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Equal Employment Opportunity Law and Firm Profitability

Joni Hersch

ABSTRACT

Based on a sample of 260 cases reported in the Wall Street Journal between 1964 and 1986, this study finds that the equity value of firms charged with violating equal employment opportunity (EEO) laws fell at the time that a suit, decision, or settlement was announced. Most dramatically, the value of firms involved in class action suits fell 15.6 percent on average around the time of the suit. Further, the average loss to shareholders exceeds the amount firms are required to spend to settle the case. This may be due to the expected costs of changing employment practices or to the information about the firm's management that is revealed by the case.

I. Introduction

A staggering number of statutes, amendments, and court decisions regulating equal opportunity in employment have been passed during the past 25 years. Firms found guilty of violations of equal employment opportunity laws have been required to pay millions of dollars in back pay and to alter their employment practices to comply with the laws. This study measures the costs to firms resulting from government and private lawsuits, and the further costs of losing those suits. I address this question by examining changes in the market value of the equity of firms at the time a lawsuit is filed for a violation of an equal employment opportunity (EEO) law and at the time a decision of guilty or a settlement

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is announced. I use the "event-study" methodology pioneered by Fama et al. (1969). This methodology has been used in a variety of applications,¹ but has never been used in the area of discrimination.

A firm's stock price is expected to change in response to a change in stockholders' expectations about the present value of its future cash flows. In particular, a lawsuit charging employment discrimination provides investors with the following information: the firm will face a costly legal defense; if the firm loses the suit it will be required to pay back pay and attorney's fees; and since most firms that are found guilty of discrimination or that make an out-of-court settlement are required to institute an affirmative action program, labor costs may rise as firms are forced to change their employment practices.²

These factors suggest that, if the information is unanticipated, investors would devalue the shares of firms that are sued at the time of the suit. The effects of decisions against the firm and out of court settlements on the value of the firm are less certain. First, even firms that believe they would win a lawsuit may settle to avoid continued and expensive litigation. Second, if the market was expecting an even worse outcome, the announcement of the decision or settlement may represent relatively good news. Third, if discrimination is perceived as inefficient, a settlement which revises the firm's current discriminatory practices may offset the decline in equity value, or even cause stock prices to rise. It should be noted, however, that given the evidence supporting an active market for corporate control, we would not expect employer practices which are systematically inefficient. (See Jensen and Ruback 1983). By examining changes in the market value of firms involved in litigation due to charges of violations of EEO laws, I measure the market's estimation of the total costs of alleged noncompliance, including legal fees, back wages, future changes in employment practices, and any output effects.³

1. Event studies have frequently been used in the finance literature to test the impact on the value of the firm of events such as stock splits, dividend announcements, and stock repurchases. Schwert (1981) explains the use of event studies in measuring the effects of regulation and also provides an extensive bibliography. Binder (1985) tests the impact on stock returns of twenty major changes in regulation. Some other recent applications include strikes (Becker and Olson 1986), OSHA cotton dust standards (Hughes, Magat, and Ricks 1986), environmental quality regulation (Maloney and McCormick 1982), product recalls (Jarrell and Peltzman 1985), and unionization (Ruback and Zimmerman 1984).

2. Other costs include the likelihood of additional lawsuits, the time management must devote to the lawsuit instead of attempting to control costs or find profitable investments, and adverse publicity that might result in the loss of sales or lead to higher wages to compensate workers for disagreeable working conditions.

3. Despite the costs associated with a lawsuit, discrimination may be ex ante profit maximizing, as in the case of customer or coworker discrimination. The firm's ex ante decision will depend on the probability that a suit will be initiated and the magnitude of any sanctions

II. Legal Framework and Data

Three major laws and one executive order which regulate equal rights in employment in the private sector are of interest in this paper. Table 1 summarizes the laws by covered class and administration. Legal proceedings against firms accused of violating EEO laws can be brought by the EEOC, Departments of Labor and Justice, other federal agencies, by state and local agencies, by individuals or groups of individuals, by unions, or as a class action suit.

Because of the number of suits, the variety of agencies and individuals that can sue for discrimination, and the number of courts at which a suit can be filed, there is no single source of lawsuits filed by date. In addition, information about out-of-court settlements is not necessarily publicly available. The sample of firms used in this study is derived from the *Wall Street Journal* for the 1964–86 period. The *Wall Street Journal* reports regularly on a variety of civil rights issues. Articles discussing employment discrimination include updates on the status of new bills and judicial interpretations of the laws, as well as reports of violations of EEO laws. The EEO activities of individual firms are reported mainly for one of two reasons: the firm involved is one of the large publicly traded firms that the *Wall Street Journal* ordinarily tracks, or the event is novel or establishes legal precedent.

In order to use stock return data available on the University of Chicago Center for Research in Security Prices (CRSP) Daily Stock Returns File, the sample is further restricted to firms listed on the New York or American Stock Exchange. Use of the *Wall Street Journal* and CRSP files impose similar restrictions on the extent one can generalize from the sample by providing information primarily on larger firms.

Over 350 articles were printed in the *Wall Street Journal* citing involvements by one or more firms in EEO disputes over the 1964–86 period. The articles include information on suits, settlements, and consent decrees, and decisions by courts and by government agencies with authority to enforce EEO law. After eliminating observations on firms that are not available on CRSP or that lacked stock return data for the relevant period, and six events in which the firm was found not guilty or had the original guilty finding reversed in appeals court, the sample consists of 123 suits, 56 decisions, and 81 settlements. All decisions reported in this paper refer to firms that were found guilty.⁴

imposed if the defense is unsuccessful. I do not examine the ex ante decision, and therefore do not address the deterrent effect of EEO laws.

4. The decisions and settlements in the sample do not necessarily correspond to suits reported earlier. This is partly because there usually is no information on suits that are

Table 1
Legal Framework

Covered Classes	Laws
Race	Title VII of Civil Rights Act of 1964
	Executive Order 11246 (1965)
Sex	Title VII of Civil Rights Act of 1964
	Pregnancy Discrimination Act of 1978
	Equal Pay Act of 1963
	Executive Order 11246 (1965)
Age	Age Discrimination in Employment Act of 1967
Administration	
Law	Agency
Title VII	EEOC; authority to bring civil suits against private employers granted by the Equal Employment Opportunities Act of 1972; "pattern or practice" suits litigated by the Justice Department until March 24, 1974
Executive Order 11246	OFCCP; suits brought by Justice Department or EEOC
Pregnancy Discrimination Act	EEOC
Equal Pay Act	EEOC; Department of Labor until July 1, 1979
Age Discrimination in Employment Act	EEOC; Department of Labor until July 1, 1979

Table 2a
Number of Suits, Decisions, and Settlements by Year^a

Year	Suits	Decisions	Settlements
1964	0	1	0
1965	0	0	0
1966	3	2	0
1967	2	0	0
1968	5	1	0
1969	1	0	2
1970	3	1	1
1971	19	2	0
1972	22	2	2
1973	23	2	7
1974	5	4	13
1975	6	2	1
1976	5	7	2
1977	7	5	7
1978	5	3	8
1979	2	3	3
1980	2	4	13
1981	4	3	7
1982	2	3	5
1983	0	2	2
1984	1	5	1
1985	2	1	0
1986	4	3	7
Total	123	56	81

a. The number of EEOC charges received and suits filed per year are listed in Table 2b.

Table 2a and b summarizes the number of suits, decisions and settlements by year. About half of the suits reported by the *Wall Street Journal* were filed between 1971 and 1973. This period marked a large increase in EEO activity. The EEOC received 162,425 charges in the 1971-73

dropped and partly because of the *Wall Street Journal* selectivity in reporting EEO events. Thus, the number of decisions and settlements does not sum to the number of suits. There are no apparent systematic differences between firms which have both the suit and it's outcome reported, and those that have only the suit or the outcome reported.

Table 2b
EEOC Charges and Suits by Year

Fiscal Year	Number of Charges Received	Number of Suits
1966	8,854	
1967	12,927	
1968	15,058	
1969	17,272	
1970	20,310	
1971	33,214	
1972	51,969	
1973	77,242	116
1974	55,900	86
1975	71,000	180
1976	93,138	484
1977	79,311	241
1978	64,579	188
1979	66,569	208
1980	79,868	326
1981	93,217	368
1982	92,400	164
1983	120,361	136

Many of these suits were settled before going to court: for instance, in 1981, the EEOC won 24 suits and lost 15, while the remainder were settled out of court or dismissed.

period which was more than twice the total number of charges received from its inception in 1965 through 1970. In addition, the EEOC received new power to bring civil suits against private employers when conciliation failed with the passage of the Equal Employment Opportunity Act of 1972. It is noteworthy that an extremely small percentage of charges received by the EEOC result in EEOC suits.

Table 3 summarizes the suits, decisions, and settlements according to charging party and according to covered class. The party that files the suit is considered the charging party. For instance, suits filed by the EEOC on behalf of individuals or classes are classified as EEOC suits.⁵

5. In this sample, only two of the class actions were filed by the EEOC, while the remainder were filed privately.

Table 3
Number of Suits, Decisions, and Settlements by Charging Party and Covered Class

Charging Party ^a	Suits	Decisions	Settlements
Public			
EEOC	45	6	34
Justice	17	3	6
Labor	9	14	5
Other Federal agencies	0	0	4
State agencies	5	8	3
Private			
Class Action	15	13	20
Individual	11	11	6
Unions	2	0	1
Civil rights groups	19	0	2
Covered Class^b			
Race	45	17	27
Sex	30	17	29
Race and sex	27	7	14
Age	15	11	5
Other	4	2	4

a. The charging party was not identifiable for one decision.

b. The covered class was not identifiable for two suits, two decisions, and two settlements.

Firm characteristics for the events in the sample and the monetary awards for decisions and settlements are reported in Table 4. Information on the number of employees, labor expenses, and the equity value of the firm is taken from *Standard and Poor's Compustat* file for 91 percent of the observations, and from *Moody's Manuals* and the *Wall Street Journal* for the remaining observations, when available. Since the unit of analysis is the event, and not the firm, and since larger firms are more likely to be involved in more than one event, the mean values are much larger than the median values. For instance, AT&T and its subsidiaries are represented 10 times in the sample.

Information about the monetary awards, when available, is taken from the *Wall Street Journal*. *Wall Street Journal* articles that did not report monetary awards generally reported some other requirement such as hir-

Table 4
Descriptive Statistics for Selected Characteristics of Events

Variable	Median	Mean	Standard Deviation	N
Number of employees (in thousands)	40.8	121.8	202.7	241
Labor expenses ^a (in millions of 1982\$)	1,075.3	2,201.9	3,207.0	134
Equity value (in millions of 1982\$)	1,666.5	5,828.5	11,795.1	245
Back pay for decisions (in millions of 1982\$)	1.76	8.48	16.6	22
Back pay for settlements (in millions of 1982\$)	1.67	4.91	10.34	61
Affirmative action for decisions	0	0	0	0
Affirmative action for settlements (in millions of 1982\$)	1.45	11.65	29.86	16

a. Labor expenses include salaries, wages, pension costs, profit sharing and incentive compensation, payroll taxes, and other employee benefits.

ing or promotion quotas or goals. The amount of money the firms were required to pay to litigants for back pay and attorney's fees was stated for 39.3 percent of the decisions and 75.6 percent of the settlements. The amount of money the firm was required to spend instituting an affirmative action program was stated in the *Wall Street Journal* article for 19.5 percent of the settlements. The average reported amounts of back pay and affirmative action programs are also given in Table 4.

III. Methodology

In an efficient market any new information is reflected immediately in stock prices.⁶ The event-study methodology pioneered by Fama et al. (1969) adjusts each firm's returns for marketwide movements

6. See Fama (1976) for a review of the literature and evidence in support of this hypothesis.

in stock prices to isolate the component of the returns due to the event under consideration. Using the estimated market model, prediction errors (or abnormal returns) are calculated for each firm on the days of interest. These prediction errors are averaged over all firms, and the statistical significance of the abnormal returns is tested using a t-statistic.

The market model of stock returns is expressed as

$$R_{jt} = \alpha_j + \beta_j R_{mt} + \varepsilon_{jt}$$

where

R_{jt} = continuously compounded daily rate of return for firm j over period t ,

R_{mt} = continuously compounded daily equal weighted market rate of return over period t ,

α_j and β_j are the regression coefficients for the j th firm, and ε_{jt} is a disturbance term of security j over period t , assumed to follow a normal distribution with mean zero and constant variance.

The announcement day is the day that an article announcing the suit, decision, or settlement appeared in the *Wall Street Journal*. Coefficients of the market model are estimated using 70 days of data beginning 100 days before the announcement day. I used the estimated coefficients from the earliest event within a single 200-day trading period for firms with multiple events occurring in overlapping 200-day trading periods. Prediction errors are calculated for each firm for each day in the period $AD \pm 30$, using the equation:

$$PE_{jt} = R_{jt} - (\hat{\alpha}_j + \hat{\beta}_j R_{mt}).$$

The average prediction error is calculated for each day t in the event period as follows:

$$APE_t = \frac{1}{N} \sum_{j=1}^N PE_{jt}, \quad t = AD - 30, \dots, AD + 30$$

where N is the number of events in the sample. The cumulative average prediction error is found by summing the average prediction errors over different periods of time in the event period.⁷

7. The statistical significance of the abnormal returns is tested using the t-statistic from Ruback and Zimmerman (1984, p. 1142) where the variance is calculated using the standard deviations from the pre-event period with a correction for heteroscedasticity, so that less weight is given to the prediction errors of more volatile firms.

IV. Results

Table 5a reports the cumulative abnormal returns and percent negative for various holding periods for suits, decisions, and settlements. The null hypotheses are that the event has no effect on average stock prices; the alternative hypotheses are that suits reduce the equity value of firms, with the effects of decisions and settlements uncertain, for reasons stated in the introduction.

The average abnormal returns on the announcement day are significantly negative at the 2 percent level in one-sided tests for suits, and significantly negative at the 1 percent and 7 percent levels, respectively, in two-sided tests for decisions and settlements. The major effect of suits and settlements appear to occur on the announcement day, with drops in the average value of the firm of 0.48 percent and 0.29 percent respectively.⁸ Average abnormal returns over longer periods are not significantly different from zero.⁹ The main effect of decisions appears to be captured over a four-day event period beginning two days before the *Wall Street Journal* article. The value of the firm drops an average of 1.59 percent over this period which is nearly triple the one day effect. Longer periods around the announcement day for decisions are not significantly different from zero.¹⁰ These results imply that the announcement of an EEO event does have a significant short-run effect on the value of the firm, but that this effect is relatively minor in the longer run when combined with other factors affecting the value of the firm. The estimated loss in 1982 dollars on the announcement day for the combined sample of suits, decisions, and settlements is \$18.5 million.

8. The two-day accumulation period $AD-1, AD$ is of special interest, since if a suit, decision, or settlement occurred before 4:00 p.m. Eastern time, the market may have learned of the event the day prior to the *Wall Street Journal* publication. Relying on *Wall Street Journal* information requires examining both days because a priori it is not possible to determine which day is the announcement day. Since the major impact of suits and settlements occurs on the *Wall Street Journal* publication day, this suggests that at least one of the following conditions are met: 1) most of the announcements occur after 4:00 p.m. Eastern time; 2) the market relies largely on the *Wall Street Journal* for information concerning EEO events; 3) the market uses the publication of EEO news as an indication that the *Wall Street Journal* expects the company to have additional difficulties.

9. An examination of the abnormal returns in the period following the announcement day indicate no clear pattern to when the announcement day losses dissipate. Thus, one could not count on making money by buying stock the day after an EEO event and holding it for a predictable period of time.

10. The average market model parameters for the portfolio, with standard errors in parentheses, are $\hat{\alpha} = -.0001 (.0001)$, $\hat{\beta} = 1.071 (.077)$. Thus, the firms did not outperform the market during the pre-event period, since α is not significantly different from zero, and are not riskier than average, since β is not significantly different from one at the 5 percent level.

Table 5a

Cumulative Average Prediction Errors and Percent Negative over Selected Periods for Suits, Decisions, and Settlements 1964–86 (t-statistics in absolute value in parentheses).

Period	Suits		Decisions		Settlements	
	CAPE(%)	%Neg	CAPE(%)	%Neg	CAPE(%)	%Neg
AD	-.480 (2.08)	66.7	-.598 (3.00)	58.9	-.294 (1.84)	58.0
AD-1, AD	-.243 (.66)	56.9	-.951 (3.13)	60.7	-.197 (.74)	53.8
AD-2, AD+1	-.091 (.24)	55.3	-1.592 (3.30)	66.1	.018 (.21)	50.0
AD-10, AD	-.154 (.12)	56.1	.115 (.22)	49.1	-.728 (1.18)	57.5
AD+1, AD+10	.490 (.87)	47.2	.336 (.38)	46.4	-.123 (.25)	49.4
AD-30, AD+30	.305 (.28)	44.3	2.230 (.42)	46.3	-3.344 (1.20)	58.4
Sample Size	123		56		81	

Table 5b

Cumulative Average Prediction Errors and Percent Negative over Selected Holding Periods for Class Action Events (t-statistics in absolute value in parentheses)

Period	Suits		Decisions		Settlements	
	CAPE(%)	%Neg	CAPE(%)	%Neg	CAPE(%)	%Neg
AD	-1.274 (4.63)	80.0	-.206 (3.42)	61.5	-.611 (2.44)	70.0
AD-1, AD	-1.486 (3.80)	73.3	-.329 (1.04)	61.5	-.710 (1.75)	65.0
AD-30, AD	-8.577 (5.04)	73.3	-.135 (.66)	46.2	.866 (1.03)	50.0
AD+1, AD+30	-7.038 (3.63)	60.0	4.759 (1.27)	46.2	.085 (.35)	57.9
Sample Size	15		13		20	

Class actions form a special case since information is likely to be widely available before the suit is filed, as lawyers talk to a great number of affected people before filing the suit. Table 5b reports the cumulative abnormal return and percent negative over selected holding periods for the 48 private class action events in the sample. Although the sample sizes are small, the findings are dramatic—class action suits are associated with a significantly negative average prediction error of 15.6 percent over the period $AD-30$ to $AD+30$. The average prediction errors for suits are significantly negative both before and after the announcement day. The average prediction errors are significantly negative for decisions and settlements on the announcement day, but are not significantly different from zero over the period $AD-30$ to $AD+30$. Thus it appears that most of the information about the class action was reflected in stock prices at the time of the suit.¹¹

To examine the effect of event characteristics on abnormal returns, I regressed abnormal returns on variables for charging party (public or private), covered class (sex, race, age), year (1972 or later, when the EEOC received authority to litigate), and reported costs of settling decisions and settlements. The estimated models were not particularly powerful and the regression results are not presented here. The results suggest that private suits reduce the value of firms more than suits filed by public agencies. Differences in the effect of public versus private suits are related to shareholders' beliefs about the strength of the case, the likelihood of winning, and access to funding to finance a costly legal battle. A tentative partial explanation for this finding is that since the EEOC has been criticized for undertaking "frivolous" suits and not dropping weak cases, shareholders may consider EEOC suits weaker than private suits.

Oddly, the results also indicate that the value of firms fell less for settlements that reported the amount of back pay required to resolve the decision or settlement. Since the standard errors are large, these results should be interpreted cautiously, but suggest that stockholders feared a worse outcome than the dollar amounts reported.

Averaged over decisions and settlements with reported costs of resolving the event, the average total required expenditure in back pay, attorneys' fees, and affirmative action program in 1982 dollars is \$7.98 million. The average loss to shareholders in 1982 dollars for the corresponding events is \$24.2 million, more than three times the direct costs of settling the suit. Some caveats apply: the total loss to shareholders may be greater than the estimates reported here if there is information leakage prior to

11. The average prediction errors on the announcement day for the sample of suits, decisions, and settlements excluding class action (with corresponding absolute *t*-statistics in parentheses) are $-.370$ (1.64), $-.717$ (3.17), and $-.190$ (1.60) respectively.

the announcement; the actual costs of resolving the event after the appeal process is complete may be larger or smaller than the initial reported amounts; and the standard errors of the loss of shareholders and costs of resolving the suit are large.

V. Discussion

There are two major issues that must be kept in mind in interpreting the results: sample selection and the size of the event window.

For an EEO event to be included in the sample, the firm must have stock prices reported on the CRSP tape and the event must be reported in the *Wall Street Journal*. The first requirement is commonly employed in event studies and restricts the sample to relatively large publicly traded corporations. The restriction to *Wall Street Journal* events is more troublesome. The *Wall Street Journal* covers few EEO events. For instance, the 1983 EEOC *Annual Report* states that the EEOC filed 136 suits in 1983, including suits against Greyhound and Texaco.¹² No suits were reported, however, in the *Wall Street Journal* (nor in the *New York Times*) in 1983. Perhaps the *Wall Street Journal* decided that the suits filed in 1983 were not sufficiently interesting to merit coverage.

Since not all EEO events are covered in the *Wall Street Journal*, it is likely that the events covered are those that may be expected to have the largest impact on the value of the firm. If so, then the average drop in the value of the firm found in this study will exceed the expected loss associated with EEO litigation.

The size of the event window is also an important concern. Since event studies measure changes in stockholder expectations, an article in the *Wall Street Journal* announcing that a firm is involved in EEO litigation will have an effect on stock prices on the announcement day only if this information is unanticipated. If the information is anticipated then a broader event window is necessary to capture the full effect of the event. Given the nature of EEO events, one would expect that the market does have advance notice of pending EEO litigation. The procedure set out by Title VII allows for a maximum of 610 days between the occurrence of the alleged unlawful employment practice and filing of a suit. During this period the EEOC investigates and attempts to conciliate the charge. Once a suit is filed, the process can be prolonged by the usual legal procedures that occur in any civil suit. Although interim information is infrequently

12. The *Annual Report* does not give exact dates for any of the EEOC litigation activities. In addition, only a small number of the firms they are litigating are named. Thus, the information provided by the *Annual Report* is of limited use in an event study.

published by the *Wall Street Journal*, such information is publicly available.

Thus, there is little reason a priori to expect the full effect of EEO action to occur on the announcement day. Yet the results indicate that except for class action suits, most of the impact on stock prices of suits and settlements do occur on the announcement day, and over a four-day span for decisions, with average abnormal returns that are negative and significant in one sided tests at the 95 percent level. Larger time spans that include the announcement day do not yield abnormal returns significantly different from zero. These findings allow at least two possible interpretations: first, the results are a fluke and we commit a type I error in rejecting the null hypothesis of no effect of EEO litigation on stock returns. The second interpretation is that EEO litigation does reduce the value of the firm on average, but has a relatively minor impact over the longer run in combination with the many other factors affecting the value of the firm, just as eating one huge meal will have a relatively minor effect on your weight over the long run but will show up on a scale after the meal. Further, although interim information is available, the information released on the announcement day is new information and does reflect a change in stockholders expectations about the status of the event.

VI. Conclusion

This study measures the impact on the equity value of firms involved in suits alleging violations of equal employment opportunity laws. Based on a sample of 260 events reported in the *Wall Street Journal* between 1964 and 1986, shareholders on average suffer negative excess returns from both the announcement and the conclusion of an EEO suit. The negative excess returns range from .294 percent on the announcement day for settlements to 15.6 percent over the 61-day holding period centered on the announcement day for class action suits. Since there may be substantial leakage of information prior to the *Wall Street Journal* announcement, these estimates may underestimate the true costs of EEO events. Further, the average announcement day loss is triple that of the average direct costs to the firm of settling the case. This suggests that the fall in the equity value of firms may be at least partially related to the costs of changing employment practices.

This paper offers new information on the economic impact of EEO laws. By examining changes in the market value of the firm around the event, the event study methodology provides an estimate of the total expected costs arising from the lawsuit. The alternative to this approach is to attempt to estimate costs directly from wage and employment data,

which requires specifying production functions and market demand conditions.

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