
A Secondary Market Test of the Merits of Class
Action Securities Litigation:
Evidence from the Reputation of Corporate
Officers

Eric Helland

Claremont McKenna College (on Leave)

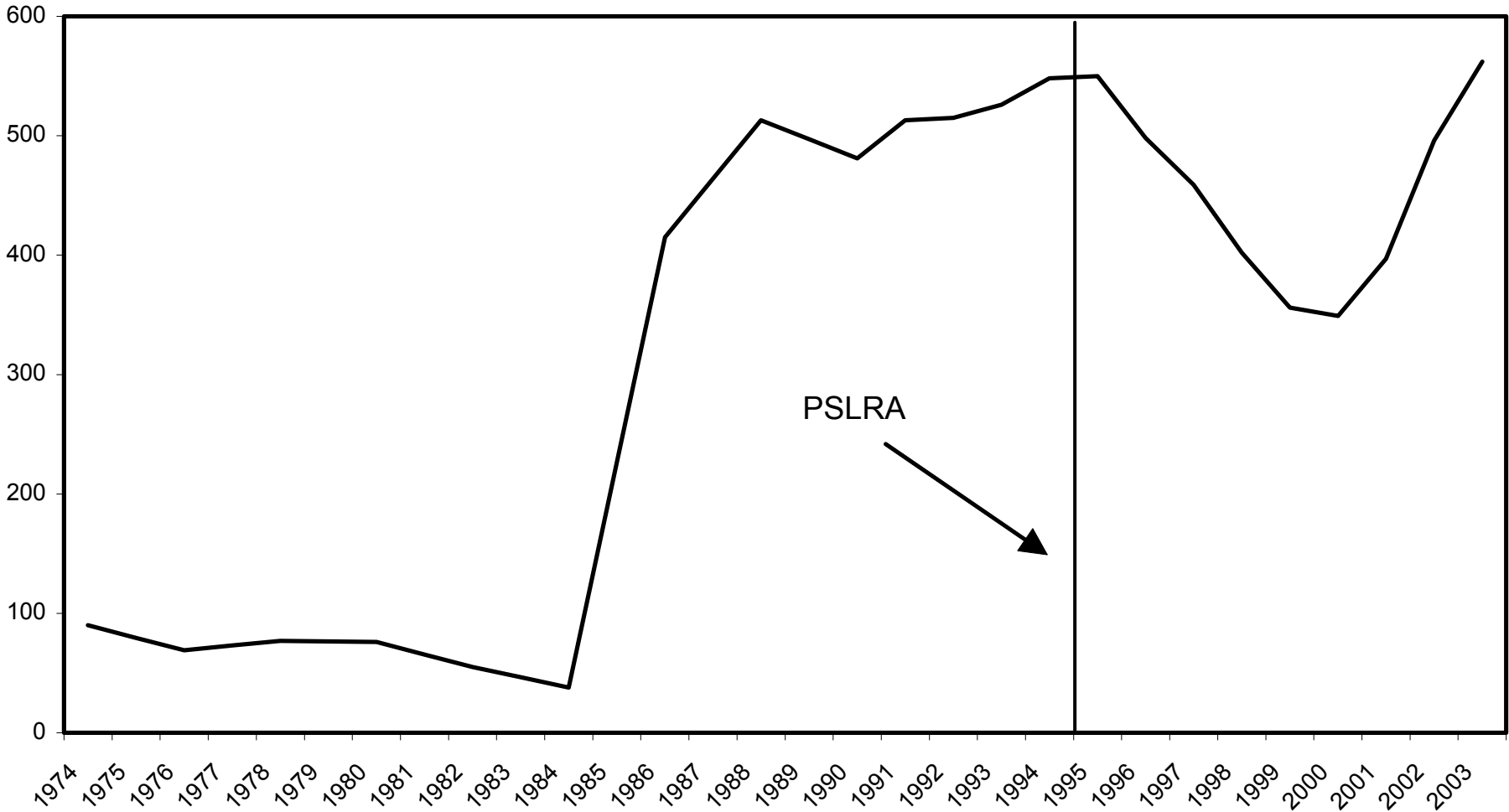
Introduction

- Corporations in the United States have come under intense scrutiny for how they report their finances.
 - Corporate governance scandals cost the economy approximately \$37 to \$42 billion of lost GDP in the year following the market's 2002 peak.
 - According to the GAO, almost 10% of all list companies restated earnings.
 - Restatements and allegations of fraud have raised concerns about the US's system of enforcing financial regulation.
 - Enforcement depends on both the actions of the SEC and private attorneys.
 - The enforcement of the anti-fraud provisions of United States' securities laws creates "private attorney generals" who enforce public law for private gain.
 - The effectiveness of the approach requires that the cases filed by the private attorney are meritorious.
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Figure 1 Director's Insurance Premiums

Directors insurance premiums rose from 1984 until 1995. The premiums began to increase again in 2001.

Index of median premiums 100=1974 premium



Source: Tillinghast-Towers Perrin, "2003 DIRECTORS AND OFFICERS LIABILITY SURVEY EXECUTIVE SUMMARY OF U.S.AND CANADIAN RESULTS."

The Deterrence Value of Shareholder Suits

- There is considerable debate as to whether private securities cases are meritorious and therefore able to serve as deterrence to future fraud.
- Private parties have incentives to bring cases that the government would never bring even if the SEC budget were unlimited.
- A defendant may agree to settle a case in which he would prevail at trial to avoid the considerable cost of litigation and in particular the sizable expense of the discovery process.

The Deterrence Value of Shareholder Suits

- The conclusions range from almost all suits being frivolous (Alexander, 1991) to a fair number being frivolous (Bohn and Choi, 1996).
 - The sample sizes have been too small to draw general conclusions and the results are difficult to interpret as there is no benchmark for what constitutes a meritorious case.
- There is also a small literature looking at the link between corporate governance and private securities litigation.
 - Beasley (1996) and Dechow, Sloan and Sweney (1996) find that accounting fraud is less likely when there are more outside directors.
 - Niehaus and Roth (1998) and Strahan (1998) find that increased turnover is due to securities class actions.
 - Ferris et al. (2002) find that derivative suits are also associated with increased turnover.
- The difficulty is that turnover and board composition are potentially endogenous.

Assessing the Merits of Securities Class Actions

- I assess the merits of private securities class actions using the reputational penalty paid by directors who serve on a board accused of fraud.
- Given the amount of discretion and hidden information implicit in corporate management, outside directors have an interest in maintaining a reputation for trustworthiness.
 - If private securities class actions are meritorious, we should see directors and officers pay a reputational penalty when accused of fraud.
- As not all outside boards are equally prestigious or lucrative, I examine the types of directorships.

The Outside Director Market

- Shareholder interests drive the market for outside directors.
 - Fama and Jensen (1983) argue that additional board appointments signal director quality.
 - Gilson (1990) and Kaplan and Reishus (1990) suggest that the number of outside directorships is a proxy for reputational capital.
 - Klein and Leffler's (1981) assertion that trust is bonded by reputations suggests that outside directors trade in their reputation.
- Directorships are quite lucrative.
 - Yermack concludes that each new directorship has a present value of almost a million dollars without considering equity incentives.

Sample Construction

- *Compact Disclosure* maintains an electronic database of all proxy statements.
 - The data contain information on the vast majority of all publicly traded firms.
 - The data contains the name and age of all directors. It also identifies which directors are officers of the company.
- I created a unique identifier for each company and each individual director.
- The measure of director reputation is the change in one of several classifications of net outside directorships between 1994 and 2002.
 - I construct a measure of change in directorships by subtracting the number of exits from new positions.
 - New positions occur when a company adds a director to the board.
 - I count a directorship as new if an existing company adds a director.

Fraud Cases

- The primary source for private fraud allegations is Securities Class Action Alert.
 - The SCAA is a litigation reporter that contains an exhaustive list of private securities litigation data between 1985 and the present.
 - It does not consistently contain pending cases. I supplement with the Securities Class Action Clearinghouse at Stanford University, which contains a comprehensive list of pending securities class action cases.
- The SEC's Accounting and Auditing Enforcement Releases (AAERs) contains data on suits filed by the SEC.
 - Almost all public cases having a parallel private class action covering the same fraud allegation.

Measures of Directorships

- Outside directorships vary in value and prestige.
- To measure the financial value of the director's outside directorships I examine
 - net outside directorships that have a director's pension system
 - have stock options,
 - are in the top quartile of option value
 - have director's fees in the top quartile of all companies in ExecuComp.
- To measure the change in prestige of the director's board-positions, I examine directorships in
 - the top quartile of all companies for industry adjusted returns on equity
 - the top quartile of sales
 - the top quartile of employment
 - the number of directorships in the Fortune 500.
- I utilize several measures of quality of board governance for the firms in the director's portfolio of outside directorships
 - the change in the director's net outside board positions in the top quartile of block ownership,
 - the top quartile of the percentage of insiders serving on the board
 - the top quartile of board size
 - the top quartile of CEO tenure.
 - Net directorships in firms that indemnify their directors are also included.

Independent Determinants

- Corporate performance is a key determinant of reputation.
 - I include the average return on equity for the director's companies lagged by one year.
 - I compute both the portion of the director's companies performing in the bottom 25th percentile of industry-adjusted performance and those in the top quartile of performance for the previous year.
- I include a control variables for directors who
 - reach retirement age and are the CEO of a company.
 - who serve on a board in the sample for which they are an officer or director.
- I include an indicator variable for CEO turnover.
- I include the current number of board positions and an indicator variable if the director is currently on six or more outside boards.
- To control for industry effects, I include indicator variables for Fama and French's 12 industry classifications and all specifications include director-fixed effects and year-fixed-effects.

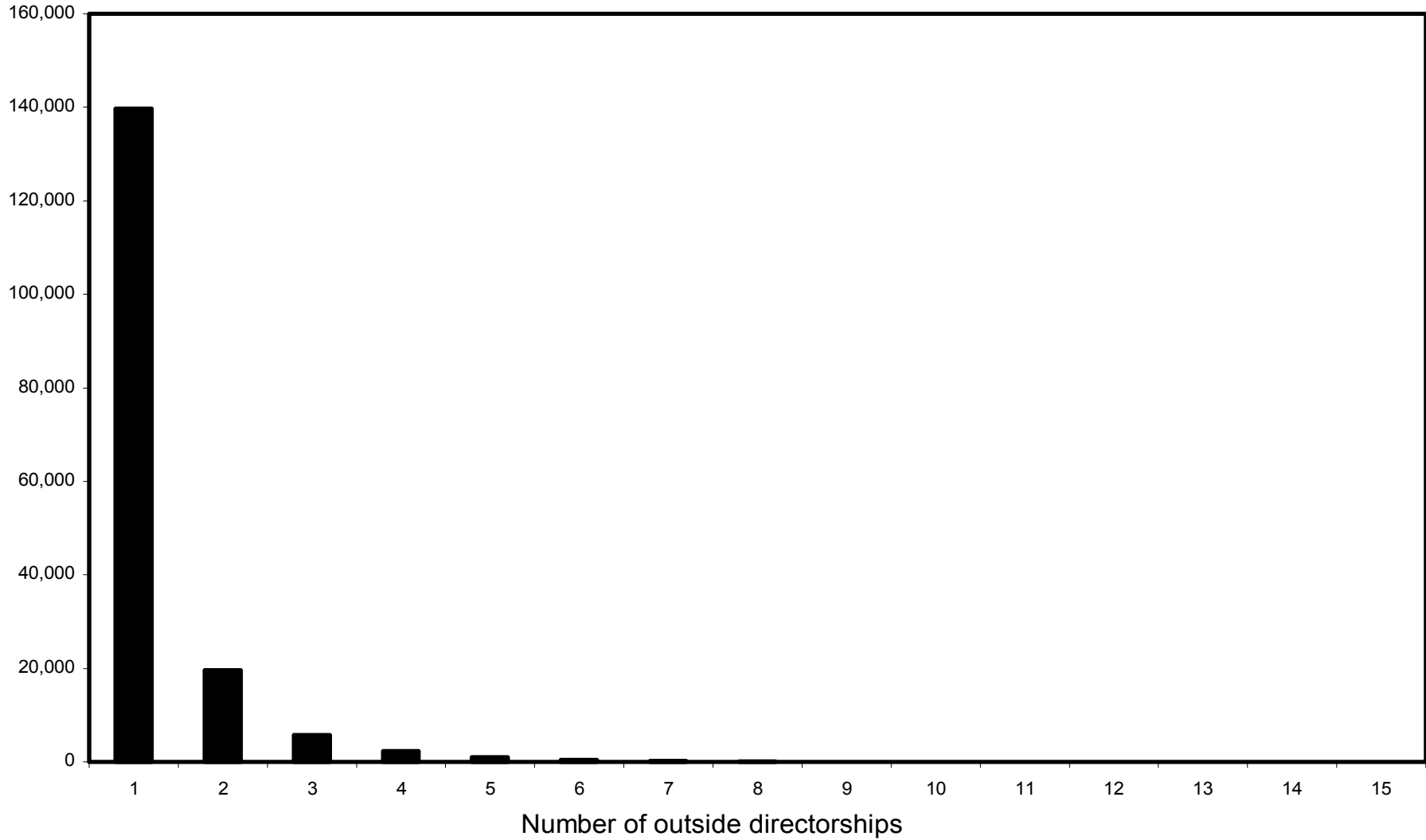
Patterns of Fraud Allegations

	Director Years	Directors	Companies
No Fraud Allegation between 1985 and 2002	334,447	68,117	9,915
Class action fraud allegation between 1985 and 2002	66,146	5,503	1,743
SEC suit alleging fraud between 1985 and 2002	6,345	956	190

Figure 2: Distribution of outside directorships 1994-2002

The distribution of the number of outside directorships for directors serving on at least one board as an outside director between 1994-2002

Number of Individuals



Source: Compact Disclosure 1994-2002

Results: All Outside Directorships

- A fraud accusation in a private securities case has a statistically significant and positive impact on the reputation of outside directors.
 - A fraud allegation increases the net number of outside directorships by .215, an almost 100% increase over directors who are not accused of fraud.
 - This is a within-director estimate and is driven not by cross-sectional variation but only by a director's company being accused of fraud.
- One explanation for a positive impact of a fraud allegation is that critics of shareholder class actions are correct.
 - The average private securities case is designed to elicit settlement but does not actually identify any fraud.
 - If this were the case, one would expect plaintiff's attorneys to target directors with a high opportunity cost of defending against these cases.
 - Companies with a board made up of directors who are particularly attractive candidates for new outside board positions are also particularly attractive candidates for a suit.
- An alternative possibility is that the impact of shareholder suits is more direct. Although the cases lack merit, a director who has served on a board defending against such a case is more effective at protecting shareholder interests.

Results: Control Variables

- A one standard deviation in the number of boards a director serves on with returns in the top quartile of performance decreases the net number of directorships by 13.8%.
- A one standard deviation increase bottom quartile reduces the net number of boards by 6.6%.
- A one standard deviation increase in return causes a 14% increase in the net number of boards.
- Becoming a CEO of a company in the sample reduces the net number of boards by 7.1%.
- The exit of the CEO of one of the companies on which the director serves causes 33% decrease in the net number of boards.
- Increasing the number of boards on which the director served in the pervious period causes a reduction in the net number of boards. A new board last period causes a .18 reduction in the net number of boards.
- This decline is mitigated somewhat if the director serves on more than six boards.
- Becoming the CEO of a Fortune 500 company has the largest effect of any factors, a 373% increase in the net number of boards.
- Beyond becoming the CEO of a Fortune 500 company, a very rare event in the data, nothing advances the reputation of a director as much as serving on a board accused of fraud in a private securities class action.

Fixed Effect Estimates

	All Outside Directorships	Pensions	Top Quartile of Compensation	Options	Top Quartile of Value	Top Quartile of Sales	Top Quartile of Employment	Fortune 500
Allegation of Fraud	0.215***	0.059***	0.106***	0.079***	0.171***	0.103***	0.119***	0.015***
	(0.014)	(0.011)	(0.022)	(0.021)	(0.023)	(0.010)	(0.010)	(0.005)

Fixed Effect Estimation Using Alternative Definitions

	Top Quartile of Block Ownership	Top Quartile of Insiders	Top Quartile of Board Size	Indemnification	Top Quartile of CEO Tenure
Allegation of Fraud	0.101***	0.045***	0.071***	0.011**	0.174***
	(0.010)	(0.007)	(0.007)	(0.005)	(0.022)

Decomposing Public and Private Allegations of Fraud

Panel A: Net outside board positions defined as all outside directors, by compensation and prestige measures								
	All Outside Directorships	Pensions	Top Quartile of Compensation	Options	Top Quartile of Value	Top Quartile of Sales	Top Quartile of Employment	Fortune 500
Private Allegation of Fraud	0.215***	0.059***	0.108***	0.079***	0.172***	0.107***	0.122***	0.017***
	(0.014)	(0.011)	(0.022)	(0.021)	(0.023)	(0.010)	(0.010)	(0.005)
Public allegation of Fraud	-0.026	0.006	-0.095***	-0.007	-0.047*	-0.136***	-0.115***	-0.066***
	(0.021)	(0.012)	(0.024)	(0.023)	(0.025)	(0.015)	(0.016)	(0.007)

Fixed Effect Estimation Using Alternative Definitions of Fraud Allegations

	All Outside Directorships	Pensions	Top Quartile of Compensation	Options	Top Quartile of Value	Top Quartile of Sales	Top Quartile of Employment	Fortune 500
Panel A: Excluding dropped or Dismissed Cases								
Allegation of Fraud	0.208***	0.059***	0.106***	0.078***	0.172***	0.099***	0.116***	0.017***
	(0.014)	(0.011)	(0.022)	(0.021)	(0.023)	(0.010)	(0.011)	(0.005)
Panel B: Excluding Dropped, Dismissed or Pending Cases								
Allegation of Fraud	0.239***	0.066***	0.061	0.111***	0.205***	0.094***	0.125***	0.004
	(0.030)	(0.021)	(0.042)	(0.040)	(0.045)	(0.022)	(0.023)	(0.010)
Panel C: Top quartile of Settlements or awards								
Allegation of Fraud	-0.066***	-0.024***	-0.049***	-0.027**	-0.030**	-0.052***	-0.053***	-0.026***
	(0.008)	(0.006)	(0.012)	(0.011)	(0.012)	(0.006)	(0.006)	(0.003)
Panel D: Standard definition of fraud interacted with post 1995 indicator variable.								
Allegation of Fraud	0.334***	0.071***	0.155***	0.097***	0.230***	0.145***	0.173***	0.033***
	(0.018)	(0.014)	(0.027)	(0.026)	(0.029)	(0.013)	(0.014)	(0.006)
Allegation Of Fraud *Post 1995	-0.134***	-0.015	-0.064***	-0.022	-0.076***	-0.048***	-0.061***	-0.020***
	(0.013)	(0.010)	(0.020)	(0.019)	(0.021)	(0.010)	(0.010)	(0.005)

Discussion

- The key findings of the paper.
 - The effect of serving on a board of company charged with fraud in a private securities class action increases the net number of outside directorships for member of that board.
 - The result is robust to several different specifications.
- This is consistent with the average case being a strike suit: one that does not identify actual fraud and does not convey negative information about the director.
- There are two explanations for why the effect on director reputation is positive.
 - Strike suits are more likely to elicit settlement for a director who is more effective and desirable as an outside director because he has a higher opportunity cost of time.
 - Directors who serve on the board of a company accused of fraud actually develop useful human capital that is beneficial to other companies and therefore they are in greater demand.