benefits through empire building activities (Baumol (1959); Marris (1964); Williamson (1964)) or risk-taking (Houston, Lin, and Xie (2018); Ni and Yin (2018)). In this regard, one expects an expansion in firms' workforce for several reasons. First, managers have the incentive to expand staff as it brings a sense of security, power, and professional achievement (Williamson (1963)), and a reduction in their litigation risk would make the expansion more difficult to resist. Second, as managers face less threat of forced replacement and reputation losses incurred by the derivative litigation (Ferris, Jandik, Lawless, and Makhija (2007)), they are more inclined to engage in risk-taking projects, which would call for more hiring. Third, as one of the most common risk-taking projects, corporate innovation increases when shareholder litigation rights are impaired (Lin, Liu, and Manso (2021)). This may increase firms' demand for highly skilled labor and stimulate a shift in the component of their workforce.

Firms' employment decisions are constrained by the cost and availability of external finance (Benmelech, Bergman, and Seru (2021)). Weakened shareholder litigation rights could therefore negatively affect labor as a consequence of increasing cost of capital (Houston, Lin, and Xie (2018)) and cost of debt (Ni and Yin (2018)). Unlike investing in capital, firms are exposed to labor market frictions and additional labor-specific adjustment costs when making hiring decisions (Matsa (2018)). This makes the financing costs of labor more expensive compared with that of capital. It

is thus likely for firms to downsize their workforce and rely more on efficient technologies when shareholder litigation rights are compromised.

Given the ambiguous theoretical predictions, how weakened shareholder litigation rights affect labor is ultimately an empirical question. In this paper, I seek to answer this question by exploiting the staggered passage of the U.S. state-level Universal Demand laws between 1989 and 2005 in a difference-in-difference setting. The UD laws introduce procedural hurdles to the initiation of derivative lawsuits. Shareholders can initiate a derivative lawsuit against managers and directors on behalf of the corporation when they believe there is a breach of fiduciary duty. The adoption of UD laws requires plaintiff shareholders to demand that board take corrective actions and to obtain board's approval before proceeding with litigation. As directors are often named as defendants in derivative lawsuits, the board almost inevitably rejects the demand, which eventually leads to the dismissal of the lawsuit (Swanson (1992)). Therefore, UD laws make it more difficult for shareholders to initiate derivative lawsuits and consequently impair shareholders' litigation rights. Existing studies have confirmed that the enforcement of UD laws effectively reduces the number of derivative lawsuits both at the firm and state level (e.g., Appel (2019); Chu and Zhao (2015)), suggesting that UD laws can be used as an exogenous negative shock to shareholder litigation rights.

My main findings suggest that the UD adoption causes an increase in firms' employment growth by approximately 16% of a pre-treatment standard deviation. This indicates that the impact of deteriorated governance on corporate labor force outweighs that of increased financing costs. To validate the difference-in-difference method, I carry out the event study method proposed by Sun and Abraham (2021) to correct the potential biases caused by heterogeneous treatment effects among groups and years. The test verifies the DiD results and provides evidence on the common trend shared by the treated and control groups prior to the UD adoption.

To rule out the possibility that firms incorporated in UD states and non-UD states are intrinsically different in characteristics, I perform a one-to-one matching exploiting the propensity score matching method. To be specific, I use a probit model to estimate a firm's probability of being treated as a function of firm-specific characteristics such as size, leverage, tangibility, and ROA one year before the UD adoption. I then assign one control firm to each treated firm and obtain the matched sample. The employment growth of treated firms in the matched sample increases significantly following the UD adoption, roughly by 15.7% of a pre-treatment standard deviation.

I then proceed to explore potential channels through which the UD adoption affects firms' employment level. As firms expand their labor force irrespective of increased financing cost incurred

by the UD laws, my initial focus is on the deterioration of governance. My main results suggest that managers do not seek a "quiet life" when shareholder litigation rights are weakened as there is an expansion of the labor force. Building on this basic finding, I explore whether the workforce expansion can be explained by managers' risk-taking behaviors. If this mechanism holds, one would expect a resultant increase in firms' capital expenditure. I thus examine firms' investment activities as the first step and find a significant increase in CAPEX following the UD adoption. I also explore whether firms increase their R&D expenditure as it is considered as a common risk-taking project. The results confirm firms' risk-taking tendency following the UD adoption and coincide with that of Lin, Liu, and Manso (2021) - reduced litigation risks spur corporate innovation. Furthermore, I investigate firms' M&A activities, especially acquisitions, following the UD adoption. I find that the likelihood of a firm acquiring another firm as well as the size of the M&A deals increase in states that passed the UD laws. Specifically, my results suggest that firms undertake more non-diversifying M&As, which further confirms the risk-taking channel as prior evidence suggests that managers use diversifying acquisitions to reduce firms' risk (Gormley and Matsa (2016)).

A natural question to ask is whether the expansion of labor can be fully explained by the increase in investment and acquisitions. In order to test this, I follow Benmelech, Bergman, and Seru (2021) and directly include variables on investment and acquisitions in the baseline regression. The coefficients of the UD indicator remain positive and significant, indicating that the labor expansion cannot be fully explained by the capital expansion and UD laws contribute to the employment growth through other channels as well.

Another potential channel driving the workforce expansion could be firms' intensified R&D activities following the UD adoption. A crucial input of innovation is human capital. As a result, firms may increase their demand for high-skilled labor. It is empirically challenging to directly examine firms' labor component due to the data limitation, I therefore exploit the heterogeneity effects of industry-level human capital intensities. If the human capital channel plays a role in the post-UD employment growth, firms operating in human capital intensive industries should experience a larger increase in employment. I construct four measures of human capital intensity and perform a cross-sectional analysis. My findings coincide with the hypothesis, supporting the view that firms demand for more high-skilled labor following the UD adoption.

Finally, I provide corroborating evidence by carrying out a battery of robustness checks. First, I confirm that my findings are not driven by other confounding factors such as firms' governance and state-level anti-takeover legal regimes. Second, my results can be potentially biased by the

political economy of UD. I therefore refine the sample to only including treated firms incorporated in Pennsylvania where the UD was passed by the Supreme Court and is thus clean from lobbying - my findings still survive. In a similar vein, I also limit my sample in other ways to isolate various factors that might discredit my results. For instance, controlling for legislations regarding the class actions or omitting firms incorporated in Delaware. The results remain both qualitatively and quantitatively similar. Last but not least, my findings are not subject to the inclusion of fixed effects - the results survive after further controlling for headquarter state*year fixed effect.

My research contributes to several strands of literature. First, it adds value to the sprouting literature on how derivative litigations shape corporate finance and corporate governance. Early studies in this field exploit the specific lawsuits and document evidence on the positive impact of derivative lawsuits on corporate governance. Erickson (2010) deems derivative litigation as a new form of shareholder activism in corporate governance and Ferris, Jandik, Lawless, and Makhija (2007) document the evidence on improved board quality following derivative lawsuits.

More recent studies exploit the staggered adoption of the U.S. state-level Universal Demand laws as a negative shock on firms' derivative litigation risk and further shed light on its impact on corporate governance issues such as managerial entrenchment (Appel (2019)), CEO turnover (Hayes, Peng, and Wang (2020)), board quality (Masulis, Shen, and Zou (2020)), and its peer effect on governance (Foroughi, Marcus, Nguyen, and Tehranian (2019)). Contrary to the conventional wisdom that shareholder litigation is frivolous and incurs high attorney fees, researchers have also unveiled its impact on a wide range of corporate finance issues. Some of the papers demonstrate the bright side of the UD laws and find evidence on their positive influence on corporate innovation (Lin, Liu, and Manso (2021)), takeover efficiency (Chu and Zhao (2015)), and value of cash (Nguyen, Phan, and Sun (2018)). Other papers disclose the dark side of the UD laws and show that their adoption leads to an increase in the cost of capital (Houston, Lin, and Xie (2018)), cost of debt (Ni and Yin (2018)), and insider trading (Adhikari, Agrawal, and Sharma (2021)). My findings add value to this research area by bridging the litigation literature and the labor literature.

Firms' employment strategies are determined by various factors. A growing number of papers have revealed the implications of corporate events on firms' employment decisions. Davis, Haltiwanger, Jarmin, Lerner, and Miranda (2011) examine the effect of leveraged buyouts on job creation and destruction, while Borisov, Ellul, and Sevilir (2021) investigate how IPOs affect corporate employment growth through different channels such as the relaxation of financial constraints. Similarly, Benmelech, Frydman, and Papanikolaou (2019) and Giroud and Mueller (2017) find that financial

frictions as well as corporate leverage play an important role in firms' employment level in the setting of the Great Depression. Aside from the financing factor, conflicts between different stakeholders also exert an influence on firms' employment strategies. Atanassov and Kim (2009) find that weak investor protection and strong union laws stimulate the emergence of a manager-worker alliance, thus reducing the risk of mass layoffs when firms are under-performing. In a related paper, Falato and Liang (2016) show a substantial employment cut in the presence of creditor rights after firms violate loan covenants. In addition, corporate characteristics affect corporate decision making on labor. Ellul, Pagano, and Schivardi (2018) find that family firms provide more employment insurance than non-family firms, and Landier, Nair, and Wulf (2009) show that geographic dispersion negatively affects firms' employment policies. My research contributes to this strand of literature by dissecting the firm-level employment strategies from a new angle - firms' litigation risk.

2 Institutional Background

2.1 Derivative Lawsuits And The Universal Demand Laws

Corporate directors and officers are required to fulfil two main fiduciary duties, "the duty of loyalty" and "the duty of care". When the fiduciary duty is breached, shareholders can initiate legal proceedings against the directors and officers to protect their rights. Derivative lawsuits provide a legal mechanism targeting the misconducted directors and officers. In a derivative lawsuit, plaintiff shareholders sue directors or officers on behalf of the corporation and the subsequent financial recovery goes to the company itself.

Despite the argument that the indemnifications in derivative lawsuits hardly impose financial burdens on sued directors and officers [1], managers must bear their own attorney fees, time loss, and reputation loss (Houston, Lin, and Xie (2018); Lin, Mai, Zhang, and Zhang (2021)). Moreover, the settlements of derivative lawsuits usually focus on corporate governance reforms (Erickson (2010)), which may substantially affect the behaviors of directors and officers.

In the United States, shareholders are required to demand that the board takes corrective action before bringing forward a derivative lawsuit. The board can either accept or reject the demand. Given that at least some of the directors are named as defendants in a typical case, the board almost always rejects the demand. In reality, once a board rejects the demand, in most cases the court follows the board's decision citing the business judgement rule. However, shareholders can

[1] The D&O insurance policies and the exculpatory charter provisions adopted by most states both protect directors and officers from the personal liability incurred by derivative litigations (Appel (2019)).

circumvent the demand requirement by providing evidence that the demand is a futile act. In practice, shareholders almost always argue that the demand is futile instead of making the demand, which entails substantial judicial time and resource and engenders a large number of litigations.

Between 1989 and 2005, 23 states passed the Universal Demand Laws, which remove shareholders' option of pleading demand futility when they wish to bring forward a derivative lawsuit. The timing of the UD laws adoption is reported in Table A.1 in the Appendix.[2] Similar to the anti-takeover laws, a state UD law applies to firms incorporated in that state.

Another major type of litigation is the direct litigation, which addresses harms to shareholders. Direct lawsuits are normally initiated by a single shareholder or multiple shareholders. In the case of multiple shareholders alleging the harm, they can file a class action lawsuit, where federal or state securities laws will be enforced. Overall, class actions and derivative litigations are different in nature and have different procedural requirements. In this paper, I focus exclusively on derivative lawsuits.

2.2 UD Laws As An Exogenous Shock

The difference-in-difference setting in this paper relies on the exogeneity of the UD adoption. It is possible that the passage of UD laws was influenced by various economic and political forces: although the UD appears to be a non-partisan legislation, it was affected by the lobbying from interest groups.[3] Of all the states that have adopted the UD laws, only Pennsylvania passed it by the state Supreme Court and thus can be viewed as a clean setting.[4] Therefore, I conduct several empirical tests to alleviate the concerns over potential endogeneity issues.

First, I conduct some preliminary empirical tests on examining whether the timing of UD adoption is driven by the previous employment growth aggregated at state level. Following Beck, Levine, and Levkov (2010) and Lin, Liu, and Manso (2021), I exploit the Weibull hazard model where the dependent variable is the log value of time expected until the adoption of UD. The null hypothesis here is that employment growth does not affect the timing of the UD adoption. I use two measures of firm-level employment growth to form the state-aggregated employment growth, the percentage change of the employee numbers between year t and $t-1$, and the change of the log value of employee numbers between year t and $t-1$. Moreover, I control for several state characteristics

[2] In most cases, the UD laws adopted by states are based on a version of the rule from the Model Business Corporation Act (MBCA), which is the basis for corporate statutes in 32 states (Appel (2019)).

[3] Appel (2019) documents the example of lobbying activities over UD in New York State. Even though the action was eventually put off, it certifies that the attitude of a state towards UD is the revelation of negotiations among interest parties.

[4] Following the literature, I include only the firms incorporated in Pennsylvania as treated firms as a robustness check. The result is shown in Section 6.2.

such as GDP, union coverage, and unemployment rate, to capture regional economic factors that may confound the results. Column (1) - (4) in Table B.2 report the results of the Weibull regression. All the coefficients of the state-level employment growth measures are insignificant, with and without state-level controls. This suggests that the adoption of UD laws is irrelevant to corporate employment growth, which verifies the exogeneity of UD laws.

Second, firms may strategically choose their states of incorporation. It is possible that firms "shop" the states of incorporation based on UD laws. To address this concern, I run the regression using the log value of the number of firms incorporated in each state in a given year as the dependent variable. I use the UD indicator which equals one if a state has passed a UD law as the main explanatory variable and control for the state fixed effects and year fixed effects. The standard errors are clustered at the state of incorporation level. As is shown in Column (5) and (6) in Table B.2, the number of firms incorporated in each state is not affected by the UD adoption, ruling out the possibility of state of incorporation shopping.

2.3 The Effect of UD Laws on Litigation

The identifying assumption of this paper is that the UD adoption effectively reduces firms' derivative litigation risk. To test this, I assemble a derivative lawsuit database relying on two sources: Audit Analytics (AA) and SEC filings from the EDGAR system. Following the literature (e.g. Appel (2019); Lin, Liu, and Manso (2021)), I identify derivative lawsuits as those that are categorised as both "shareholder suits" and "derivative" in AA. Due to the limitations of the AA database[5], I supplement the sample with derivative lawsuits disclosed in 10-K filings. To be specific, I web scrape all the 10-K filings disclosed in the EDGAR system between 1994 and 2010 and identify filings that use the terms "derivative lawsuit/suit" or "derivative litigation". For those filings, I collect the corresponding firm identifier (CIK number), year, and state of incorporation and append them to the AA database after omitting the overlapped cases.[6]

Using the combined dataset, I construct an indicator of firm-level derivative lawsuits and conduct an OLS regression on a sample where states that had adopted UD laws before 1994 are excluded. The results are reported in the first two columns of Table 1. The dependent variable is the derivative lawsuit indicator that equals one if a firm has a derivative lawsuit in a given year, zero otherwise;

[5]The coverage of the AA database only begins in 2000, and only includes lawsuits that are filed in federal courts.

[6]Note that firms usually disclose their derivative lawsuits in all the years between when the lawsuit was started and when it got settled, I thus only take into account of the first year in a row that a firm reports its derivative lawsuits in its 10-K. For instance, a derivative lawsuit was filed by shareholders against Firm A in 2006 and was settled in 2008, Firm A usually reports this lawsuit in its 10-K filings in all the years between 2006 and 2008. To avoid counting the derivative lawsuits repeatedly, I only count the derivative lawsuit of Firm A in 2006, not in 2007 or 2008.

and the main explanatory variable is the UD indicator that equals one if a state has adopted the UD, zero otherwise. I include firm fixed effects and industry*year fixed effects in both specifications and in Column (2), state-level characteristics such as GDP, unemployment rate and union coverage are also controlled for. In both columns, the coefficients of the UD indicator are significantly negative, suggesting that UD laws cause a substantial drop in firms' derivative litigation risks.

As another major form of shareholder litigations, class actions might serve as a substitute to derivative lawsuits. I therefore examine whether the UD adoption is associated with changes in firms' risks of being sued in class actions. I extract class action lawsuits data from the Stanford Securities Class Action Clearinghouse (SCAC), which covers all the class actions filed in federal courts since 1996. I then construct the class action indicator in the same way as the derivative lawsuit indicator and regress it on the UD indicator. The results are presented in Column (3) and (4) of Table 1. No evidence is found on UD's effect on class actions, contradicting the hypothesis that shareholders may resort to class actions when derivative lawsuits are more difficult to initiate.

To sum up, the results regarding UD's effect on litigation are in line with the literature (e.g., Appel (2019), Lin, Liu, and Manso (2021), Chu and Zhao (2015)) - the UD adoption causes a substantial drop in the risk of derivative lawsuits. This confirms the rationale of using UD as a negative shock to managers' derivative litigation risks.

3 Data and Methodology

3.1 Data and Sample Construction

My sample consists of all the U.S. public firms between 1994 and 2010 excluding financial firms. I obtain the firm-level financial data from Compustat and the stock price data from CRSP. The sample period begins in 1994 because this is the first year when the electric filings are available on the EDGAR system, which enables me to accurately retrieve the historical state of incorporation data.[7] Note that some states adopted the UD laws before 1994, which may introduce bias to my results, I omit those states from the final sample. My sample ends in 2010 to ensure that there is 5 years' data after the last UD adoption in 2005.

To gauge a firm's governance, I obtain the widely used E index and G index from Bebchuk, Cohen, and Ferrell (2009) and Gompers, Ishii, and Metrick (2003) respectively.[8] I also calculate

[7]Firms' historical state of incorporation data is extracted from the Augmented 10-X Header Data provided by Bill McDodald. See `https://sraf.nd.edu/data/augmented-10-x-header-data/`.

[8]The E index (entrenchment index) is based on six corporate governance provisions (staggered boards, supermajority voting requirements for mergers, limits on shareholder bylaws amendments, limits on shareholder charter amendments, poison pills, and golden parachute arrangements). The G index (governance index) also uses governance

firms' total institutional ownership holdings and their concentration as other proxies for governance, of which the data is extracted from the Refinitiv 13F Institutional Holdings dataset.

Regarding the state-level data, I rely on the Bureau of Economic Analysis to obtain data on real GDP. The data on unemployment rate is extracted from the Local Area Unemployment Statistics provided by the Bureau of Labor Statistics. Furthermore, I retrieve the union coverage data from the Union Membership and Coverage Database (Hirsch and Macpherson (2003)).[9] In order to rule out the potential impact other state-level laws may exert, I construct indicators using the anti-takeover laws and labor protection laws following Gormley and Matsa (2016), Karpoff and Wittry (2018), Chava, Danis, and Hsu (2020), and Serfling (2016). All the summary statistics are reported in Table 2.

3.2 Methodology

The Universal Demand laws mitigate managers' litigation risks by reducing the threat of derivative lawsuits. The adoption of UD laws provides a natural experiment that can be used in a difference-in-difference setting - firms incorporated in the UD-adopted states are viewed as the treated and firms in other states serve as controls. The baseline regression model is defined as below:

$$Emp\_Growth_{ijst} = \alpha + \beta UD_{s,t-1} + \theta_i + \gamma_{jt} + \epsilon_{ijst} \tag{1}$$

where Emp_Growth_{ijst} represents the employment growth of firm i in industry j from year $t-1$ to t, with the state of incorporation being s. UD is defined as a dummy variable that equals one if a firm incorporates in a state that has adopted the UD law, zero otherwise. θ_i denotes the firm fixed effects, and γ_{jt} denotes the industry_year fixed effects.

Note that it is possible that firms change their states of incorporation seeking better business conditions. Although there is no evidence of state of incorporation shopping in my sample (see section 2.2), I exclude firms that moved their states of incorporation across the UD-adopted and the non UD-adopted states to further rule out any potential endogeneity issues.[10]

The conventional method used in the staggered difference-in-difference setting has recently raised questions in the econometrics field. The potential heterogeneity problem of the treatment effects between groups or over time can severely bias the TWFE results. To address this concern, I

provisions but covers a wider range (up to 24 provisions). Both of these two indices proxy for a firm's governance quality.

[9] See `www.unionstats.com`.

[10] I exclude firms that moved their states of incorporation from a state without the UD laws to a state with UD laws, and vice versa.

conduct an analysis using the method proposed by Sun and Abraham (2021) as a validation test to the traditional TWFE analysis. The results are reported in Section 4.1.

To mitigate the concern over "bad controls", I do not include control variables in the baseline regressions. In other specifications, I include common firm-level controls such as leverage, firm size (log of assets), asset tangibility (ratio of plant, property and equipment to total assets), and ROA, all lagged by one year. Regarding state-level controls, I include unemployment rate, union coverage, and real GDP to capture the economic conditions at the state level.

4 Empirical Results

In this section, I present the empirical results of the main analysis on how the UD adoption affects firm-level employment.

4.1 The UD Adoption Increases Firm-Level Employment Growth

Table 3 reports the main results of the staggered difference-in-difference setting. To sum up, I find that firm-level employment growth increases significantly after a state adopts the UD law. To control for unobservable firm-level characteristics and industry-level trends, I include the firm fixed effects and the industry_year fixed effects. Column (1) is the baseline regression without any control variables, whilst Column (2) and (3) include firm-/state-level controls. As is shown in Table 3, the magnitude of the effect varies from 4.82% to 5.24%, depending on the specification. This effect is economically important and indicates an increase by 16% of a standard deviation over the pre-treatment sample (the standard deviation of the pre-treatment sample is 0.3041, see Table B.1).

It has been shown by some recent papers that the conventional TWFE estimators could be biased in the presence of heterogenous treatment effects (e.g., De Chaisemartin and d'Haultfoeuille (2020); Sun and Abraham (2021)). The conventional DiD method and its subsequent test of parallel trends through conducting dynamic regressions are hence problematic. To confirm the validity of my baseline results and further provide evidence on the parallel trend assumption, I exploit the event study method proposed by Sun and Abraham (2021) and estimate the "interaction-weighted" coefficients. The event study plot is shown in Figure 1 (a). In line with the baseline results, firms' employment growth increases significantly after the UD adoption, which peaks at $\tau = 1$ and $\tau = 2$. Furthermore, there is no pre-trend on employment growth prior to the passage of UD laws.

As an additional analysis, I use two other common measures of the employment growth to demonstrate that the results are not driven by the choice over measurement. First, I calculate the

difference between the log value of employee numbers between year t and $t-1$ following Ellul, Pagano, and Schivardi (2018). Second, I adopt the symmetric employment growth measure used by Davis, Haltiwanger, and Schuh (1998) and Falato and Liang (2016). This measure is calculated as the ratio of the difference between numbers of employees in year t and $t-1$ over one half of the sum of these two years' numbers of employees. The advantage of the second measure is that it addresses the asymmetries between large employment increases and cuts. Table 4 reports the results using these two additional measures. There is consistent evidence that the passage of UD laws significantly increases corporate employment growth - the increase ranges from 2.95 percentage points to 3.49 percentage points, depending on the specification.

4.2 Results on The Matched Sample

Although the baseline results survive after controlling for various firm-/state-level characteristics, it is possible that my finding is driven by some unobservable factors which make the treated and control firms intrinsically different. To assuage this concern, I perform a propensity score matching using leverage, firm size, asset tangibility, and ROA to ensure the comparability between the treated and controls.

Specifically, for each year that a UD law is adopted, I identify all firms incorporated in states that have newly passed the UD in that year as the treated firms. I then obtain all the firms incorporated in states that have never adopted and will not adopt the UD laws in the future as controls ("clean controls"). I then rely on a probit model to estimate a firm's probability of being treated using various firm-specific characteristics one year before the UD adoption. Each treated firm is matched with one control firm that has the nearest propensity score. This matching process eventually yields a sample with 327 treated firms and 327 control firms.

Results using the matched sample are reported in Table 5. Panel A shows the descriptive statistics of the treated and control firms one year before UD adoption. The differences of the means of each matching variable between the treated and controls and the corresponding p-values are also reported - there is no significant difference between the treated and control firms prior to the UD adoption. Panel B shows the regression results exploiting different measures of employment growth. There is a consistent significant increase in the firm-level employment growth with and without control variables. Overall, the effect of UD adoption on the main employment growth measure *Emp_Growth* is about 5.13%. This amounts to an approximate increase by 15.7% of a standard deviation over the pre-treatment sample (untabulated) for the treated firms, which is

similar to the estimated increase using the full sample.

5 Underlying Channels

In this section, I explore the potential channels that cause the workforce expansion following UD adoption. In particular, I focus on managers' risk-taking behaviors due to the deterioration of governance and firms' increased demand for high-skilled labor.

5.1 Risk-Taking

5.1.1 Investment And R&D

Derivative litigation serves as a way of corporate governance (Ferris, Jandik, Lawless, and Makhija (2007)); Appel (2019)). The UD adoption, by reducing managers' litigation risk, exacerbates the agency conflicts, thus induces managers to carry out risk-taking activities.

In order to test this, I first examine how the UD adoption shapes firms' investment strategies. I exploit two conventional investment proxies, the ratio of capex over beginning-of-year property, plant and equipment, and the R&D expense. Table 6 reports the regression results. Across all the specifications, I control for firm fixed effects and industry*year fixed effects. There is an 2.72 percentage points increase in investment and 6.03 percentage point increase in firms' R&D expenditure after including all the firm and state controls. Compared with the pre-treatment sample, the increases in investment and R&D are 7.09% and 7.99% of a standard deviation respectively.

These results suggest that the UD adoption leads to an increase in investment, especially for risky investment such as R&D, which are in line with the findings in Lin, Liu, and Manso (2021). The results also suggest that managers are not seeking a "quiet life" where new investment opportunities would not be pursued. Consistent with my conjecture, the findings validate that managers take more risks when their exposure to litigation is limited. The post-UD employment growth can thus be at least partially explained by this investment expansion.

5.1.2 Mergers And Acquisitions

M&A deals are often used as a measure of risk-taking as managers have the incentive to pursue acquisitions when they are exposed to less monitoring. In light of this, I examine whether firms are more likely to engage in corporate acquisitions as well as whether the size of acquisitions increases following the UD adoption. I rely on the M&A data extracted from the SDC database and construct two variables or interest, *Acquiror* and *Deal Value/Mkt Cap*. *Acquiror* is an indicator variable that

equals one if a firm acquires a target firm in a given year, zero otherwise. It captures firms' likelihood of expanding through acquisitions. *Deal Value/Mkt Cap* is calculated using the sum of the values of all M&A deals a firm has in one year, scaled by the firm's market capitalization. This variable captures the size of a firm's acquisitions of a given year.

Panel A in Table 7 presents the evidence that UD adoption leads to an increase in both the likelihood and the size of acquisitions. Column (1) and (2) show the regression results on a firm's chance of being an acquiror, and Column (3) and (4) demonstrate the results on the total size of a firm's acquisitions. All coefficients of the UD indicators are significantly positive. After controlling for firm and state characteristics, there is a 4.71 percentage point increase in a firm's likelihood of going through an acquisition, which amounts to a 13.28% increase of a pre-treatment standard deviation. Similarly, firms' sizes of acquisitions increase by 1.59 percentage points after including controls, which indicates a 12.12% increase of a pre-treatment standard deviation.

One can argue that the increase in takeover activities is not necessarily a manifestation of risk-taking. In fact, it is possible that managers resort to diversifying M&A deals in order to reduce risk (Gormley and Matsa (2016)). I therefore follow the literature (e.g. Gormley and Matsa (2016); Ni and Yin (2018)) and categorize all the M&A deals into diversifying M&As and non-diversifying M&As. To be specific, I define a non-diversifying M&A if the acquiror and target have the same prime SIC code, and define all other deals as the diversifying ones. According to my conjecture, as managers are inclined to undertake excessive risk following the UD adoption, we should see an increase in firms' non-diversifying deals. Note that I do not rule out the possibility of a firm engaging in diversifying deals, since the UD adoption increases the overall M&A efficiency by eliminating managers' need to make suboptimal merger decisions (Chu and Zhao (2015))

Panel B and C in Table 7 present the results of my analysis. As Panel B shows, firms' sizes of diversifying acquisitions increase significantly after the UD adoption. However, the likelihood of a firm being an acquiror in a diversifying M&A remains almost unchanged. This indicates that firms are more likely to carry out larger diversifying M&A deals compared with the pre-UD period. Regarding the non-diversifying M&As, there is an increase in both the probability and size of acquisitions. This confirms my conjecture that firms undertake more risk following the UD adoption, and conducting horizontal mergers is one of the many strategies managers pursue.

5.1.3 Over-Investment in Labor

To what extent can the risk-taking driven expansion explain the employment growth? In order to test whether the capital investment is fully responsible for the labor force expansion, I follow Benmelech, Bergman, and Seru (2021) and include investment-related variables as controls in the baseline regression. In particular, I control for the contemporary changes in investment (*Investment Growth*) and the current year investment (*Investment*) to capture firms' direct capital investment; I also control for the indicator of whether a firm acquires a target in a given year (*Acquiror*) and the size of acquisitions (*Deal Value/Mkt Cap*) as a measure of firms' M&A activities. If the increased investment and M&As can fully explain the employment growth, the corresponding control variables should absorb the effect and the coefficient of UD should be approximately zero and insignificant.

Table 8 reports the results of this analysis. In Column (1)-(2), I include investment-related controls aside from other firm-level and state-level control variables. As is expected, the coefficients of *Investment* and *Investment Growth* are both significant and positive, suggesting that capital investment contributes to the employment growth. In Column (3)-(4), I further include the M&A measures. Similarly, the coefficients of M&A-related controls are also positive and significant. This coincides with the expectation that firms' labor force expand after acquiring targets' employees. Most importantly, the inclusion of these extra controls barely affects the statistical significance of the UD indicator, with only a slight drop in the economic magnitude. This result provides further support for the positive effect of UD adoption on firms' employment, and infers that there exists other channels apart from managers' risk-taking behaviors.

5.2 Increased Demand for High-Skilled Labor

In this section, I explore the underlying channel that contributes to the part of the UD induced increase in workforce that cannot be explained by the investment expansion. Specifically, I explore whether firms increase hiring and change the structure of their labor force due to the increased innovation activities. The UD adoption stimulates firms to undertake more R&D activities as a result of reduced litigation risk. In the presence of UD laws, managers no longer need to worry about being sued if there is a failure in innovation and if this further leads to a unrealized short-term earning goal. As an important input of innovation, high-skilled labor would be more in demand following the UD adoption, which may spur a shift in the component of firms' workforce. Due to the data limitation, it is impossible to directly measure the proportion of high-skilled labor for each firm. I therefore follow Borisov, Ellul, and Sevilir (2021) and rely on four industry-specific measures

of human capital intensity to examine whether firms operating in those industries experience a higher employment growth following the UD adoption. All of the four measures are at the 3-digit SIC industry level.

I construct the first industry-specific measure of human capital intensity following Borisov, Ellul, and Sevilir (2021). As wage is correlated with skill, I use the average annual wage for each industry from the Occupational Employment and Wage Statistics (OEWS) as a proxy for industry-level skill. Since the OEWS survey began using the Office of Management and Budget (OMB) Standard Occupational Classification (SOC) system in 1999, I collect the wage data starting from 1999. Moreover, the survey used SIC as the industry classification code before 2002 and switched to NAICS afterwards. Given that the industry codes used in this paper are SIC codes, I rely on the average wage data collected from 1999 to 2001 for all occupations within each industry to rank the industries. I classify the industries with the average annual wage in the top tercile as the human capital intensive industry and define the indicator *High Skill* as one if a firm operates in such an industry, zero otherwise.

The second measure of human capital intensity is similar to the first one, but exploits the data on the proportion of skilled worker in each industry. Specifically, *Management Occupations*, *Computer and Mathematical Occupations*, *Architecture and Engineering Occupations*, and *Life, Physical, and Social Science Occupations* are often considered as human capital intensive occupations. I again employ the OEWS data and calculate the total percentage of workers in high-skilled occupations for each industry. I then define the *High Skill Percentage* indicator equals one if an industry's high-skilled worker proportion is in the top tercile, zero otherwise.

The last two measures use the industry-level innovation inputs and outputs to categorize industries that rely more on human capital. In particular, using the average R&D expenditure of each industry, I assign the indicator *High R&D* of value one if an industry's R&D expenditure is in the top tercile of the sample, zero otherwise. In a similar vein, the fourth human capital intensity measure, *High Patents*, relies on the average number of patents in an industry. If an industry's number of patents is in the top tercile of the sample, *High Patents* equals one, zero otherwise.

Table 9 presents the results of cross-sectional analysis. I augment the baseline regression by including the interaction terms of the UD indicator and the industry-level human capital intensity measures. Of all the four measures, three of the corresponding interaction terms have positive and significant coefficients. This indicates that human capital intensive industries are more inclined to experience a boom in employment growth following the UD adoption. This is consistent with

the view that UD laws affect firms' employment policies through stimulating corporate innovation, which eventually leads to an increase in firms' demand for high-skilled labor.

5.3 Labor Investment Inefficiency

As discussed in the previous section, firms expand their workforce following the UD adoption due to managers' risk-taking behaviours as well as firms' increased demand for high-skilled labor. However, the analysis does not shed light on whether this expansion in workforce is efficient or not. If managers avoid risky but value-enhancing projects before the UD adoption, the resultant increase in employment growth would be efficient. For instance, managers could be reluctant to innovate due to the potential litigation risk, then the UD adoption would mitigate this concern and leads to a healthy expansion in firms' workforce. Nevertheless, if the UD laws stimulate managers to take excessive risks and over-invest, the subsequent workforce expansion would be inefficient. In this section, I aim to answer this question.

I examine the overall efficiency of firms' labor investment exploiting the labor demand model proposed by Pinnuck and Lillis (2007). The model takes into account of an extensive list of firm-specific characteristics and has been widely used in the literature (e.g., Khedmati, Sualihu, and Yawson (2020); Ghaly, Dang, and Stathopoulos (2020)). The model is defined as below:

$$\begin{aligned} Emp\_Growth_{it} =& \alpha + \beta_1 Sales\_Growth_{it} + \beta_2 Sales\_Growth_{i,t-1} + \beta_3 Profit_{it} + \beta_4 \Delta Profit_{it} + \\ & \beta_5 \Delta Profit_{i,t-1} + \beta_6 Return_{it} + \beta_7 Size_{i,t-1} + \beta_8 Quick\_Ratio_{i,t-1} + \\ & \beta_9 \Delta Quick\_Ratio_{i,t-1} + \beta_{10} \Delta Quick\_Ratio_{it} + \beta_{11} Leverage_{i,t-1} + \\ & \Sigma_{l=1}^{5} \delta_l Loss\_Bins_{itl} + \gamma_j + \epsilon_{it} \end{aligned} \tag{2}$$

where i, j, t denotes firm, industry, and year, respectively. Emp_Growth represents the percentage change in a firm's number of employees. Similarly, $Sales\_Growth$ denotes the percentage change in a firm's sales. $Profit$ is the net income scaled by beginning-of-year total assets, and $\Delta Profit$ is the change in net income scaled by beginning-of-year total assets. $Return$ represents the total annual stock return for the given fiscal year. $Size$ is the market value of equity ranked into percentiles. $Quick\_Ratio$ is the ratio of cash and short-term investments plus receivables over current liabilities. $Leverage$ is calculated using the total debt divided by total assets. $Loss\_Bin_{itl}$ is defined as a dummy variable that equals one if a firm's $Profit$ falls in the corresponding 0.005 interval between -0.025 and 0.[11] The model also includes γ_j as the industry fixed effects to control for unobserved

[11] For instance, $Loss\_Bin_{it1}$ takes the value one if the profit of firm i in year t is between -0.005 and 0.

industry characteristics.

I rely on this labor demand model to estimate firms' expected employment growth, which is the fitted value of the regression. The inefficiency of firms' labor investments is measured as the absolute value of the difference between firms' actual hiring and expected hiring, which is exactly the regression residual - the unexplained portion of employment growth from the model.[12] The regression results of this labor demand model are reported in Table B.3.

Table 10 presents the results regressing the labor investment inefficiency proxy on the UD indicator. There is a significant increase in labor investment inefficiency after the UD adoption, suggesting that firms are over-investing in labor. This suggests that the overall effect of UD laws on firms' employment is inefficient - the dark side of managers' risk-taking behaviors outweighs the innovation gains.

6 Additional Analysis And Robustness Checks

6.1 Additional Analysis on Confounding Factors

In this section, I extend the analysis by exploring potential omitted factors that may affect firms' employment growth and confound the results.

First, the underlying mechanisms driving the employment growth following the UD adoption can be affected by corporate governance. For instance, firms with better governance may suffer less from agency conflicts and are less prone to over-invest in labor, which would affect the results. I therefore include four governance indicators in the regression, firms' institutional ownership, institutional ownership concentration (IO HHI), E index, and G index. The institutional ownership is measured as the sum of a firm's total institutional holdings, whilst the institutional ownership concentration is calculated as the Herfindahl-Hirschman index of ownership. The E index and G index are obtained from the data used in Bebchuk, Cohen, and Ferrell (2009) and Gompers, Ishii, and Metrick (2003). Note that the E index and G index are only available for approximately every three years from 1990 to 2006, I exploit the conventional method used in the literature and fill in the missing values with the nearest non-missing values.

Panel A of Table 11 reports the regression results controlling for corporate governance proxies. Column (1) and (2) control for firms' overall institutional ownership and IO HHI; Column (3) and (4) include firms' E index whilst the last two columns control for G index. As is shown in the table,

[12]To better capture firms' labor investment inefficiency (e.g., to obtain a more accurate firm size ranked in percentile), I apply this model using the data merged from Compustat and CRSP before omitting firms with no accurate historical state of incorporation data from the EDGAR filings.

the UD adoption continues to play a significant role in firms' employment growth. This suggests that the effect of UD laws on employment is not sensitive to controlling for various governance measures.

Second, I proceed to examine if firms' employment growth is affected by other state laws. The timing of UD adoption overlaps with some of the state-level anti-takeover laws, which may obscure the results. Moreover, the passage of anti-takeover laws, by strengthening firms' takeover defenses, can also affect corporate labor investment. For instance, with the anti-takeover laws being enacted, managers are protected from takeovers and may thus seek a "quiet life", (Bertrand and Mullainathan (2003)), which would bias my results. To address this issue, I follow Ni and Yin (2018) and Chu and Zhao (2015) and control for all the confounding law changes in the state-level anti-takeover legal regime documented in Karpoff and Wittry (2018). To be specific, I include the control share acquisition laws (CS), business combination laws (BC), fair price laws (FP), directors' duties laws (DD), and poison pill laws (PP). Similar to the UD indicator, I generate an indicator variable for each anti-takeover law and define it as one once a state passes the law, and zero otherwise. If the increase in employment growth is driven by these laws, the coefficient of the UD indicator should no longer be significant once these laws are controlled for.

Panel B of Table 11 reports the corresponding results. In Column (1)-(5), each column controls for one anti-takeover law; Column (6) includes all the anti-takeover laws in the regression. Across all the specifications, I include firm-level and state-level characteristics. I also control for firm fixed effects and industry*year fixed effects. The coefficients of the UD indicator remain significant in all columns, suggesting that the results are not driven by state-level anti-takeover laws.

6.2 Robustness Checks

I next proceed to carry out a battery of robustness checks and present the results in Table 12. I first address the potential endogeneity issue of the UD adoption by narrowing down the treated states to including only Pennsylvania. Pennsylvania is the only state where the UD was adopted by the Supreme Court - its UD adoption can therefore be deemed as a clean shock without concerns over lobbying. Although evidence on the exogeneity of the timing of UD adoption relative to employment growth has been demonstrated in section 2.2, this test can further mitigate the endogeneity concern. Column (1) and (2) in Table 12 present the regression results. The coefficients of the UD indicator remain significantly positive, suggesting a solid causal effect.

Second, I refine my sample with only the control states that have closely followed the MBCA

(Appel (2019)), whilst the treated states remain the same as those in the main analysis.[13] Given that the UD adopted by many states are originated from MBCA, the previous findings can be subject to spurious correlation. The regression results using this refined sample are reported in Column (3) and (4). The effect of UD is still positive and statistically significant, suggesting that the previous results can not be attributed to the latent effect of MBCA.

Third, the effect of UD on employment growth can be confounded by legal changes regarding other types of shareholder litigations. For instance, a ruling by the Ninth Circuit in 1999 is often viewed as a shock for the class action litigations (Crane and Koch (2018); Chu (2017)).[14] After 1999, firms incorporated in states that are covered by the Ninth Circuit are more protected from class action lawsuits due to the increased difficulty in their initiation.[15] I subsequently control for this Ninth Circuit ruling in the regression and present the results in Column (5) and (6). As is shown by the results, the effect of UD is not absorbed by the Ninth Circuit ruling, which further verifies the main results.

I also conduct robustness checks addressing the "Delaware Effect". Previous studies have shown that Delaware corporate law improves firm value (Daines (2001)). Given that firms often make the decision on incorporation based on corporate laws such as anti-takeover statutes (Bebchuk and Cohen (2003)), many firms choose to incorporate in Delaware regardless of their headquarter states. This yields a sample with over half of the public firms incorporated in Delaware, which may introduce the "Delaware Effect" bias to my results. I therefore exclude all the firms that are incorporated in Delaware to alleviate this concern. As is shown in Column (7) and (8), the effect of UD remains positive and significant after restricting the sample in this manner.

Note that the UD laws are determined by the state of incorporation, which is similar to the Business Combination Laws exploited in Bertrand and Mullainathan (2003). This allows the comparison between firms that are headquartered in the same state but are incorporated in different states, and are thus subject to different legislations. I therefore include headquarter state*year fixed effects in the baseline regression to rule out possible noise introduced by regional economic shocks. Column (9) and (10) report the results. There is still a positive and significant effect of UD laws on firms' employment growth, indicating that my results are not affected by the inclusion of different fixed effects.

[13] These states are specifically AL, CO, IL. KY, MD, NM, ND, OR, SC, TN, and WA.

[14] See the Silicon Graphics case.

[15] States that are covered by the Ninth Circuit are Alabama, Arizona, California, Hawaii, Idaho, Nevada, Oregon, and Washington.

7 Conclusion

Despite the debate over the frivolity of shareholder litigations, recent literature has documented their real effects on various corporate issues ranging from governance mechanisms to financing and innovation strategies (e.g., Appel (2019); Nguyen, Phan, and Sun (2018); Lin, Liu, and Manso (2021)). In this paper, I study the relationship between derivative litigations and firms' employment growth. For identification, I exploit the staggered passage of the U.S. state-level Universal Demand laws as a quasi-natural experiment and adopt a difference-in-difference setting. The UD laws bring forward procedural hurdles in initiating a derivative lawsuit, which mitigates firms' litigation risk. This allows me to investigate how the threat of litigation affects corporate hiring.

My findings highlight a negative relationship between litigation risks and firms' employment growth - firms hire more after their states of incorporation adopt the UD laws. I also explore the channels that could explain this observed relation. First, the UD adoption leads to a deterioration of corporate governance and exacerbates agency conflicts. As a result, managers are prone to undertake excessive risks and engage in risk-taking projects. My findings suggest that firms increase their investment, innovation, and M&As following the UD adoption, which can partially explain the employment growth. Second, firms' increased innovation activities indicate a potential shift in the labor component, where high-skilled labor is more in demand. Specifically, I find that firms operating in human capital intensive industries experience larger workforce expansion compared with firms from other industries.

Overall, this paper contributes to the ongoing debate on shareholder litigations by building a bridge between the litigation literature and the labor literature. My findings emphasize the unintended effect of legal changes regarding shareholder litigations on corporate employment growth. Although the reduced threat of litigation expands firms' labor force, it brings inefficiency and may harm shareholders' interests in the long run.

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Table 1. Identifying Assumption: UD Laws And Litigation

This table shows the results of the test for the identifying assumption - whether the UD adoption effectively reduces firms' litigation risk. Column (1) and (2) report the effect of UD laws on derivative lawsuits. In these two specifications, the dependent variable is an indicator that equals one if a firm has a derivative lawsuit in that year, zero otherwise. Column (3) and (4) report the results of the firm-level regression on class action lawsuits, where the dependent variable is an indicator that equals one if a firm has a class action lawsuit in that year, zero otherwise. Firm and industry*year fixed effects are controlled for; in some specifications state-level and firm-level controls are included. *UD* is a dummy variable indicating whether a state has enacted the UD laws. All standard errors are clustered by the state of incorporation and are reported in parentheses.

	Litigation Risk			
	Derivative Lawsuits		Class Action	
	(1)	(2)	(3)	(4)
UD	-0.0124***	-0.0120***	0.0045	0.0044
	(0.0037)	(0.0032)	(0.0032)	(0.0036)
Leverage		0.0046		-0.0043
		(0.0049)		(0.0039)
Size		0.0136***		0.0193***
		(0.0012)		(0.0021)
Tangibility		0.0251**		-0.0064
		(0.0115)		(0.0079)
ROA		-0.0107***		-0.0087*
		(0.0030)		(0.0052)
Unemployment Rate		-0.0013		0.0027
		(0.0026)		(0.0025)
Union Coverage		0.0005		-0.0006
		(0.0006)		(0.0007)
GDP		0.0034		-0.0016
		(0.0026)		(0.0030)
Observations	38737	38737	38260	38260
R^2	0.223	0.225	0.205	0.209
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 2. Descriptive Statistics

This table shows the descriptive statistics for the full sample excluding states that passed the UD laws before the sample begins. The sample period spans from 1994 to 2010. All continuous variables are winsorized at 1% level.

	Mean	Median	SD	Obs
Employment Growth Measures				
Emp_Growth	0.0908	0.0293	0.3517	46821
Log_Emp_Growth	0.0467	0.0290	0.2766	46813
Sym_Emp_Growth	0.0310	0.0231	0.2457	39996
Firm-Level Variables				
Leverage	0.2174	0.1754	0.2141	46821
Size	5.5381	5.4304	2.0102	46821
Tangibility	0.2643	0.1913	0.2270	46821
ROA	0.0505	0.1065	0.2280	46821
Investment	0.3648	0.2238	0.4577	46380
R&D Expense	0.2649	0.0026	1.2265	46426
Deal Value	0.0437	0.0000	0.1514	46801
Acquiror	0.1838	0.0000	0.3873	46821
State-Level Variables				
Unemployment Rate	4.8516	4.4583	1.5553	46821
Union Coverage	14.9499	14.1000	3.9334	46821
GDP	11.5847	11.0112	1.1163	46821

Table 3. The Effect of UD Laws on Employment Growth

This table reports the results of my baseline regressions. *UD* is a dummy variable indicating whether a state has enacted the UD laws. I include firm fixed effects and industry*year fixed effects. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Employment Growth		
	(1)	(2)	(3)
UD	0.0524**	0.0482***	0.0487***
	(0.0205)	(0.0174)	(0.0174)
Leverage		-0.2041***	-0.2045***
		(0.0249)	(0.0251)
Size		-0.1353***	-0.1353***
		(0.0067)	(0.0067)
Tangibility		-0.3223***	-0.3228***
		(0.0290)	(0.0289)
ROA		0.2453***	0.2452***
		(0.0121)	(0.0121)
Unemployment Rate			0.0056
			(0.0040)
Union Coverage			0.0021
			(0.0013)
GDP			-0.0052
			(0.0054)
Observations	38737	38737	38737
R^2	0.293	0.332	0.332
Firm FE	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes

Table 4. The Effect of UD Laws on Employment Growth - Additional Measures

This table reports the results of my baseline regressions using two additional measures of employment growth, *Log_Emp_Growth* and *Sym_Emp_Growth*. *Log_Emp_Growth* is measured as the difference between the log value of the numbers of employees at year t and $t-1$. *Sym_Emp_Growth* denotes the symmetric employment growth and is calculated as the ratio of the difference of numbers of employees between year t and $t-1$ over one half of the sum of these two years' numbers of employees. Column (1)-(2) show the results using *Log_Emp_Growth* as the dependent variable, whilst Column (3)-(4) present the regression results on *Sym_Emp_Growth*. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Employment Growth			
	Log_Emp_Growth		Sym_Emp_Growth	
	(1)	(2)	(3)	(4)
UD	0.0349*	0.0323**	0.0318*	0.0295**
	(0.0173)	(0.0147)	(0.0168)	(0.0143)
Observations	38731	38731	38737	38737
R^2	0.302	0.340	0.309	0.347
Controls	No	Yes	No	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 5. The Effect of UD Laws on Employment Growth - Matched Sample

This table reports the results of regressions on how firms' employment growth is affected by UD adoption using the matched sample. In this sample, each treated firm is matched with one control firm based on leverage, size, asset tangibility, and ROA. Panel A reports the summary statistics of both the treated and control firms. The differences between the means of the treated and control firms are shown in Column (5), whilst the p-values are reported in Column (6). Panel B reports the regression results using the main dependent variable *Emp_Growth* as well as the two additional measures *Log_Emp_Growth* and *Sym_Emp_Growth*. The regressions control for various fixed effects and include firm-level and state-level controls such as leverage, size, tangibility, ROA, unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Matched Sample					
	(1)	(2)	(3)	(4)	(5)	(6)
Panel A	Treated Firms		Control Firms		Difference	
	Mean	Median	Mean	Median	Diff	p
Leverage	0.198	0.170	0.199	0.163	0.001	0.958
Size	4.997	4.837	4.842	4.631	-0.155	0.266
Tangibility	0.327	0.242	0.323	0.254	-0.004	0.831
ROA	0.104	0.125	0.108	0.127	0.005	0.684
Emp_Growth	0.092	0.033	0.101	0.040	0.009	0.725
Log_Emp_Growth	0.055	0.032	0.066	0.039	0.012	0.565
Sym_Emp_Growth	0.015	0.019	0.032	0.019	0.017	0.335
Panel B	Emp_Growth		Log_Emp_Growth		Sym_Emp_Growth	
UD	0.0513***	0.0513***	0.0284**	0.0282*	0.0239*	0.0231
	(0.0157)	(0.0166)	(0.0133)	(0.0143)	(0.0134)	(0.0142)
Observations	4513	4513	4511	4511	4513	4513
R^2	0.379	0.408	0.383	0.413	0.393	0.425
Control Variables	No	Yes	No	Yes	No	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes	Yes	Yes

Table 6. Channels: Risk-Taking I

This table reports the regression results of the UD adoption's effect on corporate investment. *Investment* is measured as the ratio of CAPEX over the beginning-of-year PPE . *R&D* is calculated as the ratio of the R&D expenditure over firms' total assets. Column (1)-(2) show the results using *Investment* as the dependent variable, whilst Column (3)-(4) present the regression results on *R&D*. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Investment		*R&D*	
	(1)	(2)	(3)	(4)
UD	0.0368**	0.0272**	0.0730**	0.0603**
	(0.0178)	(0.0133)	(0.0302)	(0.0278)
Observations	38405	38405	38464	38464
R^2	0.385	0.459	0.721	0.726
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 7. Channels: Risk-Taking II

This table reports the regression results of the UD adoption's effect on M&As. *Acquiror* is a dummy variable that equals one if a firm has acquired a target in a given year, and *Deal Value/Mkt Cap* denotes the total value of all the acquisitions a firm goes through in one year divided by its market capitalization. Panel A shows the regression results using all the M&A deals when calculating the dependent variables. Panel B focuses on diversifying M&As, where only deals with different prime SIC industries of the acquiror's and target's are included. Panel C only includes non-diversifying M&As, and I define them as the rest of M&A deals apart from those in Panel B. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Acquiror		*Deal Value/Mkt Cap*	
	(1)	(2)	(3)	(4)
Panel A: All M&A				
UD	0.0490**	0.0471*	0.0165***	0.0159***
	(0.0240)	(0.0259)	(0.0044)	(0.0045)
Observations	38737	38737	38722	38722
R^2	0.306	0.313	0.263	0.273
Controls	No	Yes	No	Yes
Panel B: Diversifying M&A				
UD	0.0169	0.0157	0.0112***	0.0109***
	(0.0157)	(0.0154)	(0.0029)	(0.0031)
Observations	38737	38737	38722	38722
R^2	0.304	0.309	0.268	0.275
Controls	No	Yes	No	Yes
Panel C: Non-Diversifying M&A				
UD	0.0303**	0.0294*	0.0037*	0.0036*
	(0.0138)	(0.0147)	(0.0020)	(0.0020)
Observations	38737	38737	38722	38722
R^2	0.275	0.278	0.244	0.247
Controls	No	Yes	No	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 8. Over-Investment in Labor Compared with Capital

This table reports the regression results of UD adoption's effect on employment controlling for firms' capital investment as well as M&A deals. Column (1)-(2) include measures of firms' direct capital investment. *Investment* is measured as the ratio of CAPEX over the beginning-of-year PPE . *Investment Growth* is calculated as the percentage increase in firms' investment. Column (3)-(4) further include M&A related controls. *Acquiror* is a dummy variable that equals one if a firm has acquired a target in a given year, and *Deal Value/Mkt Cap* denotes the total value of all the acquisitions a firm goes through in one year divided by its market capitalization. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Employment Growth			
	(1)	(2)	(3)	(4)
UD	0.0452***	0.0461***	0.0389***	0.0404***
	(0.0140)	(0.0146)	(0.0135)	(0.0118)
Investment	0.2422***	0.1987***	0.1911***	0.1925***
	(0.0073)	(0.0062)	(0.0065)	(0.0066)
Investment Growth		0.0165***	0.0157***	0.0158***
		(0.0015)	(0.0015)	(0.0015)
Acquiror			0.1736***	
			(0.0049)	
Deal Value/Mkt Cap				0.5037***
				(0.0168)
Observations	38405	38197	38197	38182
R^2	0.382	0.384	0.414	0.422
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 9. Channels: Human Capital

This table reports the results of the cross-sectional analysis with respect to industry-level human capital intensity. Specifically, I construct four measures of industry-level human capital intensity and categorize an industry as human capital intensive if its value of the measure is in the top tercile of the sample. *High Skill* exploits the average annual wage of an industry as the proxy for the corresponding skill level. *High Skill Percentage* relies on the proportion of high-skilled labor of each industry as a measure of human capital intensity. *High R&D* uses the averaged industry R&D expenses as the proxy whilst *High Patents* uses the averaged industry number of patents. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Employment Growth			
	(1)	(2)	(3)	(4)
UD	0.0362*	0.0114	0.0290	0.0193
	(0.0195)	(0.0251)	(0.0208)	(0.0290)
UD × High Skill	0.0284			
	(0.0223)			
UD × High Skill Percentage		0.0612**		
		(0.0263)		
UD × High R&D			0.0324**	
			(0.0153)	
UD × High Patents				0.0462*
				(0.0273)
Observations	36405	36405	38737	38737
R^2	0.327	0.327	0.332	0.332
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes

Table 10. Labor Investment Inefficiency

This table reports the regression results of the UD adoption's effect on firms' labor investment inefficiency. *Labor Investment Inefficiency* captures firms' inefficiency in labor investing and is measured as the absolute value of residuals of the labor demand model used in the literature (e.g., Pinnuck and Lillis (2007); Ghaly, Dang, and Stathopoulos (2020); Khedmati, Sualihu, and Yawson (2020)). *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Labor Investment Inefficiency		
	(1)	(2)	(3)
UD	0.0341***	0.0328***	0.0334***
	(0.0047)	(0.0047)	(0.0044)
Leverage		-0.0630***	-0.0631***
		(0.0110)	(0.0109)
Size		-0.0431***	-0.0431***
		(0.0019)	(0.0019)
Tangibility		-0.1128***	-0.1133***
		(0.0183)	(0.0180)
ROA		-0.0447***	-0.0447***
		(0.0129)	(0.0129)
Unemployment Rate			0.0009
			(0.0033)
Union Coverage			0.0022***
			(0.0008)
GDP			-0.0015
			(0.0028)
Observations	37193	37193	37193
R^2	0.351	0.362	0.362
Firm FE	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes

Table 11. The Effect of UD Laws on Employment Growth - Controlling for Confounding Factors

This table reports the regression results of UD adoption's effect on employment growth after controlling for confounding factors. In Panel A, various corporate governance proxies are included. Column (1)-(2) include firms' total institutional ownership and IO concentration as measures of corporate governance; Column (3)-(4) exploit the E index whilst Column (5)-(6) use the G index. In Panel B, different anti-takeover laws are controlled for to mitigate the concern that the employment growth is not driven by UD laws. *CS Law*, *BC Law*, *FP Law*, *DD Law*, *PP Law* are indicators for anti-takeover laws that equal one if a state has passed the corresponding law, zero otherwise. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Employment Growth					
	(1)	(2)	(3)	(4)	(5)	(6)
Panel A: Corporate Governance						
UD	0.0417***	0.0343***	0.0395**	0.0328**	0.0308**	0.0270**
	(0.0135)	(0.0114)	(0.0155)	(0.0127)	(0.0146)	(0.0110)
Institutional Ownership	0.0515***	0.1118***				
	(0.0080)	(0.0082)				
IO HHI	-0.0127	-0.0774***				
	(0.0133)	(0.0240)				
E Index			0.0045	0.0060		
			(0.0037)	(0.0037)		
G Index					-0.0025	-0.0005
					(0.0023)	(0.0022)
Observations	29735	29735	16084	16084	13555	13555
R^2	0.344	0.384	0.350	0.389	0.349	0.388
Controls	No	Yes	No	Yes	No	Yes
Firm*Cohort FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year*Cohort FE	Yes	Yes	Yes	Yes	Yes	Yes
Panel B: Anti-Takeover Laws						
UD	0.0488***	0.0547***	0.0487***	0.0487***	0.0489***	0.0551***
	(0.0174)	(0.0107)	(0.0174)	(0.0171)	(0.0171)	(0.0104)
CS Law	0.0308					0.0379
	(0.0590)					(0.0866)
BC Law		-0.0316				-0.0328
		(0.0249)				(0.0248)
FP Law			0.0085			-0.0043
			(0.0287)			(0.0557)
DD Law				0.0011		0.0079
				(0.0204)		(0.0216)
PP Law					-0.0034	-0.0105
					(0.0143)	(0.0156)
Observations	38737	38737	38737	38737	38737	38737
R^2	0.332	0.332	0.332	0.332	0.332	0.332
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes	Yes	Yes

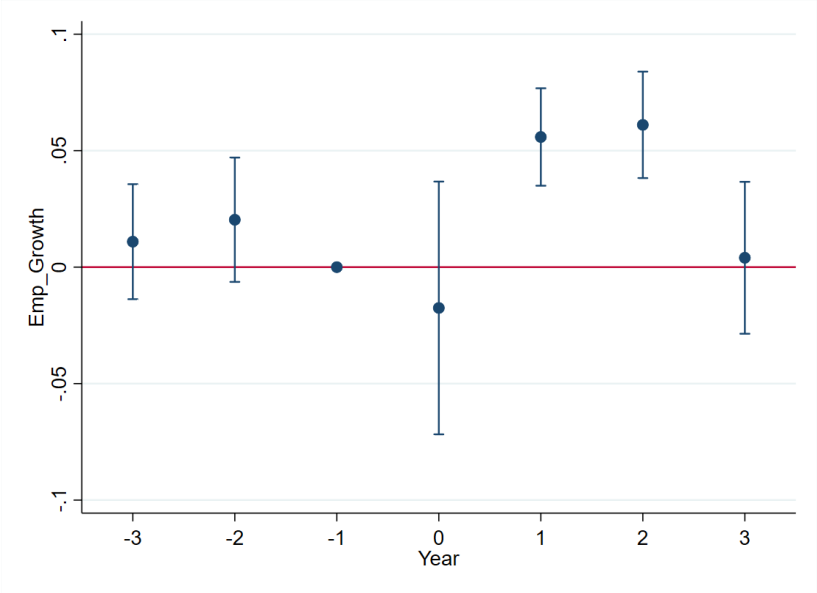
Table 12. Robustness Results

This table presents the results of robustness checks. Column (1)-(2) use only firms that are incorporated in Pennsylvania as treated firms. Column (3)-(4) exclude control states that do not follow MBCA. Column (5)-(6) control for the Ninth Circuit indicator after 1999 to rule out the possibility that the previous results are affected by legal changes with respect to class action lawsuits. Column (7)-(8) omit firms incorporated in Delaware to alleviate the concern over the "Delaware Effect". Column (9)-(10) further include Headquarter_State*Year fixed effects to compare the effects of UD laws between firms that are headquartered in the states but are subject to different legislations. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Various fixed effects and firm-/state-level controls are included across the specifications. Firm-level controls included in the regressions are leverage, size, asset tangibility, and ROA. State-level controls included in the analysis are unemployment rate, union coverage, and real GDP. All standard errors are clustered at the state of incorporation level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

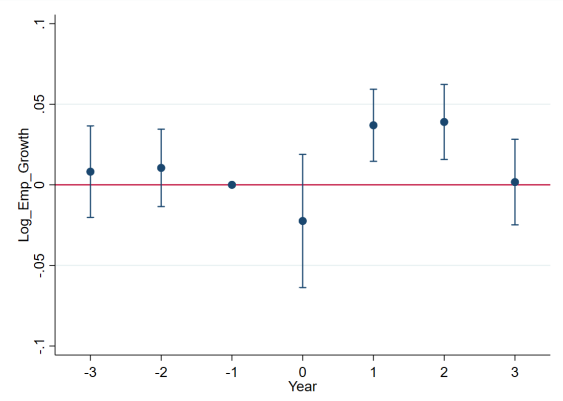
	Employment Growth									
	Only PA		Only MBCA		Ninth Circuit		Excl DE		Hdqt_State*Year FE	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
UD	0.0879***	0.0705***	0.0505***	0.0542***	0.0525**	0.0488***	0.0364**	0.0396**	0.0278**	0.0286**
	(0.0091)	(0.0088)	(0.0157)	(0.0139)	(0.0205)	(0.0174)	(0.0174)	(0.0189)	(0.0136)	(0.0112)
Observations	36042	36042	5153	5153	38737	38737	13407	13407	38617	38617
R^2	0.296	0.335	0.395	0.424	0.293	0.332	0.346	0.378	0.311	0.349
Controls	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry*Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Headquarter_State*Year FE									Yes	Yes

Figure 1: Dynamic Effect of UD Laws

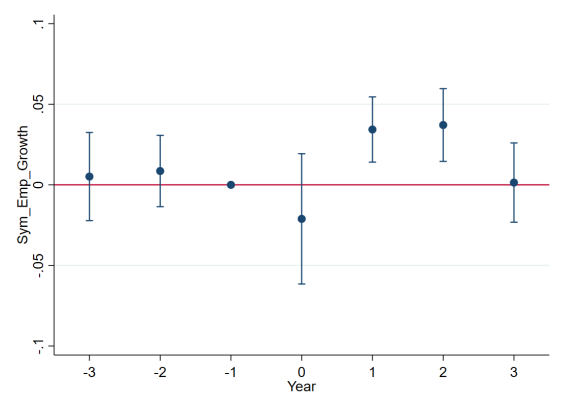
This figure depicts the dynamic effect of UD laws using the method proposed by Sun and Abraham (2021). The graph is plotted using the Stata package eventstudyinteract.



(a)



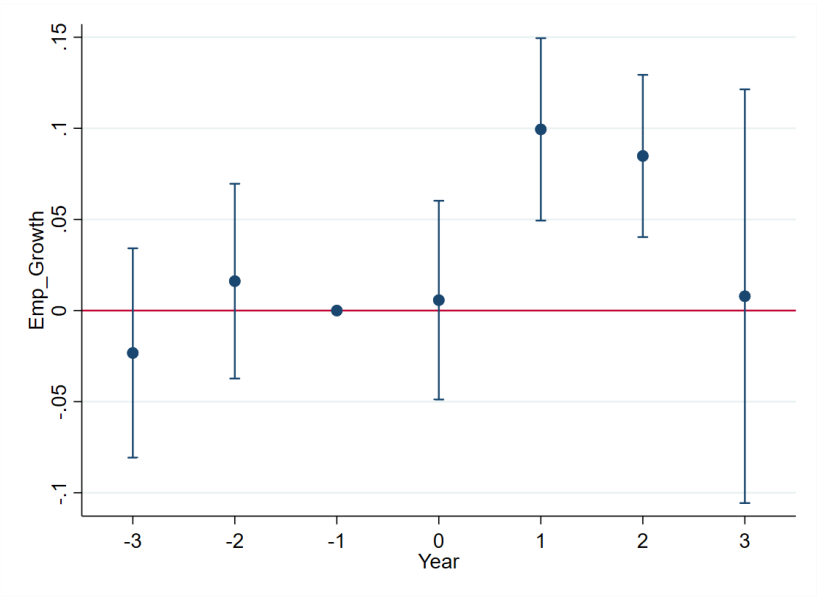
(b)



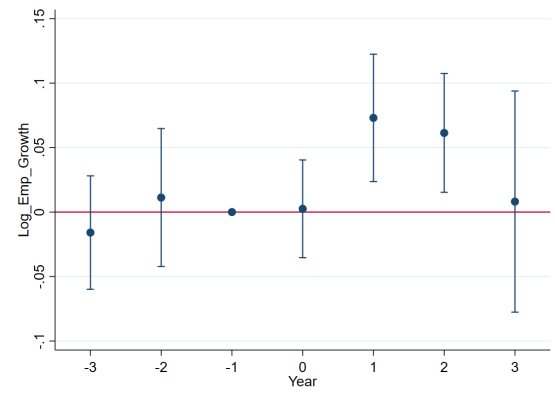
(c)

Figure 2: Dynamic Effect of UD Laws - Matched Sample

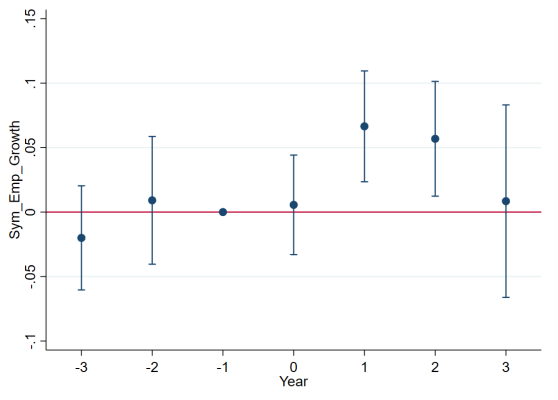
This figure depicts the dynamic effect of UD laws using the method proposed by Sun and Abraham (2021) on the matched sample. There are 327 treated firms and 327 control firms after propensity score matching. The graph is plotted using the Stata package eventstudyinteract.



(a)



(b)



(c)

Appendix A: Universal Demand Laws

Table A.1. The Adoption of Universal Demand Laws

This table provides the details of the timing of UD adoption in different states and their corresponding references.

Year	State	Citation
1989	GA	Ga. Code Ann. §14-2-742
1989	MI	Mich. Comp. Laws Ann. §450.1493a
1990	FL	Fla. Stat. Ann. §607.07401
1991	WI	Wis. Stat. Ann. §180.742
1992	MT	Mont. Code. Ann. §35-1-543
1992	VA	Va. Code Ann §13.1-672.1B
1992	UT	Utah Code. Ann. §16-10a-740(3)
1993	NH	N.H. Rev. Stat. Ann. §293-A:7.42
1993	MS	Miss. Code Ann. §79-4-7.42
1995	NC	N.C. Gen. Stat. §55-7-42
1996	AZ	Ariz. Rev. Stat. Ann. §10-742
1996	NE	Neb. Rev. Stat. §21-2072
1997	CT	Conn. Gen. Stat. Ann. §33-722
1997	ME	Me. Rev. Stat. Ann. 13-C, §753
1997	PA	*Cuker v. Mikalauskas* 692 A.2d 1042
1997	TX	Tex. Bus. Org. Code. Ann. §21.553
1997	WY	Wyo. Stat. §17-16-742
1998	ID	Idaho Code §30-1-742
2001	HI	Haw. Rev. Stat. §414-173
2003	IA	Iowa Code Ann. §490.742
2004	MA	Mass. Gen. Laws. Ann. Ch. 156D, §7.42
2005	RI	R.I. Gen. Laws. §7-1.2-710(C)
2005	SD	S.D. Codified Laws §47-1A-742

Appendix B: Ancillary Results

Table B.1. Descriptive Statistics - Treated Firms Before The UD Adoption

This table shows the descriptive statistics for the treated firms prior to the UD adoption. States that passed the UD laws before 1994 are excluded. Treated firms are those that are incorporated in UD-adopted states. The full sample period spans from 1994 to 2010, but only observations before the UD adoption are included. All continuous variables are winsorized at 1% level.

	Mean	Median	SD	Obs
Emp_Growth	0.0760	0.0234	0.3041	1336
Log_Emp_Growth	0.0423	0.0231	0.2420	1336
Sym_Emp_Growth	0.0237	0.0160	0.2064	948
Leverage	0.1863	0.1230	0.2020	1336
Size	5.1835	5.0447	1.6874	1336
Tangibility	0.2963	0.2130	0.2297	1336
ROA	0.0957	0.1201	0.1580	1336
Investment	0.3406	0.2228	0.3835	1312
R&D Expense	0.1427	0.0128	0.7548	1333
Deal Value	0.0327	0.0000	0.1312	1335
Acquiror	0.1475	0.0000	0.3547	1336

Table B.2. Validity Tests on UD Adoption As An Exogenous Shock

This table shows the results of the validity tests for using UD adoption as a natural experiment. The sample period spans from 1994 to 2010. Column (1) to (4) report the regression results using Weibull hazard model. The dependent variable is the log expected time for the enforcement of UD laws and the main explanatory variables are the employment growth/log value of the employment growth aggregated at state level. In Column (2) and (4), state-level controls such as the unemployment rate, union coverage, and real GDP are included. Column (5) and (6) report the regression results on state of incorporation shopping. The independent variable is the log value of the number of firms incorporated in each state in each year. *UD* is a dummy variable indicating whether a state has enacted the UD laws. Year and state of incorporation fixed effects are included and Column (6) includes state-level controls. All standard errors are clustered by the state of incorporation and are reported in parentheses.

	Timing of the UD Laws				State of Incorp Shopping	
	(1)	(2)	(3)	(4)	(5)	(6)
Mean_Emp_Growth	1.3530	2.4669				
	(2.3924)	(2.4878)				
Mean_Log_Emp_Growth			0.9269	1.7376		
			(2.0452)	(2.0708)		
UD					0.0988	0.0969
					(0.1174)	(0.1117)
Observations	478	478	478	478	619	619
Controls	No	Yes	No	Yes	No	Yes
Year FE					Yes	Yes
Incorp_State FE					Yes	Yes

Table B.3. Model of Labor Demand

This table reports the estimates of the labor demand model used in the literature (e.g., Pinnuck and Lillis (2007); Ghaly, Dang, and Stathopoulos (2020); Khedmati, Sualihu, and Yawson (2020)). The expected sign of each explanatory variable is presented in the column "Expected Sign". All standard errors are clustered at the firm level and are reported in parentheses. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

	Net Hiring	Expected Sign
Sales Growth	.3151***	+
	(0.007)	
L.Sales Growth	.0247***	+
	(0.004)	
Profit	.1792***	+
	(0.010)	
Delta_Profit	-.223***	-
	(0.012)	
L.Delta_Profit	.0414***	+
	(0.010)	
Return	.0409***	+
	(0.002)	
L.Size	.0196***	+
	(0.004)	
L.Quick_Ratio	.0038***	+
	(0.001)	
Delta_Quick_Ratio	-.0159***	+/-
	(0.003)	
L.Delta_Quick_Ratio	.0198***	+
	(0.002)	
L.Leverage	-.0565***	+/-
	(0.006)	
Loss_Bin1	-.0253***	-
	(0.008)	
Loss_Bin2	-.0174**	-
	(0.007)	
Loss_Bin3	-.0254***	-
	(0.009)	
Loss_Bin4	-.0404***	-
	(0.008)	
Loss_Bin5	-.0228***	-
	(0.008)	
Cons	.0134***	+/-
	(0.003)	
Obs	86940	
R_2	0.2507	
Industry FE	Yes	