

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

Eric Helland*

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Abstract

Corporations in the United States have come under intense scrutiny for how they report their finances. Enforcement of financial regulation in the United States depends on both the actions of the SEC and private citizens. Because of limited enforcement resources, the SEC argues that private suits are necessary to police corporate behavior and ensure firms obey security laws. Critics of shareholder suits argue that the majority of cases are frivolous and impose a heavy cost on firms while providing little in the way of deterrence. This study utilizes a secondary market to examine the merits of shareholder class actions. Specifically, it examines the reputational penalty paid by officers and directors accused of fraud. Given the amount of discretion and hidden information implicit in corporate management, directors have a considerable interest in maintaining a reputation for trustworthiness. I examine the market for new outside directorships. If private securities class actions 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. There is 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.

Eric Helland, Dept. of Economics, Claremont-McKenna College, email: Eric_Helland@McKenna.edu. Much of this work was undertaken while I was a visitor at the Stigler Center. I wish to thank Sam Peltzman, the Olin Foundation and University of Chicago for their generous support. I also wish to thank Jeff Milyo and Sam Peltzman for helpful comments.

1. Introduction

Corporations in the United States have come under intense scrutiny for how they report their finances. One estimate is that corporate governance scandals cost the economy approximately \$37 to \$42 billion of lost GDP in the year following the market's March 2002 peak (Graham et al. 2002). According to the GAO (2002), almost 10% of all list companies announced a least one earnings restatement. Such restatements, along with high-profile cases of alleged fraud, such as Enron, WorldCom, and Tyco, have raised concerns that America's system of enforcing financial regulation is in need of reform. Enforcement of financial regulation in the United States depends in both the actions of the Securities and Exchange Commission (SEC) and private attorneys who initiate suits against firms. Many observers have noted that the SEC has too few resources to police corporate behavior and therefore needs private suits to ensure that firms obey security laws.¹

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).² 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.³ A time series of directors' insurance premiums, shown in Figure 1, indicates a dramatic increase in

¹ For a discussion of this debate see Grundfest, (1994) and Seligman (1994)

² The approach is widespread in regulatory enforcement; environmental and anti-trust law are two well-known examples.

³ Alexander (1991) lays out the case against private securities class actions arguing that the class actions do not contain proper incentives to assure that such cases in fact serve the interests of shareholder plaintiffs.

premium rates in the mid-1980s and a fall in rates in 1995 with the passage of Private Securities Litigation Reform Act (PSLRA). Rates then fall until 2000 when they return to 1995 levels. What is interesting about this trend is that it coincides with changes in the legal environment: The rise of shareholder class-action litigation in the 1980s and the passage of the PSLRA in 1995. Expanding the private attorneys' reach increases premium rates while limiting their reach reduces them. As shareholders generally pay for directors' insurance, imposing the additional costs of insuring against the actions of private attorney generals makes sense only if there is an offsetting deterrent benefit.

The methods for evaluating the merits of private securities class-action litigation, and therefore their deterrent value, follow one of several 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.⁴ 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.⁵ 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. ?⁶

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

⁴ Several examples of this method are Alexander (1991), Romano (1991), and Ferris et al. (2002).

⁵ For example see Romano (1991)

⁶ See for example Alexander, 1991, Martin, et al. (1999)

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.⁷ The alternative approaches that examine 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.

I utilize an alternative 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.⁸ 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. This is true regardless of whether the legal action accused them personally because oversight is a key function of any board. In addition, I compare both public, i.e. filed by the SEC, and private fraud allegations on the net number of outside directorships held by a director.⁹ As not all outside boards are equally prestigious or lucrative, I also examine the types of directorships by several criteria such as compensation, company size and director options.

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. Only in cases in the top quartile of settlement

⁷ It is important to notice that management might take this step even if the fraud allegations are unlikely to be proven at trial.

⁸ 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.

⁹ As explained below, public allegations actually represent only a subset of all allegations as almost all SEC suits have private suits dealing with the same allegation.

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.¹⁰ 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.

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.”¹¹ However, Grundfest (1994) argues,

¹⁰ 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).

¹¹ 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.”

“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).”¹²

The case for the social utility of private litigation ultimately rests on compensating victims and deterring future violations. The evidence belies the social utility of the compensation motive in these cases because most corporate officers and directors who are accused in private litigation do not personally contribute to the settlement although they may bear a personal cost such a loss of employment or reputation. Director’s insurance, purchased by the company, typically pays officers’ and directors’ portion of any settlement (Alexander, 1991). In the event of corporate liability, it is typically the responsibility of the current shareholders to pay those who purchased their shares in the class-action period. Harming one group of innocent individuals to reimburse another group has little or no precedence in civil litigation (Arlen and Carney, 1992). Easterbrook and Fischel (1985) note that in security cases, settlements benefit former shareholders at the expense of current ones and, as such, damages are a transfer payment with a very high transaction cost (the contingent fee and litigation expenses). Thus, if shareholder class actions are to serve a social function, that function must be deterrence of future fraud rather than merely compensating victims.

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

¹²Others have made similar claims about the deterrence value of private shareholder litigation while noting the compensation value of these suits as well. Perino (2002), for example, quoting a House conference report, notes “Congress expressly adopted this view, long espoused by courts, the SEC and plaintiff’s class action attorneys, that private securities litigation helps to deter wrongdoing,” and “...is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action (Perino (2002) page 7).”

budget and delegating enforcement authority to private attorneys leaves the SEC free to pursue cases that are not profitable enough for private action.¹³

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).¹⁴ 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 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).¹⁵

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.¹⁶ 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

¹³ See for example Bohn and Choi (1996).

¹⁴ Grundfest notes "...the [SEC] consistently sought to avoid instituting an enforcement action if it did not in good faith believe that the action would likely prevail on the merits (Grundfest (1994) page 970)."

¹⁵ For example, Perino (2002) cites estimates that discovery constitutes 80% of litigation costs.

¹⁶ See for example Alexander (1991), Grundfest (1994), Dunbar et al. (1995), and Bohn and Choi (1996).

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.¹⁷ 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 CEO of defending against the allegation. By contrast, the absence of exit may mean that CEO or 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

¹⁷ 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.

(1981) assertion that trust is bonded by reputations suggests that outside directors trade in their reputation.¹⁸

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 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.¹⁹

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

¹⁸ 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) and Brown and Maloney (1996) examine the impact of performance and new board positions.

¹⁹ 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.

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 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.^{20, 21} From these two identifiers, I construct the total number of board positions held by each

²⁰ 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

director and the addition of new directorships. Table 1 gives the breakdown of firms and directors per year.

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.²² I define an exit as a company continuing in the sample but no longer listing an existing director on the board.²³ 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.

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.

²¹ I used only first initial and birth year for those directors without a middle initial.

²² 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.

²³ Thus, 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.

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.²⁴ 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.²⁵ Using these sources, I constructed a comprehensive list of all fraud allegations made between 1985 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.

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.²⁶ 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.

²⁴ For other studies utilizing SCAA data, see Carelton et al. (1996), Bajaj et al. (2000), and Johnson et al. (2002).

²⁵ Ferris et al. (2003) utilizes the Stanford database.

²⁶ 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 serving prison sentences.

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.²⁷ 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.²⁸

I include a director in the relevant fraud category beginning in the year that the fraud allegation becomes public.²⁹ 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.

²⁷ 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.

²⁸ 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 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.

²⁹ 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.

I supplement the data on board and fraud litigation with data from COMPUSTAT. The COMPUSTAT database contains extensive information on each firms' 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 updated it and adds a new firm. I collect the stock returns data from CRSP.³⁰

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 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.³¹ 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

³⁰ Missing observations or sample differences cause the sample to vary considerably depending on the specification.

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.³²

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 in this study is Yermack (2002), who utilizes the average equity performance of director's boards.³³ 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

³¹ 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.

³² This sample contains a different set of firms and therefore restricts the sample to a different set of directors.

³³ 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).

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 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 two 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 the current year.³⁴ 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 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. 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.

³⁴ 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.

4. Sample Characteristics

Table 1 provides the number of companies and directors by year. Table 2 provides the descriptive statistics of the directors' sample.

4.1 Patterns of Fraud Allegations

Table 3 provides three 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 1992 and 2002 sat on the board of a company accused of fraud during their tenure on the board. Almost 20% of all director-year observations fall into this category.³⁵ By contrast, only 1.9% 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 8% of directors have at some point sat on the board of a company accused of fraud while only 1.4% of directors have sat on such boards accused by the SEC. If we use the company as the unit of observation, 18% of companies were accused of fraud in a shareholder class action between 1985 and 2002 while only 2% had similar accusations made by the SEC.

4.2 Patterns of Outside Directorships

Figure 2 presents the distribution of directorships for the sample. The vast majority of directors serve on one board throughout the sample. The distribution is highly skewed with 21,132 observations indicating a director serving on 2 boards and less than 75 serving on eight or more. The change in directorships, shown in Figure 2, reflects this. In any year, the vast majority of directors do not change the number of outside boards on which they serve. The next largest category loses a directorship at some point in the sample. Only 2,334 cases gain one or more

³⁵ Note that a director may have been accused prior to 1992 but fixed effects capture this.

directorship in a year, and only 44 cases gain more than one directorship in a year. The left tail of the distribution largely reflects directors who exit the sample due to retirement, illness or death.

5. Impact of fraud allegations on future directorships

5.1 Estimation Technique

The net change in 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 change in 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 since 1986, 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 4. 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 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 has 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 a director serves on with returns in the top quartile of performance decreases the net number of directorships by 13.8%. 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 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 6.6%. 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 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 previous 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 when it is only .14. Finally, 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. 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 4 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. For directorships in the top quartile of director compensation, fraud allegations cause a 56% increase in the number of directorships. The impact is larger in directorships that offer directors stock options. A fraud allegation causes a 288% increase in the net number of such directorships. Column 4 presents results for directorships in the top quartile of director option value. A fraud allegation causes an 87% increase in the net number of directorships in the top quartile of 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. A fraud allegation causes a 105% and a 102% increase in net directorships respectively. Finally, fraud allegations also positively influence directorships in the Fortune 500. A fraud allegation causes a 105% increase in net Fortune 500 directorships.

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 Fortune 500 company. One possible explanation for 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.

5.4 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 (91% increase from a fraud allegation).

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 with fraud allegations causing a 100% increase. 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 a 130% 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 with a fraud allegation causing a 90% increase net board positions in the top quartile of CEO tenure.

The impact of fraud allegations does have a dramatically larger impact in one category of board: those that offer indemnification against shareholder class action lawsuits. A fraud allegation causes a positive and significant increase in the number of net boards that offer indemnification of directors. The impact is quite large. Net indemnified directorships increases by 455% after the

director has served on the board of a defendant company in a shareholder class-action lawsuit. The reason for this effect is likely that directors named in a suit prefer to sit on boards that protect their personal wealth from any future litigation.

5.5 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,

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

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 impact of SEC sponsored allegations of fraud are generally negative or not significant. In the case of all board positions, the impact is not significant (although it is significant in a joint test for both public and private allegations of fraud). In the case of net board positions defined by the top quartile of compensation, top quartile of value, top quartile of sales and employment and Fortune 500, the impact is significant and negative. This is smaller than the positive effect of private fraud

allegations but still not trivial. Serving on a board that is accused of fraud by the SEC causes a 50% 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 loss of 13% and 11% respectively. Finally, for Fortune 500 companies the impact is a 6% loss in net outside directorships in the Fortune 500.

Table 6 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. This result is intriguing but is not robust to changes in the definition of a public fraud allegation (see below).

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 identical to the previous section with only directorships in the top quartile of director compensation being insignificant although still having a positive coefficient.

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 1992 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 30% reduction in the net number of board seats for the director. The other effects are similarly large with such directors experiencing a 180% drop in their net board positions in the Fortune 500.

6.2 The Private Securities Litigation Reform Act

Panel D addresses a different policy question. 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.³⁶ 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).

In the wake of the Enron bankruptcy and other accounting failures, a number of groups and individuals have called for the repeal of both the PSLRA and the SLUSA, which was intended to strengthen PSLRA. By the director's reputation measure, PSLRA and SLUSA seem to have been effective. The post-1995 control is significant and negative. For example, a post-1995 private fraud allegation causes a 30% 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 results indicate that PSLRA and SLUSA did not go far enough in improving case quality.

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 by 20% when the

³⁶ 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

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.

6.4 Discussion

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

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

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. Finally, 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. 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.

6. Conclusions

It is easy to see why a CEO or other corporate officer might decide to commit fraud. The reasons are similar to the pickpocket — he benefits if the crime is successful. Yet, in shareholder litigation, one group of shareholders (the class) is paid by another group of shareholders (those not in the class). Is private enforcement of public law a good idea? Despite a large amount of literature on the merits of private securities class action, there has yet to be a systematic comparison of the determinants and relative impact of public versus private enforcement. Without such an analysis, as former SEC Commissioner Joseph Grundfest explains in his 1994 Harvard Law Review article, the current faith in the efficiency of private enforcement of the nation’s securities laws is unwarranted.

I find that a director’s number of net outside directorships increases after a board on which he is serving is accused of fraud in a private securities class action. This result is robust to different classifications of both outside directorships and fraud allegations. I also find that in cases in the top quartile of settlements or in cases that go to trial, the impact on director reputation is negative. The impact is also negative in cases filed by the SEC. Finally, the positive impact of a fraud allegation

on director reputation is smaller post PSLRA, which is consistent with the law's stated objective of reducing strike suits.

The study has broader implications than the current PSLRA debate. It clarifies two positions on the role of the private attorney general. One view is that the private attorney general represents a method of allowing private parties to enforce the nation's laws and removes a burden from the public treasury. The alternative is that private attorney generals represent a method of extorting money from the corporate treasury and ultimately the investing public. The findings of this study indicate that, at least for shareholder class actions, the evidence is consistent with the latter view.

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Table 1: The Sample of Directors and Firms by Year

The sample consists of XXX directors and XXX firms between 1994 and 2002. I collect data from Compact Disclosure.

Year	Number of Director Positions	Number of Firms
1994	48028	8971
1995	52308	9632
1996	45780	8679
1997	51874	10131
1998	50451	9772
1999	52912	9841
2000	51744	9872
2001	38974	7610
2002	24163	4036

Table 2: 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.

Variable	mean	p50	sd	min	max
All Outside Directorships	-.2156263	0	.4690099	-6	3
Pensions	-.0068997	0	.0933068	-5	1
Top Quartile of Compensation	-.1893524	0	.4355154	-6	2
Options	-.0274126	0	.1780644	-4	2
Top Quartile of Value	-.1951981	0	.4419983	-6	3
Top Quartile of Sales	-.100668	0	.3366246	-6	2
Top Quartile of Employment	-.1123297	0	.3495315	-6	2
Fortune 500	-.0144851	0	.1401527	-5	2
Top Quartile of Block Ownership	-.1099043	0	.3346985	-4	2
Top Quartile of Insiders	-.0449327	0	.2207105	-3	2
Top Quartile of Board Size	-.0520653	0	.2445264	-4	2
Indemnification	.002417	0	.0495329	0	2
Top Quartile of CEO Tenure	-.1913504	0	.4372242	-6	2
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	.1141541	0	.317999	0	1
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	.0113655	0	.1060016	0	1
Number of boards in the top quartile of industry adjusted returns	.1326151	0	.3203859	0	1
Number of boards in the bottom quartile of industry adjusted returns	.0869135	0	.2680905	0	1
Mean stock return of boards t-1	.1901926	.174915	.9738987	-8.1388	7.866
Director age>65 (=1)	.2668069	0	.4422915	0	1
Director is CEO of company in sample (=1)	.0470407	0	.2117265	0	1
The CEO of one of the director's companies exits	.0025313	0	.0502484	0	1
Director is an officer of a company in the sample	.1684121	0	.3742326	0	1
Total number of boards	1.095148	1	.6867622	0	12
Total number of boards in t>6	.0140449	0	.308485	0	12
Director is a CEO of a Fortune 500 company	.0000423	0	.006506	0	1

Table 3: 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 1985 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 1985 and 2002.

	Director Years	Directors	Companies
No Fraud Allegation between 1985 and 2002	334,447	68,117	9,915
Class action fraud allegation between 1992 and 2002	66,146	5,503	1,743
SEC suit alleging fraud between 1985 and 2002	6,345	956	190

Table 4 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 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
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	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)
Number of boards in the top quartile of industry adjusted returns	-0.093***	-0.004	-0.053***	-	-0.047***	-0.049***	-0.052***	-0.002
	(0.004)	(0.003)	(0.005)	0.055***	(0.005)	(0.003)	(0.003)	(0.001)
Number of boards in the bottom quartile of industry adjusted returns	-0.053***	-0.005	0.006	-0.005	0.006	-0.005	-0.015***	0.001
	(0.005)	(0.003)	(0.007)	(0.006)	(0.007)	(0.003)	(0.004)	(0.002)
Mean stock return of boards t-1	0.031***	-0.001	0.029***	0.027***	0.027***	0.018***	0.016***	0.001**
	(0.002)	(0.002)	(0.003)	(0.003)	(0.003)	(0.001)	(0.001)	(0.001)
Director age>65 (=1)	0.008	0.004	-0.007	-0.002	-0.009	-0.018***	-0.013***	-
	(0.006)	(0.004)	(0.007)	(0.007)	(0.007)	(0.004)	(0.004)	0.010***
Director is CEO of company in sample (=1)	-0.071***	-0.022***	-0.040***	-	-0.049***	-0.032***	-0.036***	0.001
	(0.008)	(0.006)	(0.011)	0.029***	(0.011)	(0.006)	(0.006)	(0.003)
The CEO of one of the director's companies exits	0.050**	-0.013	-0.008	-0.009	0.010	0.078***	0.052***	-0.002
	(0.021)	(0.012)	(0.024)	(0.023)	(0.026)	(0.015)	(0.016)	(0.007)
Director is an officer of a company in the sample	0.009	0.008	-0.007	-	-0.017	0.010*	0.020***	0.008***
	(0.007)	(0.006)	(0.012)	0.036***	(0.011)	(0.012)	(0.005)	(0.006)
Total number of boards	-0.184***	-0.025***	-0.102***	-	-0.130***	-0.105***	-0.106***	-
	(0.004)	(0.003)	(0.006)	0.092***	(0.006)	(0.007)	(0.003)	0.016***
Total number of boards in t>6	0.036***	-0.001	-0.022**	0.004	0.001	0.026***	0.018***	0.006***
	(0.004)	(0.005)	(0.010)	(0.009)	(0.010)	(0.003)	(0.003)	(0.002)
Director is a CEO of a Fortune 500 company	0.804***	0.349***	0.460**	0.486***	0.506***	0.739***	0.777***	0.753***
	(0.148)	(0.091)	(0.181)	(0.172)	(0.191)	(0.109)	(0.113)	(0.049)

Observations	209404	56171	56171	56171	56171	209404	209404	209404
Directors	50995	14739	14739	14739	14739	50995	50995	50995
R-squared	0.23	0.02	0.10	0.10	0.09	0.10	0.11	0.02
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 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)	0.101*** (0.010)	0.045*** (0.007)	0.071*** (0.007)	0.011** (0.005)	0.174*** (0.022)
Number of boards in the top quartile of industry adjusted returns	-0.048*** (0.003)	-0.021*** (0.002)	-0.008*** (0.002)	-0.004*** (0.001)	-0.042*** (0.005)
Number of boards in the bottom quartile of industry adjusted returns	-0.021*** (0.003)	-0.020*** (0.002)	-0.012*** (0.003)	-0.005*** (0.002)	-0.010 (0.007)
Mean stock return of boards t-1	0.013*** (0.001)	0.010*** (0.001)	0.002* (0.001)	0.000 (0.001)	0.025*** (0.003)
Director age>65 (=1)	0.013*** (0.004)	0.010*** (0.003)	-0.014*** (0.003)	0.001 (0.002)	0.009 (0.007)
Director is CEO of company in sample (=1)	-0.042*** (0.006)	-0.020*** (0.004)	-0.021*** (0.005)	0.009*** (0.003)	-0.030** (0.012)
The CEO of one of the director's companies exits	0.033** (0.015)	0.035*** (0.010)	-0.009 (0.011)	0.017*** (0.006)	0.025 (0.025)
Director is an officer of a company in the sample	-0.011** (0.005)	0.002 (0.003)	0.006 (0.004)	-0.000 (0.003)	-0.014 (0.012)
Total number of boards	-0.099*** (0.003)	-0.031*** (0.002)	-0.044*** (0.002)	0.028*** (0.002)	-0.093*** (0.006)
Total number of boards in t>6	0.009*** (0.003)	0.006*** (0.002)	0.015*** (0.002)	-0.007*** (0.002)	-0.010 (0.010)
Director is a CEO of a Fortune 500 company	0.217** (0.107)	0.117 (0.071)	0.555*** (0.080)	0.497*** (0.059)	0.463** (0.185)
Observations	209404	209404	209404	57247	56171
Directors	50995	50995	50995	14906	14739
R-squared	0.10	0.06	0.05	0.03	0.10

Standard errors in parentheses

* significant at 10%; ** significant at 5%; *** significant at 1%

Table 6: Fixed Effect 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.

Panel A

	(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)	0.215*** (0.014)	0.059*** (0.011)	0.108*** (0.022)	0.079*** (0.021)	0.172*** (0.023)	0.107*** (0.010)	0.122*** (0.010)	0.017*** (0.005)
Public allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.026 (0.021)	0.006 (0.012)	-0.095*** (0.024)	-0.007 (0.023)	-0.047* (0.025)	- 0.136*** (0.015)	-0.115*** (0.016)	-0.066*** (0.007)
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)	0.101*** (0.010)	0.045*** (0.007)	0.074*** (0.007)	0.011* (0.005)	0.173*** (0.022)			
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.015 (0.015)	-0.004 (0.010)	-0.088*** (0.011)	0.025*** (0.006)	0.029 (0.024)			
Standard errors in parentheses * significant at 10%; ** significant at 5%; *** significant at 1%								

Table 7: Fixed Effect Estimation Using Alternative Definitions of 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 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. All models include director and year fixed effects.

	(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 dropped or Dismissed Cases								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	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 (Directors has served on a board named in a class action lawsuit)	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 (Directors has served on a board named in a class action lawsuit)	-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 (Directors has served on a board named in a class action lawsuit)	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 (Directors has served on a board named in a class action lawsuit)*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)
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.

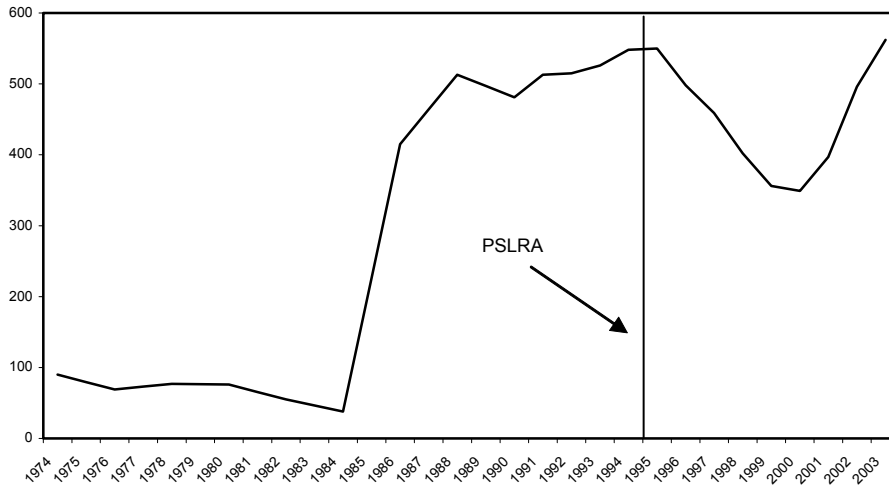
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	All Outside Directorships	Pensions	Top Quartile of Compensation	Options	Top Quartile of Value	Top Quartile of Sales	Top Quartile of Employment	Fortune 500
Panel A: no dropped, dismissed or injunctions								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.209*** (0.014)	0.060*** (0.011)	0.108*** (0.022)	0.078*** (0.021)	0.173*** (0.023)	0.103*** (0.010)	0.119*** (0.011)	0.018*** (0.005)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.045** (0.021)	-0.008 (0.013)	-0.096*** (0.025)	0.002 (0.024)	-0.062** (0.026)	-0.143*** (0.016)	-0.126*** (0.016)	-0.070*** (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)	0.240*** (0.030)	0.066*** (0.021)	0.065 (0.042)	0.111*** (0.040)	0.208*** (0.045)	0.100*** (0.022)	0.129*** (0.023)	0.006 (0.010)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.036* (0.021)	-0.007 (0.013)	-0.094*** (0.025)	0.003 (0.024)	-0.059** (0.026)	-0.138*** (0.016)	-0.121*** (0.016)	-0.069*** (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)	-0.066*** (0.008)	- 0.024*** (0.006)	-0.049*** (0.012)	-0.027** (0.011)	-0.030** (0.012)	-0.052*** (0.006)	-0.053*** (0.006)	-0.026*** (0.003)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.030 (0.021)	-0.007 (0.013)	-0.093*** (0.025)	0.004 (0.024)	-0.057** (0.026)	-0.136*** (0.016)	-0.117*** (0.016)	-0.068*** (0.007)
Panel D: standard definition post 1995 interaction								
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	0.335*** (0.018)	0.071*** (0.014)	0.157*** (0.027)	0.097*** (0.026)	0.231*** (0.029)	0.149*** (0.013)	0.177*** (0.014)	0.035*** (0.006)

Allegation of Fraud (Directors has served on a board named in a class action lawsuit)*Post 1995	-0.134***	-0.015	-0.063***	-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)
Allegation of Fraud (Directors has served on a board named in a class action lawsuit)	-0.027	0.006	-0.094***	-0.007	-0.046*	-0.136***	-0.115***	-0.067***
	(0.021)	(0.012)	(0.024)	(0.023)	(0.025)	(0.015)	(0.016)	(0.007)
Standard errors in parentheses								
* significant at 10%; ** significant at 5%; *** significant at 1%								

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

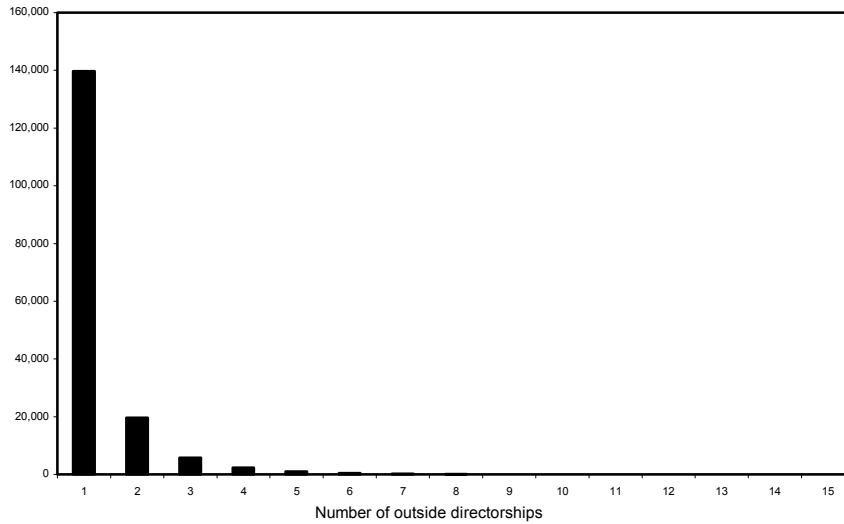


Source: Tillinghast-Towers Perrin, "2003 DIRECTORS AND OFFICERS LIABILITY SURVEY EXECUTIVE SUMMARY OF U.S. AND CANADIAN RESULTS."

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

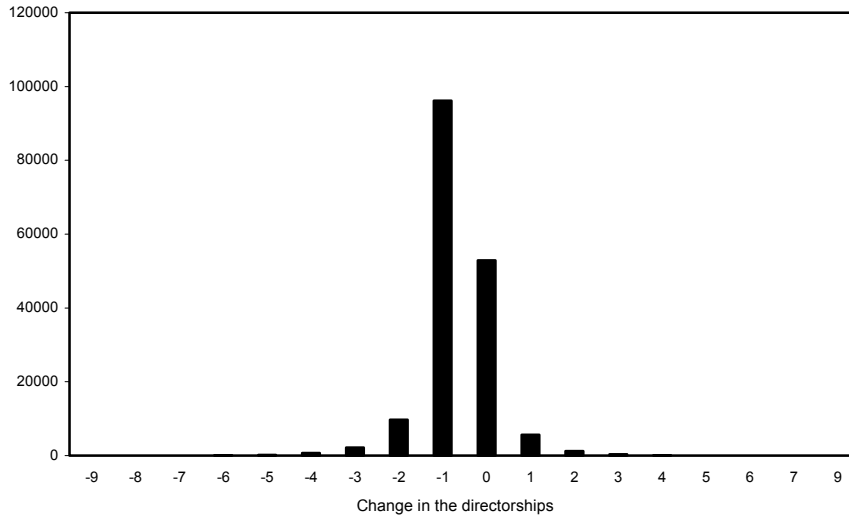


Source: Compact Disclosure 1994-2002

Figure 3: Distribution of the change in directorships

The distribution of change in 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