Securities fraud and corporate board turnover: New evidence from lawsuit outcomes

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- to investigate whether private securities litigation in the US acts to discipline corporate directors and improve corporate governance
- to investigate whether private securities lawsuits with merit discipline the perpetrators of securities fraud

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The US operates a dual system for the enforcement of securities laws: public and private.

- Public enforcement efforts are carried out by the Securities and Exchange Commission (SEC) and Department of Justice (DOJ).
- Private enforcement involves lawsuits brought by private investors who believe they have been harmed by violations of the relevant statutes.
- There is ongoing interest in evaluating the efficacy of litigation to enforce securities laws, both public and private.
- Our research focuses on private actions and how their effects on corporate boards’ turnover are related to the merit of the actions.
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Derivative suits (DS) are filed by a shareholder on behalf of the corporation, alleging that damage has been done: in some cases violations of fiduciary duties by officers or directors. Proceeds are awarded to the corporation.

Ferris, Jandik, Lawless and Makhija (JFQA, 2007) find that DS are associated with firms with greater agency conflicts.

They also find that DS are associated with changes in the board in favor of greater outside representation.

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From an analytical perspective, what is the rationale for private enforcement efforts?

... firm-level penalties—i.e., those paid by shareholders—can be efficient if internal mechanisms work to discipline culpable managers, because firm-level monitoring and control can be less costly than direct monitoring by regulators.” (Karpoff et al., note 3)

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A SFCA claims that the value of shareholders’ investments have been damaged by fraudulent action by the company or its agents. All shareholders comprise a class of parties, which must be certified by the court. This aggregation of claims allows the small individual shareholder to seek redress, and puts pressure on the corporation to address the claim.

More than 99% of SFCAs are either dismissed by the court at some stage or lead to a financial settlement between the plaintiffs and the corporation. Per the quotation above, settlement awards represent transfers between shareholders as the corporate treasury funds the settlement.
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A large share of the award is typically claimed by the legal firms who have initiated the case. In February 2008, the most famous member of the “plaintiff’s bar”, William Lerach of Milberg Weiss, was sentenced to two years in jail and fined for improperly soliciting ‘professional plaintiffs’ who received ‘kickbacks’ from settlement awards. His most famous case involved a $7 billion judgment against Enron.

Given the incentives to bring such actions, prior studies that compare firms who have been sued and similar firms which have not may be merely considering whether attorneys considered the firm an appropriate “target of opportunity”.

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A major institutional change in the workings of SFCAs was instigated by the Private Securities Litigation Reform Act of 1995 (PSLRA). This legislation, generally seen as tightening the requirements for a class action suit, was passed in response to concerns that a sizable number of SFCAs were eventually considered frivolous and dismissed. Shareholders cannot claim damages merely because the market value of their shares fell.

Under the PSLRA, plaintiffs must cite specific statements or omissions that are alleged to be misleading, and must provide evidence that defendants willfully sought to deceive investors or were reckless in their statements. Merely alleging negligence (‘bad management’) is insufficient. The court must consider the adequacy of the allegations put forth by plaintiffs to allow the suit to continue.
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The restrictions placed on SFCAs by the PSLRA imply that research carried out on pre-1995 suits considered a quite different environment.

Findings from early studies are mixed. Romano (J.LawEcOrg., 1991) suggests that securities litigation may align the interests of shareholders and managers. She considers whether SFCAs and other private lawsuits cause changes in corporate governance. Niehaus and Roth (FinMgt., 1999) also study the pre-PSLRA period, considering inside director and CEO turnover rates. Agrawal, Jaffe and Karpoff (J.LawEc., 1999) consider turnover and governance changes following the revelation of fraud.
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If SFCAs are effective tools for disciplining managers, their outcomes should be related to the underlying *merit* of the action. Alexander (Stanf.LawRev., 1991), again using pre-PSLRA data, found that SFCA outcomes were unrelated to the seriousness of the underlying violation. Coffee (Colum.LawRev., 2006) has argued that the SFCA mechanism does little to sanction wrongdoers.

More recent research (using a post-PSLRA sample) has tried to consider the merit of SFCAs by considering threats to outside directors’ reputation (Helland, JLawEc., 2006; Fich and Shivdasani, JFE, 2007).
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Our research strategy differs from much of this literature by focusing on a set of firms who have all been named as defendants in SFCAs. We are concerned with the effect of the underlying merit of the action on corporate governance.

**Research questions:**

- Does merit drive the outcome of securities fraud class actions (SFCAs)?
- Are corporate directors linked to alleged securities fraud disciplined?
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- Are corporate directors linked to alleged securities fraud disciplined?
To answer these research questions, we construct a joint test. If merit drives the outcome of SFCAs and disciplinary mechanisms are effective, we should detect higher rates of corporate board turnover when an SFCA is settled than when it is dismissed.

Our key intuition: pooling of dismissed and settled lawsuits will dilute the observed disciplinary impact of SFCAs if the likelihood of dismissal is related to lack of merit or seriousness of the allegations. Studies which have ignored this distinction are less likely to find a clear relationship between merit and turnover outcomes.
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Figure: Typical series of events in a SFCA
We analyze a comprehensive dataset of 333 SFCAs filed in the aftermath of the Private Securities Litigation Reform Act (PSLRA) of 1995 in order to evaluate turnover in the corporate board of directors.

- Unlike prior research, we avoid the drawbacks of creating a matched sample to investigate the efficacy of SFCAs.
- We classify the lawsuits as *Dismissed* or *Settled* based on their status as of January 2009.
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We observe the board composition at $T=0$, the annual meeting prior to the lawsuit filing date, and in each of four years hence: at $T=1$, $2$, $3$ and $4$. We record all changes in board composition during those years.

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Of the 333 actions, 140 (42%) were dismissed and 193 (58%) were settled.

For the settled actions, the average settlement amount was $90 million.

24% of all actions and 31% of settled actions involved restatements of financials.

Cumulative abnormal returns (CARA) computed at the time of the end of the class period, when the news emerged, does not differ significantly between settled and dismissed actions. Thus, identifying ‘high-impact’ suits by focusing on CARA will be misleading. The market does not predict the lawsuit’s outcome.
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2,364 outside directors and 800 inside directors are included in the sample.

- Inside directors include current and former employees, relatives and directors with business dealings with the firm.
- Outside directors include all other board members.
- Of the inside directors, 325 (41%) serve as CEOs.
- Outside directors were on average 59 years old when the action was filed; inside directors were on average 53 years old.
- 42.6% of outside directors, 56.4% of inside directors and 53.8% of CEOs depart within four years after they are initially observed.
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Table IV.A: Outside director retention rates by SFCA outcome.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dismissed</th>
<th></th>
<th>Settled</th>
<th></th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number Directors</td>
<td>Retention Rate</td>
<td>Number Directors</td>
<td>Retention Rate</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>1006</td>
<td>100.00</td>
<td>1358</td>
<td>100.00</td>
<td></td>
</tr>
<tr>
<td>1</td>
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<tr>
<td>2</td>
<td>776</td>
<td>77.14</td>
<td>964</td>
<td>70.99</td>
<td>0.001</td>
</tr>
<tr>
<td>3</td>
<td>681</td>
<td>67.69</td>
<td>840</td>
<td>61.86</td>
<td>0.003</td>
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<tr>
<td>4</td>
<td>615</td>
<td>61.13</td>
<td>743</td>
<td>54.71</td>
<td>0.002</td>
</tr>
</tbody>
</table>

Reported p-values of two-sided tests for differences in retention rates between dismissed and settled/ongoing actions.
## Table IV.B: Inside director retention rates by SFCA outcome.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dismissed</th>
<th></th>
<th>Settled</th>
<th></th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Directors</td>
<td>Retention Rate</td>
<td>Number of Directors</td>
<td>Retention Rate</td>
<td></td>
</tr>
<tr>
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<td>344</td>
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<td>456</td>
<td>100.00</td>
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<tr>
<td>1</td>
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<td>84.88</td>
<td>319</td>
<td>69.96</td>
<td>0.000</td>
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<tr>
<td>2</td>
<td>229</td>
<td>66.57</td>
<td>247</td>
<td>54.17</td>
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<td>3</td>
<td>202</td>
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<td>45.39</td>
<td>0.000</td>
</tr>
<tr>
<td>4</td>
<td>175</td>
<td>50.87</td>
<td>174</td>
<td>38.16</td>
<td>0.000</td>
</tr>
</tbody>
</table>

Reported p-values of two-sided tests for differences in retention rates between dismissed and settled/ongoing actions.
Table IV.C: CEO retention rates by SFCA outcome.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dismissed</th>
<th>Settled</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Number</td>
</tr>
<tr>
<td></td>
<td>Retention Rate</td>
<td>Retention Rate</td>
</tr>
<tr>
<td>0</td>
<td>135</td>
<td>190</td>
</tr>
<tr>
<td>1</td>
<td>118</td>
<td>129</td>
</tr>
<tr>
<td>2</td>
<td>99</td>
<td>105</td>
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<tr>
<td>3</td>
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<td>86</td>
</tr>
<tr>
<td>4</td>
<td>75</td>
<td>75</td>
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</table>

Reported p-values of two-sided tests for differences in retention rates between dismissed and settled/ongoing actions.

In our analysis below, we study the overall (T=0->T=4) survival rate. In follow-on work, we consider year-to-year survival rates using a discrete-time hazard model.
### Table IV.C: CEO retention rates by SFCA outcome.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dismissed Number</th>
<th>Dismissed Retention Rate</th>
<th>Settled Number</th>
<th>Settled Retention Rate</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>135</td>
<td>100.00</td>
<td>190</td>
<td>100.00</td>
<td></td>
</tr>
<tr>
<td>1</td>
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<td>129</td>
<td>67.89</td>
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</tr>
<tr>
<td>2</td>
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<td>73.33</td>
<td>105</td>
<td>55.26</td>
<td>0.001</td>
</tr>
<tr>
<td>3</td>
<td>89</td>
<td>65.93</td>
<td>86</td>
<td>45.26</td>
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<tr>
<td>4</td>
<td>75</td>
<td>55.56</td>
<td>75</td>
<td>39.47</td>
<td>0.004</td>
</tr>
</tbody>
</table>

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In our analysis below, we study the overall (T=0->T=4) survival rate. In follow-on work, we consider year-to-year survival rates using a discrete-time hazard model.
We observe the board at $T=0$ (prior to SFCA filing) and at $T=1, 2, 3, 4$. We estimate

$$Pr[depart] = \Phi(SFCAOutcome, Alleg, CARA, Size, Age, Tenure, controls) + \epsilon$$

where $Pr[depart]$ is the probability that a director seated at $T=0$ will no longer be seated at $T=4$. All models are estimated with binomial probit with cluster-robust standard errors.

*controls* include whether an inside director is CEO, whether an outside director is a member of the audit committee, whether a director is personally named in the SFCA and their voting share.
### Table V: Outside director turnover: average marginal effects.

<table>
<thead>
<tr>
<th>Variable</th>
<th>[1]</th>
<th>[2]</th>
<th>[3]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suit Settled+</td>
<td>0.048</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.021)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Settlement in Q4+</td>
<td>0.058</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.028)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Scaled Sett. Q4+</td>
<td></td>
<td></td>
<td>0.128</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.032)***</td>
</tr>
<tr>
<td>Restatement of financials+</td>
<td>0.051</td>
<td>0.051</td>
<td>0.052</td>
</tr>
<tr>
<td></td>
<td>(0.026)**</td>
<td>(0.026)**</td>
<td>(0.025)**</td>
</tr>
<tr>
<td>Board Tenure</td>
<td>-0.027</td>
<td>-0.026</td>
<td>0-0.026</td>
</tr>
<tr>
<td></td>
<td>(0.013)**</td>
<td>(0.013)**</td>
<td>(0.013)**</td>
</tr>
</tbody>
</table>

Dependent variable: director’s Pr[depart] between T=0 and T=4.

+: marginal effect for discrete change of dummy variable from 0 to 1.
<table>
<thead>
<tr>
<th>Variable</th>
<th>[1]</th>
<th>[2]</th>
<th>[3]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suit Settled+</td>
<td>0.090</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.035)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Settlement in Q4+</td>
<td></td>
<td>0.226</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.055)**</td>
<td></td>
</tr>
<tr>
<td>Scaled Sett. Q4+</td>
<td></td>
<td></td>
<td>0.241</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.053)**</td>
</tr>
<tr>
<td>Restatement of financials+</td>
<td>0.092</td>
<td>0.076</td>
<td>0.097</td>
</tr>
<tr>
<td></td>
<td>(0.044)**</td>
<td>(0.044)**</td>
<td>(0.043)**</td>
</tr>
<tr>
<td>Firm Performance</td>
<td>-0.043</td>
<td>-0.048</td>
<td>-0.048</td>
</tr>
<tr>
<td></td>
<td>(0.020)**</td>
<td>(0.020)**</td>
<td>(0.020)**</td>
</tr>
</tbody>
</table>

Dependent variable: director’s Pr[depart] between T=0 and T=4.

+: marginal effect for discrete change of dummy variable from 0 to 1.
**Table VII: CEO turnover: average marginal effects.**

<table>
<thead>
<tr>
<th>Variable</th>
<th>[1]</th>
<th>[2]</th>
<th>[3]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suit Settled+</td>
<td>0.118</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.054)**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Settlement in Q4+</td>
<td></td>
<td>0.254</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.080)***</td>
<td></td>
</tr>
<tr>
<td>Scaled Sett. Q4+</td>
<td></td>
<td></td>
<td>0.273</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.082)***</td>
</tr>
<tr>
<td>Restatement of financials+</td>
<td>0.209</td>
<td>0.196</td>
<td>0.219</td>
</tr>
<tr>
<td></td>
<td>(0.066)***</td>
<td>(0.066)***</td>
<td>(0.064)***</td>
</tr>
<tr>
<td>Voting Share</td>
<td>-0.016</td>
<td>-0.016</td>
<td>-0.016</td>
</tr>
<tr>
<td></td>
<td>(0.004)***</td>
<td>(0.004)***</td>
<td>(0.004)***</td>
</tr>
</tbody>
</table>

Dependent variable: director’s Pr[depart] between T=0 and T=4.

+: marginal effect for discrete change of dummy variable from 0 to 1.
Key findings

1. Turnover rates of both outside and inside directors following filing of a SFCA are substantially higher when the action is not dismissed by the court.

2. Among insiders, turnover rates for CEOs are even more sensitive to outcome of the suit.

3. Pooling SFCAs that are dismissed with those that are not dismissed (as in the prior literature) will dilute the observed impact of the alleged wrongdoing on board turnover.
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1. The nature of the allegations is an important determinant of board turnover. Inside director turnover rates are significantly higher when a restatement is involved.

2. Some evidence that more concentrated external equity ownership provides greater discipline (Table IX).

3. When we focus on large-settlement lawsuits, we observe greater board independence among those firms. Outside director representation rose by 8.7%, vs. 4.8% for other actions (Table XIII).

4. Researchers should control for both the nature and strength of allegations when investigating the impact of private securities litigation on corporate governance.
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Conclusions:

- Our empirical findings are consistent with the hypothesis that SFCAs with greater merit, in terms of their outcome, affect corporate governance.
- Our findings are also consistent with the hypothesis that firms apply discipline to those most closely associated with wrongdoing.
- Directors most likely to be disciplined are inside directors, particularly CEOs.
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