

Reputational Penalties and the Merits of Class Action Securities Litigation

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Abstract

If private securities class actions alleging fraudulent behavior by officers or directors of a company are meritorious, directors and officers should pay a reputational penalty when they sit on a board of a company where the officers and directors are accused of fraud. I find little evidence of a negative impact associated with allegations of fraud. Using various definitions of board positions as a proxy for the reputation of directors who are accused of fraud, I find that the net number of board positions is consistently increased. Only shareholder class actions in the top quartile of settlements or in which the SEC has initiated a case do directors appear to suffer a reputational penalty when a board they serve on is accused of fraud. The results call into question the merits of private securities class actions.

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1. Introduction

The enforcement of the anti-fraud provisions of United States' securities laws creates "private attorney generals" who enforce public law for private gain (Hensler et al. 2000). The amount and cost of such litigation is not small. In 2003 163 private securities class actions settled for a total of 3.22 billion dollars (NERA 2004). The effectiveness of the approach requires that the cases filed by the private attorney are meritorious, i.e. that attorneys do not file cases that have a negative expected value at trial but may induce settlement. This dilemma is particularly evident in security class-action litigation. The primary potential benefit of private shareholder class actions is that they could deter future corporate misconduct by allowing punishing actions that an individual shareholder would not find cost effective to litigate (Hensler et al. 2000). Such suits have their critics who argue that most of them are frivolous and impose a heavy cost on firms while providing little in the way of deterrence.

In this paper I employ a novel approach of assessing the merits of private securities class actions using the reputational penalty paid by officers and directors who serve on a board accused of fraud in a secondary market.¹ Given the amount of discretion and hidden information implicit in corporate management, directors have a considerable interest in maintaining a reputation for trustworthiness. If private securities class actions are meritorious, we should see directors and officers pay a reputational penalty for sitting on a board of a company where a private securities class action alleges that the some of the officers and directors committed fraud (see Black et al (2004)). There is some anecdotal evidence that directors implicated in fraudulent dealings are punished in the director labor market. Prior to the October 2001 revelations of fraud the 18

¹ There is a long history in economics of using secondary market to examine the impact of public policy. The classic example is Becker's suggestion that if there is discrimination in the housing markets than we should see lower default rates for loans to minorities than for Caucasians. See for example-Berkovec, Canner, Gabriel and Hannan (1998) on lending and Ayres and Waldfoegel (2001) for evidence on bail bondsmen.

directors of the Enron Corporation sat on an average of 2.27 other boards as outside directors with a high of 6 and a median of 2. According to theyrule.net, a website tracking corporate boards, by 2004 the average had fallen to .16 with a median of zero. In fact none of the Enron board had added a new directorship and only two retained any of the positions they held in 2000.

This method differs from other evaluations the merits of private securities class-action litigation. Evaluations of the merits of securities class actions have generally followed two approaches. The first compares a sample of firms sued by shareholders for alleged fraud with a matched sample of firms not sued during the sample period.² Typically, studies evaluate several measures of corporate governance, such as the number of insiders, to determine if sued firms differ from the control group in ways that might indicate weaker governance (e.g. more insiders on the board, less stock ownership by officers and directors). Alternatively, studies examine the impact of fraud allegations on stock price or the likelihood of exit by officers and directors of the company accused of fraud.³ Another method is to examine the characteristics of the cases themselves to determine, for example, for what fraction of alleged damages are the cases settled.⁴

There are several criticisms of these approaches. The first approach suffers from a classic endogeneity problem. Finding that a fraud allegation decreases the number of insiders on the accused company's board may indicate that the fraud allegation revealed oversight failures by the board. Alternatively, it may be that the number of insiders can be used as evidence against the firm in any trial that may result, and management wishes to inoculate itself partially from charges of governance failures that might be brought at trial.⁵ The alternative approaches that examine

² Several examples of this method are Alexander (1991), Romano (1991), Ferris et al. (2002) and Talley and Johnsen (2004).

³ For example see Romano (1991)

⁴ See for example Alexander, 1991, Martin, et al. (1999)

⁵ It is important to notice that management might take this step even if the fraud allegations are unlikely to be proven at trial.

settlement rates and amounts are problematic because as Alexander (1991) indicates, firms that are accused of fraud are under considerable pressure to settle claims rather than litigate.

In this study I find that for the average case, there is no evidence of a negative impact on reputation associated with allegations of fraud. In fact, directors accused of fraud increase their net number of board positions for almost all measures of new board positions. For cases in the top quartile of settlement amounts or in those shareholder class actions in which the SEC also initiated a case do directors appear to suffer a reputational penalty measured by a decrease in net board positions. The results call into question the merits of the average private securities class actions. If private class actions were on average meritorious, outside directors who served on the corporate board during the period of alleged fraud should suffer some reputational penalty.

2. Securities Litigation and Fraud

2.1 Are private securities actions meritorious?

Securities cases whether public or private typically arise from alleged intentional violations of disclosure regulations.⁶ Federal securities laws have two major fraud enforcement methods. The first is for the federal government, under the auspices of SEC, to file civil charges or recommend that the Department of Justice file criminal charges in a case. Alternatively or simultaneously, private attorneys can file civil actions, usually on behalf of the class of defrauded shareholders, against the company in question and/or its officers and directors. Usually a private attorney brings these actions on behalf of a group of shareholders and forms the injured shareholders into a class action. Individual shareholders rarely initiate a suit. Typically, a private attorney initiates the cases.

⁶ The Securities and Exchange Commission (SEC) administers these requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, which specifies what information, corporations are required to disclose to investors. This study does not include derivative suits brought on behalf of all shareholders because they are relatively rare and there are too few in the sample period to estimate the impact on reputation. For evidence on derivative suits, see Ferris et al (2002).

Confidence in the value of private enforcement is widely held. No less than the Supreme Court has argued “...private actions are a most effective weapon in the enforcement of the securities laws.”⁷ However, Grundfest (1994) argues,

“Not so fast. Although praise for private party litigation is well-deserved in many situations, the relationship between private and federal enforcement of securities laws has not been subject to rigorous analysis (page 969).”

The case for the social utility of private litigation ultimately rests on compensating victims and deterring future violations. There is considerable debate as to whether private securities cases are meritorious and therefore able to serve as deterrence to future fraud. Seligman (1994) argues that class actions serve an important enforcement role and ensure appropriate disclosure because the SEC has a limited budget and delegating enforcement authority to private attorneys leaves the SEC free to pursue cases that are not profitable enough for private action.

Detractors claim that suits are usually without merit and exist to extract legal fees from shareholders (Alexander, 1991). They allege that private parties have incentives to bring cases that the government would never bring even if the SEC budget were unlimited (Grundfest, 1994). Private attorneys do not necessarily have the incentive to be scrupulous because directors and other corporate officers have strong incentives, in terms of litigation costs, to settle rather than go to trial (Bohn and Choi, 1996).

To understand why a private attorney might file a frivolous or non-meritorious case it is necessary to define what constitutes such a suit. The literature has generally labeled a suit frivolous if it has a negative expected value at trial (Alexander, 1991). That is, a non-meritorious case is one that the plaintiff expects to lose at trial but files the suit with the expectation that the defendant will

⁷ Grundfest (1994) quoting from *J.I. Case v. Borak* (1964). Former SEC commissioner Joseph Grundfest notes “[t]he social value of private enforcement of the federal securities laws has become an article of faith in the federal securities liturgy.”

settle the case. The obvious question is why a defendant would agree to settle a case in which he would prevail at trial. The usual explanation is to avoid the considerable cost of litigation and in particular the sizable expense of the discovery process (Alexander, 1991 and Bohn and Choi, 1996).⁸

Generally, studies of the determinants of suits find that lawsuits are more likely against larger firms (deeper pockets), firms in certain industries, and firms that experience a large decline in stock value.⁹ The conclusions range from almost all suits being frivolous (Alexander, 1991) to a fair number being frivolous (Bohn and Choi, 1996). Critics of the literature argue that it is far from conclusive (see Seligman, 1994). The basic criticisms are that the sample sizes have been too small to draw general conclusions (Alexander, 1991) or that the results are difficult to interpret as there is no benchmark for what constitutes a meritorious case (Bohn and Choi, 1996 and Dunbar et al. 1995).

There is also a small literature looking at the link between corporate governance and private securities litigation. For example, Beasley (1996) and Dechow, Sloan and Sweney (1996) find that accounting fraud is less likely when there are more outside directors. In an approach similar to one taken in this paper, 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, brought on behalf of all shareholders, are also associated with increased turnover.¹⁰ The difficulty is that turnover and board composition are potentially endogenous. Higher turnover following a fraud allegation could result from a reputational penalty or the additional cost to the director or Chief Executive Officer (CEO) of defending against the allegation. By contrast, the absence of exit may mean that CEO or

⁸ For example, Perino (2002) cites estimates that discovery constitutes 80% of litigation costs.

⁹ See for example Alexander (1991), Grundfest (1994), Dunbar et al. (1995), and Bohn and Choi (1996).

¹⁰ Derivative suits are quite rare. Unlike the typical class action suit addressed in this study, they usually specifically address governance issues rather than allegations of fraud.

directors were too secure to be removed even with the allegation and not the absence of a reputational penalty. The approach taken in this paper avoids this issue, as the reputational penalty is estimated using net board positions where the officer or director is not yet potentially entrenched.

2.2 The outside director market

According to a number of scholars in finance, shareholder interests drive the market for outside directors. Most prominently, 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. Further Klein and Leffler's (1981) assertion that trust is bonded by reputations suggests that outside directors trade in their reputation.¹¹

Directorships are quite lucrative. Yermack (2003) finds that a new outside director's tenure on the board of a Fortune 500 firm is likely to be 10 to 15 years during which he will earn nearly \$100,000 dollars in fees and benefits. The rise of stock options means that directors can potentially earn far more from certain boards. Yermack concludes that each new directorship has a present value of almost a million dollars without considering equity incentives.

It is easy to see why a meritorious allegation of fraud might harm the reputation of an officer or director. Directors are hired either by management or shareholders in order oversee management. If a director charged with overseeing a company allows management to defraud shareholders of that company, it indicates that either the director is unable to perform the function

¹¹ The literature has focused on the career impact director's (or more precisely the boards they serve on) willingness to take actions which further the interest of shareholders. Coles and Hoi (2003) focus on the boards' willingness to opt out of anti-takeover legislation on the likelihood of new directorships; Gilson (1988) examines firms in bankruptcy; and Farrell and Whidbee (2000) examine involuntary CEO exits on a director's future board positions. Several studies have focused on firm performance more generally. For example, Ferris et al. (2002), Brickley et al. (1999), Booth and Deli (1996), Brown and Maloney (1996), and Fich and Shivdasani (2004) examine the impact of performance and new board positions.

of creditable overseer or management has co-opted him. A test of the merits of private securities class actions is to examine the reputational penalties associated with a fraud allegation.¹²

Fraud may also reveal that the internal controls of a firm are weak. This reflects poorly on existing directors, but it also causes problems for several existing methods of testing of the merits of private litigation because weak internal controls suggest that meritorious cases may not remove 'bad' managers or overseers. The existing studies of the reputational penalties for firms from fraud allegations have mixed results. Agrawal, et al. (1999) find little systematic evidence that firms suspected or charged with fraud have unusually high turnover among senior managers or directors. By contrast, allegations of fraud result in statistically significant losses in market value (Karpoff and Lott, 1993).

As Weisbach (1988) and Warner, Ross and Wruck (1988) point out, a problem with interpreting the evidence is that poor corporate performance increases the probability of turnover. Since a number of critics have alleged stock price fluctuations trigger securities class actions, it is difficult to disentangle the effects of poor corporate performance and fraud allegations without some additional evidence on the reputation penalty incurred by an executive or director accused of fraud.

3. Data description

3.1 Sample Construction

The names of all corporate directors are contained in the firm's proxy statements filed with the SEC. *Compact Disclosure* maintains an electronic database of all proxy statements. The

¹² There is a large literature on the reputational penalty suffered by firms who commit malfeasance. See for example, Jarell and Peltzman (1985), Mitchel and Maloney (1989), Mithcel (1989). The related issue is whether securities fraud actually harms shareholders. As Agrawal et al. (1999) point out the most obvious harm to shareholders is that fraud itself decreases firm value or fraud signals lower firm value than anticipated. Bar-Gill and Bebchuk (2003) point out management may wish to misreport earnings either to increase the value of its own holdings in the company (presumably to sell them off to unwitting buyers) or to make new investments prospects look more promising than the actually are. In this case, fraud reveals that firm's profits were lower than management indicated and therefore management's talents are less than anticipated.

database contains data from the most current filing for a company, the date of the most recent filing, and lists as inactive the companies that have not filed in the previous year. The data contain information on all firms that trade on the NYSE and NASDEC or American Stock Exchange, the vast majority of all publicly traded firms. For each year, I extracted board and officer data for one month, December. 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. I also created a unique identifier for each individual director using the director's last name, first initial and birth year.^{13,14} From these two identifiers, I construct the total number of board positions held by each director and the addition of new directorships.

The measure of director reputation used in this study is the change in one of several classifications of net outside directorships over an eight-year period between 1994 and 2002. The period is long enough to pick up changes in directors' reputations because directors' terms typically do not exceed four years. This means that any reputational impact of a fraud allegation will have had time to influence renewal decisions as well as other companies' decisions about adding the director to the board.

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.¹⁵ I define an exit as a company

¹³ I deal with the concern that a very common name such as John Q. Smith could be falsely be attributed to the same director by examining all directors with an unusually high number of outside directorships. Generally, I found no evidence that this was a problem, as even directors with common names never had the same birth year. A larger problem is misspelling of names. To deal with this problem I examined all directors who appear on board only once or exit and reappear within a year. Random checking of several boards through time indicated that this largely dealt with the problem. One problem that I cannot easily deal with is firms that omitted a director's middle initial or age throughout while others did not. For example if B G Franklin is listed on one company as B Franklin and B G Franklin on another. A manual check of directors with the same first and last name and birth date corrected a number of these problems. However, for some directors without a recorded age it is simply impossible to determine whether they are the same individual, and I give them different identifiers.

¹⁴ I used only first initial and birth year for those directors without a middle initial.

¹⁵ Because the sample only includes publicly traded companies, I do not know which directors served on the board of a newly listed company in the years prior to listing. For this reason, when a company enters the sample, none of a company's directorships are counted as new.

continuing in the sample but no longer listing an existing director on the board.¹⁶ Although the results are similar if only new directorships are used, the net directorships measure captures the reputation of the director more effectively because an increase in reputation would not include simply replacing an existing board position when a director's term expires. An important restriction on the sample warrants notice. As it is impossible to identify the reputational impact of the fraud allegation from the sanction associated with the SEC's case, I exclude all directors banned from holding outside directorships or imprisoned.

The data on private and public allegations of fraud come from several sources. The primary source for private fraud allegations is Securities Class Action Alert (SCAA). The SCAA is a litigation reporter that contains an exhaustive list of private securities litigation data between 1985 and the present.¹⁷ The SCAA data contains all private securities cases regardless of their disposition. It does not consistently contain pending cases. For this reason, I supplement the SCAA sample with the Securities Class Action Clearinghouse at Stanford University, which contains a comprehensive list of pending securities class action cases.¹⁸ Using these sources, I constructed a comprehensive list of all fraud allegations made between 1994, the first year of complete board data, and 2002. I classify cases by the disposition of the case. A case can be unilaterally dropped by the plaintiff, dismissed by a judge, settled (in which case a settlement amount is recorded), or go to trial where the plaintiff can lose or win. Trials are extremely rare. Ninety-five percent of the cases that are not dropped unilaterally or dismissed eventually settle.

¹⁶ For example, in 1997 Alan Reynolds, a director on the board of Acme widgets is added to the board of Microcircuits, a company in the sample since 1993. Thus, he enters the sample in 1994 (with Acme) and has no new directorships until 1997 when he has one net directorship. In 2000, he exits the board of Acme and his net directorships equal -1. In 2001, he leaves Microcircuits but joins the board of Advanced Shoes. In 2001, his net directorships are zero. The later example demonstrates an important feature of the reputation measure —leaving a board to join another by construction does not represent a change in a directors' reputation.

¹⁷ For other studies utilizing SCAA data, see Carelton et al. (1996), Bajaj et al. (2000), and Johnson et al. (2002).

¹⁸ Ferris et al. (2003) utilizes the Stanford database.

The SEC's Accounting and Auditing Enforcement Releases (AAERs) contains data on suits filed by the SEC. Like the SCAA data, the AAER data contain information on cases in which there is an allegation of account fraud. I eliminate cases alleging bribery of foreign officials. The SEC cases cover similar fraud charges to the SCAA sample. I handle the SEC sample in a slightly different manner than the private cases. Almost all SEC allegations receive at least an injunction in which the defendant agrees not to commit fraud again. The case may also result in a disgorgement in which the defendant must return "ill gotten gains," a civil penalty, or criminal penalties.¹⁹ The overlap between public and private cases is nearly complete with almost all public cases having a parallel private class action covering the same fraud allegation.

Several studies have attempted to examine the number of private securities class actions by year. Seligman (1994) has argued that this is inherently misleading as a number of cases are consolidated or dismissed for technical reasons only to be refiled a short time later. For this reason, I construct a fraud allegation indicator equal to one if a private securities class action accuses the officers or directors of a company on which the individual served as a director of fraud during any case in the data that year. I further classify the fraud as public or private and by the outcome of all the cases that alleged fraud during that year.²⁰ The fraud period for private cases is determined by the class period. The class period is a bracket of time during which an individual must have purchased the stock to be eligible for compensation from the class settlement fund. The SEC's releases publish the dates of the alleged fraud. Since I am looking only at year-to-year changes in the board, the dates of the alleged fraud need only be accurate up to a year.²¹

¹⁹ In several cases, the SEC banned specific directors from being officers or directors of publicly traded companies. As noted above I removed these individuals as well as those eventually serving prison sentences.

²⁰ In the rare instance when two cases litigate fraud accusations over the same period and are not consolidated, I simply add the settlement amount. The results are robust to taking the higher valued cases or averaging the two cases. There are no cases where two actions are not consolidated and one proceeded to trial while the other settled.

²¹ It is common for cases in which both the SEC and a private party prosecute the alleged fraud for the class period to differ from the SEC alleged fraud period. In these cases, I classify a director as accused of fraud publicly based on the SEC's dates and privately

I include a director in the relevant fraud category beginning in the year that the fraud allegation becomes public.²² Although press reports likely predate filings, I take the filings as the year in which the fraud was revealed. Given the rush to file in private cases, this date usually predates any news items on the alleged fraud. A check of several fraud allegations indicates that the newspaper reports identifying fraud occur within the same year as the SEC filing for preliminary injunctions in a case. I list a director as having been accused of fraud by the public (SEC) if he or she served on the board of an accused company and the alleged fraud has been litigated at least as far as the preliminary injunction stage.

I supplement the data on board and fraud litigation with data from COMPUSTAT. The COMPUSTAT database contains extensive information on each firm's lines of business, finances, accounting practices, and stock ownership. The data on the compensation of directors comes from Standard and Poor's ExecuComp database. ExecuComp covers executive compensation data for firms in the S&P 1500 from 1992-2002. If the S&P 1500 deletes a firm, ExecuComp retains the salary information but does not update it and adds a new firm. I collect the stock returns data from CRSP.²³

3.2 Measures of Directorships

A remaining issue is how to best measure reputation using outside directorships because outside directorships vary in value and prestige. Using total net directorships may mask important changes in composition of outside board positions. I utilize a number of different measures of quality of outside directorships. The first set of classifications measures the financial value of the director's portfolio of outside directorships. To control for change in the net value of the director's

based on the class period. If more than two cases pursue the same alleged fraud, I take the earliest and latest date. If the cases are eventually consolidated, I take the class period from the consolidated case.

²² It is possible that private parties (attorneys or the press) or the SEC reveal the fraud after the director left the board of the company accused for the fraud.

²³ Missing observations or sample differences cause the sample to vary considerably depending on the specification.

board-position portfolio, I examine the change in net outside directorships that have a director's pension system, or have stock options, or have director's fees in the top quartile of all companies in ExecuComp. I derive this data from ExecuComp.²⁴ To measure the change in prestige of the director's board-position portfolio, I examine the number of directorships in the top quartile of all companies in Compustat (in the relevant years) for four variables: industry-adjusted returns on equity, the top quartile of sales, the top quartile of employment, and the number of directorships in the Fortune 500. The data for these board classifications comes from Compustat or CRSP.

It is possible that some directors who have a reputation for being inattentive to their monitoring duties will be attractive to firms where managers control the board. To a poorly governed firm, a shareholder suit perversely might signal that a director is a good choice. To capture this possibility, I utilize several measures of quality of board governance for the firms in the director's portfolio of outside directorships. I utilize 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 and the top quartile of CEO tenure. I derive the board composition data from CompactDisclosure and the CEO's tenure from Execucomp. Net directorships in firms that indemnify their directors are also included because directors who have been subject to a suit may seek out boards that protect them financially from future litigation. I derive the indemnity data from the Gompers (2003) data set.²⁵

3.3 Independent Determinants

The literature on the determinants of outside directorships motivates the control variables. Previous studies have utilized several measures of corporate performance and estimated the impact of the respective measure on future directorships. The study most closely resembling the data used

²⁴ Because ExecuComp covers only a subset of firms in the dataset, I limit the sample only to directors who at some point serve on a company with data in the ExecuComp sample. The motivation is that other directors provide no information for the regressions.

in this study is Yermack (2002), who utilizes the average equity performance of director's boards.²⁶ I include the average return on equity for the director's companies lagged by one year. Given that directors can serve on multiple boards, I also utilize a slightly different measure. For each director 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.

The literature suggests several other determinants of outside directorships. I include a control variable for directors who reach retirement age (over 65). Booth and Deli (1996) suggest that companies are more likely to add CEOs as outside board members so I include an indicator controlling for whether the director is the CEO or Chief Financial Officer (CFO) of a company. Several studies have suggested that interlock is an important determinant of outside directorships (Booth and Deli, 1996). I include an indicator variable for insiders equal to one if the director serves on a board in the sample for which he or she is also an officer or director. Yermack (2002) indicates that CEO turnover is often associated with exit by directors that the CEO appointed. As the CompactDisclosure data does not include the appointing CEO, I include an indicator variable for CEO turnover.

The literature also suggests that the current number of board positions is important in determining the number of board positions the director holds in the future. There are three different but not exclusive rationales for including some measure of the stock of current board positions. The first is that the director's initial reputation is an important determinant of future success in the outside director labor market. To capture this effect, I include the total number of board position in

²⁵ This sample contains a different set of firms and therefore restricts the sample to a different set of directors.

²⁶ Several other studies have also estimated the impact of corporate performance on future outside directorships. See for example Ferris, et al. (2003), Brickley et al, (1999) and Booth and Deli, (1996).

the previous year.²⁷ Other studies have suggested the possibility that companies or shareholders discount directors who have a large number of positions. While previous studies have not found a large number of outside positions detrimental to corporate performance, the mere perception that a large number of directorships are problematic may harm directors with a high number of outside positions (See Ferris et al. 2003). I include a spline for directorships in excess of six outside boards. Finally I include the number of board positions to standardize the gain or loss in boards. If a director serves on six boards and is removed from all of the next year this is a much larger drop than if the director only lost one board position. By contrast a director with one board position has suffered a larger reputational penalty from losing one outside position.

To control for industry effects, I include indicator variables for Fama and French's 12 industry classifications. These variables control for the expertise of the director as well as any sectors, such as technology, that may be fashionable to represent on the board. Finally, all specifications also include director-fixed effects and year-fixed-effects.

Finally I include a trend variable for the number of years the director has been in the sample. It is certainly the case that directors who have simply been in the market for a longer period of time are more likely to be sued. Ideally I would like to have the total number of years in the director labor market for each director. Since this information is not available I control for the time in the market using director fixed effects plus the number of years the director has been in the market since the first entered the sample. Since their history prior to entering the market is constant the trend measures the incremental impact of one more year in the director labor market on the number of net outside board positions. In an alternative specification I also use only directors who

²⁷ The results below are robust to utilizing any of the different measures of board quality noted above. Fortune 500 firms were utilized for consistency with previous studies.

are not serving on boards in 1994, the start of the sample, for whom the trend represents the complete experience in the director market

4. Sample Characteristics

Table 1 provides the descriptive statistics of the directors' sample. Table 2 provides two different measures of the scope of both shareholder class actions and SEC cases alleging fraud by the board of directors or management. The first measure is the number of director years in which a director has at some point between 1994 and 2002 sat on the board of a company accused of fraud during their tenure on the board. There are 29,840 director years in which the director has sat on a board accused of fraud in a private security class action.²⁸ By contrast, only 3,150 of director-year observations have sat on such a board where the SEC has made the allegation. The picture is somewhat different when we look only at directors. If we treat directors as the observation, then 4,330 of directors have at some point sat on the board of a company accused of fraud while only 691 of directors have sat on such boards accused by the SEC.

5. Impact of fraud allegations on future directorships

5.1 Estimation Technique

To explore impact of fraud allegations on director reputation suppose that the number of outside directorships is determined by

$$net_directorships_{it} = \beta_1 private_fraud_{it} + \beta_2 x_{it} + \lambda_t + \delta_i + \varepsilon_{it}$$

where $net_directorships_{it}$ is director i 's new directorships minus exits from existing boards.

$private_fraud_{it}$, which equal one if the director sat on the board of a company accused in a private suit filed since 1994, captures fraud allegations. The independent variables, x_{it} , follow the definitions given above. There is one other factor relevant to understanding the model. The model

is also estimated with director, δ_i , and year fixed effects, λ_t so that the impact of fraud is estimated using the within director and year variation.

5.2 All Outside Directorships

The results are presented in column one of Table 3. 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 .184. This represents a gain of about 17.5% gain in total board positions per year (increasing from the sample average of 1.066 outside board positions). 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 a strike suit designed to elicit settlement but without legal merit; i.e. the average case 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. Thus, 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 as served on a board defending against such a case is more effective at protecting shareholder interests.

The size of this effect is economically important as well. A one standard deviation in the number of boards that a director serves on with returns in the top quartile of performance decreases the net number of directorships by 18%. The direction of this significant coefficient is surprising as it suggests that an increase in better performing boards reduce reputation. The sign on the number

²⁸ Note that a director may have been accused prior to 1994 but fixed effects capture this.

of boards in the bottom quartile of industry-adjusted performance is more intuitive with a one standard deviation increase reducing the net number of boards by 9%. The mean of the return on equity of all the director's companies is also positive and significant. A one standard deviation increase in return causes a 17% increase in the net number of boards. Reaching retirement age increases the net number of board positions by 17%. Becoming an insider of a company in the sample reduces the net number of boards by 9%. Increasing the number of boards on which the director served in the previous period causes a reduction in the net number of boards. Adding a new board position 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.

Before returning to a discussion of why a private class action improves a director's reputation, it is possible that changes in the total number of outside directorships is the wrong measure because it masks important changes in the composition of director's portfolio of board positions. It is necessary to consider other measures of outside directorships.

5.3 Different Types of Outside Directorships

Column 2 through 8 of Table 3 contains several alternative definitions of directorships. In column 2, I present the results using only directorships that offer a director's pension plan. Again, the impact of private fraud allegations is positive and significant. The impact is similar in directorships that offer directors stock options and, in Column 4, for directorships in the top quartile of director option value. The impact of fraud allegations is also positive and significant for directorships in the top quartile of firm size, measured by either the number of employees or sales. Only in the case of net directorships in the Fortune 500 is the impact of fraud allegations not significant although it is positive.

Using a number of differing measures, the results indicate that fraud allegations improve the reputation of directors. The magnitude of these effects is similar whether I measure reputation by the compensation value of the net outside directorships, the size of the companies or whether the board position is with a large company.

5.4 Robustness Checks

There are two potential issues not addressed in the above results. The first is whether the trend controlling for a directors time in the director's labor market post 1994 adequately controls for role of experience. Table 4 panel A presents the results using only directors to boards after 1994. I am able to identify these directors as new at least to the extent that they were not serving on a board in 1994. For these directors the trend is measuring on additional year of experience starting from zero rather than one additional year starting from the director's experience in 1994. Because the model includes fixed effects these should be identical. With two exceptions the results are qualitatively identical to the full sample. In the case of net outside directorships with options the coefficient on a fraud allegation is now negative, but not significant and the coefficient on net outside directorships in the Fortune 500 remains positive but is now significant.

A second econometric issue is the use of a dummy variable to capture the impact of a fraud allegation on director reputation. There is an important advantage to using the dummy variable to capture the reputational effect of a fraud allegation. The sample period is only 8 years. While this may appear a long time I am dating the fraud allegation from the filing of the cases. Given that litigation can take several years deciding exactly when to begin any trend is difficult. The method pursued above simply compares directors before and after the allegation.

In Table 4 Panel B I replace the dummy variable with a post fraud allegation (i.e. filing) trend and trend squared. The results from the trend and trend squared are similar to the results

using a dummy variable to capture impact of a fraud allegation. In all cases the trend and the trend squared are significant. Figure 1 presents the trend for all net outside board positions. The results show that the impact of a fraud allegation increases for the first four years after which the impact is mitigated returning to almost zero after 8 years. The results for other classifications of directorships are similar. While the results are consistent with the theory that the average fraud case does not actually identify fraudulent actions by board members it is possible that the positive impact of fraud allegations is that the outside director market rewards not fraud per se but “yes men,” individuals who do not monitor management closely.

5.5 Governance measures and fraud allegation

To test the possibility that the director labor market rewards lax oversight and not fraud allegations themselves, I examine the impact of fraud allegations on net outside directorships using several common governance measures. Column 1 of Table 5 presents the result for net outside directorships in firms in the top quartile of block ownership. High levels of block ownership are associated with better oversight as large block shareholders have a greater incentive to monitor management. The impact of fraud allegations is significant, positive and of similar magnitude to the other measure of net boards.

Column 2 presents the results for board positions in the top quartile of insiders as a fraction of board memberships. Insiders are less effective monitors of management given their connection to the firm. For board positions on firms in the top quartile of insiders as a fraction of board membership, the impact is also positive and significant. Very large boards also produce less effective monitoring than smaller boards. Column 3 presents the results for board positions in the top quartile of board size. The impact is positive and significant with a fraud allegation causing an increase in the number of net board positions. Longer-serving CEOs are more entrenched and

therefore dominate the board. Column 5 presents the results for board positions in the top quartile of CEO tenure. Again, the impact of a fraud allegation is positive and significant. A fraud allegation causes a positive and significant increase in the number of net boards that offer indemnification of directors.

5.6 Differentiating SEC based fraud allegations

As noted above, one potential difficulty of the test is if management dominates the director-selection process, then although fraud allegations in private security class actions are meritorious, the market for outside directors may not value strong monitors and might actually seek out weak monitors identified by such cases. In the previous section, I use several measures and found no evidence to support such a conclusion because directorships in firms with weaker governance follow the same pattern as the other measures of outside directorships. In this section, I turn to another test: I estimate the impact of an SEC-backed fraud allegation on net directorships. Specifically, I examine whether fraud allegations against members of the board or management by the SEC harm a director who served on that board's reputation. I estimate the model,

$$net_directorships_{it} = \beta_1 private_fraud_{it} + \beta_2 public_fraud_{it} + \beta_3 x_{it} + \lambda_t + \delta_i + \varepsilon_{it}$$

where $public_fraud_{it}$ is equal one if the director sat on the board of a company accused of fraud by the SEC.

Table 6 presents the results of the model. The coefficients for the private fraud allegations are largely unchanged by controlling for SEC-filed cases. The one exception is that positive impact of fraud allegation on net outside directorships in the Fortune 500 is now statistically significant.

The impact of SEC-sponsored allegations of fraud is generally negative and in two cases not significant. Directors serving on a board accused of fraud by the SEC experience a decrease of .044 outside directorships. Serving on a board that is accused of fraud by the SEC causes a relative drop

in net board positions in the top quartile of director compensation. For those in the top quartile of sales and employment, the impact of a public allegation is a relative loss of .155 and .137 respectively. Finally, the impact is a -.069 relative loss in net outside directorships in the Fortune 500.

Table 5 Panel B shows the results using the governance measures to define net board positions. In this case, one coefficient is negative and significant and one positive and significant. Net board positions in the top quartile of board size decrease with an SEC fraud allegation while those that indemnify directors increase.

6. Extensions

6.1 Alternative definitions of fraud allegation

The results thus far have utilized all shareholder class actions as a fraud allegation regardless of the ultimate disposition of the case. This section utilizes several different measures of a fraud allegation. Panel A of Table 7 presents the results using only those fraud cases that settled out of court, the plaintiffs' won at trial, or are still pending in 2002. In the first three cases, the courts have essentially made rulings because all of the fraud allegations are private securities class actions and the courts must approve all settlements between plaintiffs and defendants, which, in effect, sanction the fraud allegation. In this specification, I do not count cases that are withdrawn or dismissed as fraud allegations. The results are substantively identical to the previous section with all different measures of net boards showing a positive and significant increase following a fraud allegation.

The exact method of treating pending cases is debatable. In Panel B of Table 7, I estimate the model without counting pending cases as fraud allegations. Again the results are substantive and identical to the previous section with one notable exception. With this alternative fraud

measure, an allegation causes a net reduction in the number of board positions. One possible explanation is that cases that result in a settlement against a large and high profile company are more meritorious than the average suit.

One major concern about securities class-action cases is that the majority are “strike suits”: lawsuits that are aimed at extracting a settlement from an opportune target but do not address actual fraud. Since strike suits are of lower value than suits that address actual fraud and therefore would win at trial, an alternative method of evaluating the merits of private fraud allegations is to repeat the analysis using only the top quartile of settlement or any case going to trial. The motivation is that such high payout cases and trials reflect a creditable allegation of fraud while low value cases are ones that accept smaller amounts.

In Panel C, I estimate the model counting only settlements in the top quartile of the settlement distribution of real dollar awards, settlements between 1994 and 2002, and cases that go to trial as fraud allegations. The results now change dramatically. In every measure of net directorships, the impact is negative and significant. Moreover, the impact is economically significant. For example, sitting on the board of a company accused of a fraud allegation that results in a settlement in the top quartile of payouts results in a .047 reduction in the net number of board seats for the director.

6.2 The Private Securities Litigation Reform Act

Panel D addresses a different policy question. It decomposes the impact of private shareholder class actions into those suits filed before 1995 and those filed after 1995. In 1995, Congress overrode President Clinton’s veto to pass the Private Securities Litigation Reform Act (PSLRA), which was intended to protect firms and their shareholders from frivolous class-action

lawsuits. Concern about non-meritorious suits motivated Congress' passage of the law.²⁹ The clear intention of the law was to improve the quality of shareholder class actions by eliminating strike suits designed only to elicit a settlement. In 1998, in response to a perceived end run around the law by filing in state court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which made class actions covered by PSLRA removable to federal court (Ratner, 2001).

The post-1995 control is significant and negative. For example, a post-1995 private fraud allegation causes a .103 reduction in the number of net boards for directors who served on the companies' board during the period covered by the allegation. In each case, however, the magnitude of the post 1995 change is smaller than the overall positive effect. One interpretation of this is that the PSLRA and SLUSA improved average case quality but that the average case still did not negatively affect the reputation of directors. The test should be interpreted with caution however as cases filed in 1994 represent the only pre PSLRA cases in the data set.

6.3 Alternative definitions and SEC suits

Table 8 repeats the above estimation and shows the results of estimating the model using the narrow definition of a private fraud allegation defined above. In addition, I utilize a narrower definition of all SEC allegations by classifying SEC fraud allegations as only those cases in which the SEC did not settle the case with only an injunction. The results are stronger than above with the majority being negative and significant. All net outside directorships decline when the director has served on the board of a company accused by the SEC of fraud and that allegation ended in a conviction, fine or disgorgement.

²⁹ The law relaxed the joint and several liability standard in effect prior to 1995 implemented a system of proportional liability based on proximity to the fraud with less culpable defendants paying a smaller proportion of the damages. The major objective of the provision was to reduce the hunt for "deep pockets," that is filing a case against a defendant with little connection to a fraud in order to increase the overall ability of defendants to pay any settlement or award. The law also limited discovery while motions to dismiss were pending. In addition, the law provided a "safe harbor" against lawsuits if statements to investors included certain risk disclosures. The act also included provisions for punishing plaintiffs' attorneys who file legally frivolous lawsuits and/or suits that

6.4 Differential Impact of Fraud Allegations by Position

Not all directors or officers are equally well positioned to know the true state of a corporation's finances. It is possible that the reputation effect of a fraud allegation differs depending on the information available to the director when he or she served on a board accused of fraud. This is problematic if the effects have different signs. Suppose, for example, that directors who were in a position to know about the fraud are punished in the outside director market while those directors not privy to this information (possibly the majority of the board) are actually rewarded by the market because they have experience dealing with a troubled company and are untainted by scandal.

Because settlements do not typically reveal which directors are actually accused of fraud, I utilize three proxies for directors who are a position to know (or who should know) the true state of the company's finances. Specifically, I include controls for the directors who served on the companies' audit committee during the period of the alleged fraud and for directors who were the CEO or CFO of the company accused of fraud. The equation estimated is

$$\begin{aligned} net_directorships_{it} = & \beta_1 private_fraud_{it} \\ & + \beta_2 audit_fraud_{it} \\ & + \beta_3 CEO_fraud_{it} \\ & + \beta_4 CFO_fraud_{it} \\ & + \beta_5 x_{it} + \lambda_t + \delta_i + \varepsilon_{it} \end{aligned}$$

where $audit_fraud_{it}$ equals one if the director served on the audit committee for a company accused of fraud in a private class action, CEO_fraud_{it} equals one if the director served as CEO of a company accused of fraud and CFO_fraud_{it} equals one if the director served as CFO of a company accused of fraud in a private class action. The other variables retain their meaning from

lack any supporting evidence. Finally, the act imposed heightened pleading standards raising the standard required to prove a fraud allegation (Ratner, 2001).

the above specifications. In addition, I also decompose the results using each individual classification and creating an indicator variable equal to one if the director held any of the three positions on a board accused of fraud. I present the results in Table 9. Finally, because these three classifications are rare, I present the results using only overall directorships. The respective cell sizes are simply too small to provide meaningful estimates for the various classifications of outside directorships.

In each case the impact of having additional information is positive, although in the case of audit committee membership the effect is not significant. Both CEO and CFO experience a relative increase in the number of net outside board positions beyond that experienced by any director serving on the board of a company accused of fraud. The evidence suggests that directors who we would suspect of having inside information about any fraud perpetrated by the company do not suffer a reputational penalty. In the case of CEO and CFO, they appear to actually do better than other CEO or CFOs in their net outside board positions and better than other outside directors serving on a board accused of fraud.

6. Conclusions

Before turning to an interpretation of the results, it is useful to review 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 of outside directorships and several different definitions of which class actions constitute an allegation of fraud. This is consistent with the average case being a strike suit: one that does not identify actual fraud. Because the average private securities class action is a strike suit, it does not convey negative information about the director.

There are two explanations for why the effect on director reputation is positive. One explanation is that a strike suit is 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. Given this targeting method of filing suits, the coefficient on fraud allegations is positive. An alternative explanation for the positive coefficient is that 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.

The positive coefficient is also consistent with the hypothesis that the director labor market actually rewards lax oversight and not being the target of a suit per se. The other results of the paper argue against such an interpretation. The impact is no different when I estimate the reputational impact of a fraud allegation using net outside board positions on companies classified by lax oversight characteristics. When I define a fraud allegation only as cases in the top quartile of settlements or that go to trial, the impact of a fraud allegation is negative and significant across different measures of outside directorships. Moreover, when the SEC files a case the impact is negative and significant. Directors who serve on more than one board accused of fraud also seem to improve their reputation at least for reputation measures based on company size or outside directorships in the Fortune 500. Following the passage of the PSLRA —a 1995 law designed to reduce the ability of plaintiffs’ attorneys to file strike suits — the impact on the reputation of directors is reduced, although it is still positive. This is consistent with the law’s intended purpose of reducing strike suits. Finally, directors who are the CEO or CFO of a company accused of fraud actually increase their net outside directorships beyond the increase experienced by all directors on fraud-accused boards. This suggests that even directors directly in a position to observe the fraud if it occurred, or who at least had been charged with preventing it, are rewarded in the director labor

market. The evidence is consistent with the hypothesis that the average private securities case does not provide evidence of director malfeasance or a failure of oversight. While the evidence is consistent with a number of suits not being meritorious it also suggests that some suits, those with large settlements, do identify officer or director malfeasance. The policy implication of the results is ambiguous. The results suggest that cases of limited social value are ending up in the courts. At the same time meritorious cases clearly exist. Whether the social benefit of the meritorious cases is larger than the cost of the non-meritorious cases is impossible to say. The results do suggest that PSLRA, which aimed to increase the hurdle necessary to bring a securities case, was at least moving in the right direction. Exactly how restrictive the law should be is, as they say, worth further study but beyond the scope of this paper.

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Table 1: Descriptive Statistics

The sample size used in the estimation varies due to missing data. I collect data from Compact Disclosure, firm's proxy statements, COMPUSTAT, CRSP, and EXECUCOMP.

Dependent Variable	Mean	Standard Deviation	Min	Max
Change in all Outside Directorships	-.1705726	.4806516	-6	3
Change in directorships with pensions	-.018866	.1657114	-5	1
Top Quartile of Compensation	-.0826445	.3191591	-5	2
Change in directorships with options	-.073992	.3057692	-4	2
Change in directorships in the top Quartile of Value	-.0984925	.3562055	-5	2
Change in directorships in the top Quartile of Sales	-.0846285	.3372159	-6	2
Change in directorships in the top Quartile of Employment	-.0934022	.3519999	-6	2
Change in directorships in the Fortune 500	-.0122075	.1380086	-5	2
Change in directorships in the top Quartile of Block Ownership	-.0904105	.3381627	-4	2
Change in directorships in the top Quartile of Insiders	-.0320854	.2152677	-3	2
Change in directorships in the top Quartile of Board Size	-.0426873	.247628	-4	2
Change in directorships with director indemnification	.0140469	.1183	0	2
Change in directorships in the top Quartile of CEO Tenure	-.0876695	.3338758	-4	2
Independent Variables				
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	.1055248	.307229	0	1
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	.0111395	.1049546	0	1
Director has served on the audit committee of a board named in a class action lawsuit	.000099	.0099503	0	1
Director was the CEO of a company named in a class action lawsuit	.0103191	.1010576	0	1
Director was the CFO of a company named in a class action lawsuit	.0006012	.0245117	0	1
Director has served on the board of two companies named in different class action lawsuits	.000046	.0067802	0	1
Number of boards in the top quartile of industry adjusted returns	.1329462	.3228819	0	1
Number of boards in the bottom quartile of industry adjusted returns	.0903499	.2747448	0	1
Mean stock return of boards t-1	.1827525	.9701447	-8.138741	9.480934
Director age>65 (=1)	.2610255	.4391946	0	1
Director is CEO of company in sample (=1)	.0606485	.2386849	0	1
Director is CFO of company in sample (=1)	.0046927	.0683428	0	1
The CEO of one of the director's companies exits	.0062063	.0785354	0	1
Director is an officer of a company in the sample	.18336	.3869621	0	1
Total number of boards last year	1.066972	.7260761	0	13
Total number of boards if t>6 last year	.0152983	.3239734	0	13

Table 2: Number of Directors and Companies Accused of Fraud by Private Parties or the SEC

The private fraud allegations are securities class actions detailed in the Security Class Action reporter between 1994 and 2002. I supplement the data with pending cases from the Stanford Law School's Securities Class Action Clearinghouse. I derive SEC-filed cases from Accounting and Auditing Enforcement Releases between 1994 and 2002.

	Director Years	Directors
No Fraud Allegation between 1994 and 2002	250,742	50,476
Class action fraud allegation between 1994 and 2002	29,840	4,330
SEC suit alleging fraud between 1994 and 2002	3150	691

Table 3 Fixed Effect Estimates of the Change in Net Outside Directorships

Fixed effect estimates of the change in the net number of outside directorships. I construct the change in the number of net directorships by subtracting the number of boards the director exits from in year t from the number of boards that add the director in year t. Observations are for a director year for all directors holding at least one outside directorship between 1994 and 2002. Model (1) includes all outside directorships. Model (2) includes only outside directorships with a director's pension plan. Model (3) includes only directorships in the top quartile of director compensation. Model (4) includes all directorships that offer stock options. Model (5) includes only directorships in the top quartile of industry adjusted market value. Model (6) and (7) includes only directorships in the top quartile of sales or employment. Model (8) includes only directorships in Fortune 500 firms. All models include director, industry and year fixed effects.

	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 (Directors has served on a board named in a class action lawsuit)	0.184*** (0.014)	0.066*** (0.011)	0.107*** (0.021)	0.058*** (0.021)	0.171*** (0.023)	0.086*** (0.010)	0.100*** (0.011)	0.007 (0.004)
Number of boards in the top quartile of industry adjusted returns	-0.101*** (0.004)	-0.005** (0.002)	-0.056*** (0.005)	-0.059*** (0.004)	-0.053*** (0.005)	-0.051*** (0.003)	-0.055*** (0.003)	-0.002* (0.001)
Number of boards in the bottom quartile of industry adjusted returns	-0.057*** (0.004)	-0.008*** (0.003)	0.002 (0.006)	-0.008 (0.006)	-0.005 (0.007)	-0.006* (0.003)	-0.018*** (0.003)	0.000 (0.001)
Mean stock return of boards t-1	0.030*** (0.002)	-0.002 (0.001)	0.027*** (0.003)	0.026*** (0.003)	0.025*** (0.003)	0.016*** (0.001)	0.015*** (0.001)	0.001** (0.001)
Director age>65 (=1)	0.013** (0.005)	0.004 (0.003)	-0.008 (0.007)	-0.001 (0.006)	-0.009 (0.007)	-0.018*** (0.004)	-0.010** (0.004)	-0.009*** (0.002)
Director is CEO of company in sample (=1)	-0.002 (0.007)	0.000 (0.005)	0.023*** (0.009)	0.011 (0.009)	0.033*** (0.010)	0.013*** (0.005)	0.014*** (0.005)	0.010*** (0.002)
Director is CFO of company in sample (=1)	-0.012 (0.021)	-0.005 (0.016)	0.025 (0.032)	0.023 (0.030)	0.026 (0.034)	-0.020 (0.015)	-0.016 (0.016)	-0.001 (0.007)
The CEO of one of the director's companies exits	0.004 (0.013)	-0.006 (0.008)	-0.002 (0.016)	0.009 (0.015)	-0.011 (0.017)	0.021** (0.009)	0.004 (0.010)	-0.008** (0.004)
Director is an officer of a company in the sample	-0.017*** (0.005)	-0.000 (0.004)	0.018** (0.008)	0.008 (0.007)	-0.014* (0.008)	0.017*** (0.004)	0.023*** (0.004)	0.008*** (0.002)
Total number of boards	-0.180*** (0.004)	-0.017*** (0.003)	-0.059*** (0.006)	-0.067*** (0.006)	-0.093*** (0.007)	-0.071*** (0.003)	-0.073*** (0.003)	-0.005*** (0.001)
Total number of boards in t>6	0.035*** (0.004)	-0.012*** (0.004)	0.016* (0.009)	0.025*** (0.008)	0.014 (0.009)	0.016*** (0.003)	0.009*** (0.003)	0.007*** (0.001)

Observations	250161	63977	63977	63977	63977	250161	250161	250161
Directors	59674	16369	16369	16369	16369	59674	59674	59674
Standard errors in parentheses								
* significant at 10%;								
** significant at 5%;								
*** significant at 1%								

Table 4: Fixed Effect Estimation Robustness Checks

Fixed effects estimates of the change in the net number of outside directorships. In Panel A, includes only directors added to boards after 1994. Panel B replaces the fixed effect estimate with a post fraud allegation trend.

	(1) All Outside Directorships	(2) Pensions	(3) Top Quartile of Compensation	(4) Options	(5) Top Quartile of Value	(6) Top Quartile of Sales	(7) Top Quartile of Employment	(8) Fortune 500
Panel A: Excluding directors serving on boards before 1994								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.158***	0.075***	0.186***	-0.059	0.099*	0.067***	0.073***	0.014*
	(0.033)	(0.027)	(0.054)	(0.056)	(0.059)	(0.022)	(0.024)	(0.008)
Panel B: Post Fraud Revelation Trend								
Trend following an allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.039***	0.013***	0.029***	0.019***	0.055***	0.030***	0.035***	0.012***
	(0.005)	(0.003)	(0.006)	(0.006)	(0.006)	(0.003)	(0.004)	(0.002)
Trend squared	-0.005***	-0.001***	-0.004***	-0.003***	-0.007***	-0.005***	-0.005***	-0.003***
	(0.001)	(0.000)	(0.001)	(0.001)	(0.001)	(0.000)	(0.000)	(0.000)

Standard errors in parentheses
* significant at 10%; ** significant at 5%; *** significant at 1%

Table 5: Fixed Effect Estimation Using Alternative Definitions of Outside Directorships

Fixed effect estimates of the change in the net number of outside directorships. I construct the change in the number of net directorships by subtracting the number of boards the director exits from in year t from the number of boards that add the director in year t. Observations are for a director year for all directors holding at least one outside directorship between 1994 and 2002. Model (1) includes only directorships in the top quartile of block ownership. Model (2) includes only outside directorships in the top quartile of insider proportion on the board. Model (3) includes only directorships in the top quartile of board size. Model (4) includes only outside directorships on the boards of companies that indemnify their directors against shareholder suits. Model (5) includes only directorships in the top quartile of CEO tenure. All models include director, industry and year fixed effects.

	(1) Top Quartile of Block Ownership	(2) Top Quartile of Insiders	(3) Top Quartile of Board Size	(4) Indemnification	(5) Top Quartile of CEO Tenure
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.085***	0.040***	0.061***	0.018**	0.179***
	(0.010)	(0.006)	(0.008)	(0.008)	(0.022)

Standard errors in parentheses
* significant at 10%; ** significant at 5%; *** significant at 1%

Table 6: Fixed Effects Estimation Decomposing Public and Private Allegations of Fraud

Fixed effect estimates of the change in the net number of outside directorships. A private allegation of fraud indicated that the director has served on the board of a company accused of fraud in a private securities class action. A public allegation of fraud indicates that the director served on a board accused by the SEC of fraud.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
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
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.186***	0.066***	0.112***	0.059***	0.174***	0.091***	0.104***	0.009**
	(0.014)	(0.011)	(0.021)	(0.021)	(0.023)	(0.010)	(0.011)	(0.004)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.044**	0.013	-0.133***	-0.027	-0.090***	-0.155***	-0.137***	-0.069***
	(0.019)	(0.011)	(0.022)	(0.021)	(0.024)	(0.014)	(0.015)	(0.006)
Panel B: Net outside board positions defined by governance								
	(1) Top Quartile of Block Ownership	(2) Top Quartile of Insiders	(3) Top Quartile of Board Size	(4) Indemnification	(5) Top Quartile of CEO Tenure			
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.085***	0.040***	0.064***	0.017**	0.181***			
	(0.010)	(0.006)	(0.008)	(0.008)	(0.022)			
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.002	-0.003	-0.083***	0.030***	-0.029			
	(0.014)	(0.009)	(0.011)	(0.008)	(0.023)			
Standard errors in parentheses								
* significant at 10%; ** significant at 5%; *** significant at 1%								

Table 7: Fixed Effect Estimation Using Alternative Definitions of Fraud Allegations

Dynamic panel estimates of the change in the net number of outside directorships. In Panel A, a fraud allegation does not include any case that a judge eventually dismisses or that plaintiffs drop unilaterally. Panel B uses the same definition of fraud as Panel A but also excludes cases that are pending when I created the sample. Panel C classifies only those cases that go to trial or have a settlement in the top quartile of settlements as fraud allegations. Panel D interacts the encompassing definition of fraud allegations with a dummy variable equal to one if the case was filed during or after 1995. Panel E identifies directors who served on companies with two separate fraud allegations during the sample period. All models include industry and year fixed effects.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	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 (Directors has served on a board named in a class action lawsuit)	0.180***	0.067***	0.108***	0.056***	0.172***	0.083***	0.098***	0.008*
	(0.014)	(0.011)	(0.021)	(0.021)	(0.023)	(0.010)	(0.011)	(0.005)
Panel B: Excluding Dropped, Dismissed or Pending Cases								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.201***	0.054**	0.099**	0.126***	0.162***	0.066***	0.094***	-0.017*
	(0.031)	(0.021)	(0.042)	(0.040)	(0.045)	(0.023)	(0.024)	(0.010)
Panel C: Top quartile of Settlements or awards								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.047***	-0.027***	-0.061***	-	-0.049***	-0.051***	-0.053***	-0.028***
	(0.008)	(0.006)	(0.012)	0.034***	(0.011)	(0.013)	(0.006)	(0.003)
Panel D: Standard definition of fraud interacted with post 1995 indicator variable.								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.275***	0.066***	0.160***	0.093***	0.233***	0.129***	0.151***	0.026***
	(0.018)	(0.014)	(0.027)	(0.026)	(0.029)	(0.013)	(0.014)	(0.006)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)*Post 1995	-0.103***	-0.000	-0.068***	-0.045**	-0.080***	-0.048***	-0.057***	-0.022***
	(0.014)	(0.010)	(0.020)	(0.020)	(0.022)	(0.010)	(0.010)	(0.004)
Standard errors in parentheses								
* significant at 10%; ** significant at 5%; *** significant at 1%								

Table 8: Fixed Effect Estimation Using Alternative Definitions of Fraud Allegations and Decomposing Public and Private Fraud Allegations

Fixed effect estimates of the change in the net number of outside directorships. In Panel A, a fraud allegation does not include any case that a judge eventually dismissed or was drop by the plaintiffs unilaterally. Panel B uses the same definition of fraud as Panel A but also excludes cases that are pending when I created the sample. Panel C classifies only those cases that go to trial or have a settlement in the top quartile of settlements as fraud allegations. Panel D interacts the encompassing definition of fraud allegations with a dummy variable equal to one if the case was filed during or after 1995. The public fraud allegations are constructed using SEC cases that involve a fine, disgorgement, civil penalty and/or a criminal conviction. All models include director and year fixed effects.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	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: no dropped, dismissed or injunctions								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.182***	0.067***	0.113***	0.056** *	0.177***	0.088***	0.102***	0.010**
	(0.014)	(0.011)	(0.021)	(0.021)	(0.023)	(0.010)	(0.011)	(0.005)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.058***	0.000	-0.146***	-0.016	-0.127***	-0.167***	-0.157***	-0.071***
	(0.020)	(0.012)	(0.023)	(0.022)	(0.025)	(0.015)	(0.016)	(0.007)
Panel B: no dropped, dismissed no pending or injunctions								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.203***	0.054**	0.106**	0.126** *	0.167***	0.073***	0.101***	-0.014
	(0.031)	(0.021)	(0.042)	(0.040)	(0.045)	(0.023)	(0.024)	(0.010)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.051**	0.003	-0.142***	-0.015	-0.122***	-0.163***	-0.152***	-0.070***
	(0.020)	(0.012)	(0.023)	(0.022)	(0.025)	(0.015)	(0.016)	(0.007)
Panel C: Top quartile of Settlements or awards								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.047***	-0.027***	-0.061***	- 0.034** *	-0.049***	-0.050***	-0.053***	-0.028***
	(0.008)	(0.006)	(0.012)	(0.011)	(0.013)	(0.006)	(0.006)	(0.003)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.046**	0.003	-0.141***	-0.013	-0.120***	-0.160***	-0.149***	-0.070***
	(0.020)	(0.012)	(0.023)	(0.022)	(0.025)	(0.015)	(0.016)	(0.007)
Panel D: Standard definition of fraud interacted with post 1995 indicator variable.								

Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.277*** (0.018)	0.066*** (0.014)	0.164*** (0.027)	0.094*** (0.026)	0.235*** (0.029)	0.133*** (0.013)	0.155*** (0.014)	0.028*** (0.006)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)*Post 1995	-0.103*** (0.014)	-0.000 (0.010)	-0.066*** (0.020)	-0.045** (0.020)	-0.078*** (0.022)	-0.048*** (0.010)	-0.057*** (0.010)	-0.022*** (0.004)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.044**	0.013	-0.132***	-0.026	-0.089***	-0.155***	-0.138***	-0.069***
Standard errors in parentheses								
* significant at 10%; ** significant at 5%; *** significant at 1%								

Table 9: Fixed Effect Estimation of Decomposition by Position

This table provides fixed effects estimates of the change in the net number of outside directorships. A fraud allegation is decomposed to identify the differential impact of directors who served on the audit committee, those who were the CEO, CFO or any of the three during the period of the alleged fraud.

	(1)	(2)	(3)	(4)	(5)
	All Outside Directorships	All Outside Directorships	All Outside Directorships	All Outside Directorships	All Outside Directorships
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.177***	0.184***	0.179***	0.183***	0.178***
	(0.014)	(0.014)	(0.014)	(0.014)	(0.014)
Audit committee member on a board named in a class action lawsuit	0.074	0.071			
	(0.293)	(0.293)			
CEO of a company named in a class action lawsuit	0.104***		0.105***		
	(0.027)		(0.027)		
CFO of a company named in a class action lawsuit	0.197**			0.200**	
	(0.082)			(0.082)	
Director has been an audit committee member, CEO or CFO for a company named in a class action lawsuit					0.112***
					(0.026)

Standard errors in parentheses
* significant at 10%; ** significant at 5%; *** significant at 1%

Figure 1 Post fraud allegation trend in net new directorship

