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When governance fails: Naming directors in class action lawsuits

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A B S T R A C T

This paper examines one type of failure in the governance system, the case where directors do not protect shareholders from securities fraud. We find that shareholders can influence large changes in governance and compensation by targeting the full board of directors, but it is more costly in terms of legal fees. Naming directors in a class action lawsuit based on securities fraud, on average, leads to increases in CEO incentive pay, but decreases in director incentive pay. Additionally, naming directors results in a greater change in board composition. These changes in compensation and corporate governance appear to lead to enhanced performance in the years following the lawsuit.

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1. Introduction

A strong signal of the breakdown in the shareholder–director agency relationship is a shareholder-initiated lawsuit that specifically targets the full board of directors. As the representative of shareholders, the board of directors ideally provides oversight and reduces, rather than creates, agency problems. However, board members may breach their fiduciary duty by not providing sufficient oversight of management or even participating in misleading shareholders. In this paper, we provide evidence that when all independent directors are targeted in shareholder class action lawsuits, shareholders are able to influence boards to implement large reforms in board structure and compensation.[3]

When miscreant behavior occurs, shareholder-initiated lawsuits may be the only way to penalize the officers and directors of the corporation. For instance, in 2002 Dynegy violated securities law by misleading investors in the way it accounted for a $300 million

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[3] We use the Stanford Law School Securities Class Action Clearinghouse to create our sample. This database “provides detailed information relating to the prosecution, defense, and settlement of federal class action securities fraud litigation.” Fraud is an all-encompassing term that describes a deceptive practice in the stock or commodities markets that induces investors to make purchase or sale decisions on the basis of false information, resulting in losses to investors.

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financing scheme and its directors were named in a class action lawsuit. As part of the settlement, Dynegy agreed to appoint two plaintiff-nominated directors to help monitor corporate governance reforms put in place at the company.[4] Shareholders can theoretically vote against individual members of the board who are not acting in shareholders' best interests, but this proves to be a difficult and expensive process (Bebchuk, 2003).

While the primary reason for the lawsuit is to compensate shareholders for losses, there can be the additional benefit of improved governance. By targeting directors in a class action lawsuit, shareholders are holding the board responsible for poor decision-making or fraud in the company. If a lawsuit is directed toward the board members, it may cause greater reputational losses to directors than lawsuits not aimed at directors. Outside board members rarely pay with personal funds (due to Director and Officer insurance) in director lawsuits, but they may suffer a reputation loss, including decreases in the number of other board positions, as well as time spent dealing with the lawsuit that could be spent monitoring and advising the firm. Given these costs, outside directors may have greater incentive to reform the governance and compensation in reaction to being specifically targeted in a shareholder lawsuit. This paper provides insight into the power of shareholder lawsuits. Since, at a minimum, board and compensation changes require agreement by the majority of a board, the board members themselves being sued may cause differences in changes in compensation and board structure to avoid further lawsuits and reputational loss.

When shareholders specifically include outside directors in a class action lawsuit, the lawsuit may become more costly. Black et al. (2005) suggest that there is a higher standard of proof in proving directors liable; noting that, even with company violations, directors are not liable as long as they exercised due diligence. As settlements are based on the losses to the plaintiffs, settlements are not expected to be larger if directors are named. Why then, if there is a higher burden of proof, would shareholders ever name directors in a lawsuit? Armour et al. (2009) suggest that while inside directors are the primary targets in a board lawsuit, the outside directors are included to put pressure on the board to quickly settle the lawsuit. Perhaps by naming directors, shareholders also expect substantial changes in board structure and compensation packages.

The contribution of our paper is the finding that when directors are targeted in a fraud-based lawsuit, this increases both the cost of the lawsuit and changes in governance and compensation. Prior research has focused on the determinants and aftermath of lawsuits against firms. However, less attention has been paid to lawsuits that specifically name independent directors as defendants, and how the effects of these lawsuits may differ from traditional lawsuits. Brochet and Srinivasan (2014) are an exception; they examine why individual directors are targeted; they find that directors who might have stopped the fraud are more likely to be targeted. Our paper shows how targeting the whole board, rather than just a few members, affects the firm and lawsuit outcome.

Our paper contributes to the existing literature in 3 ways. First, we show that there are fundamental differences in governance and compensation between lawsuit firms naming all of the directors versus lawsuit firms naming only the executives. Second, we show that there are increased costs associated with naming directors, which is why not all plaintiffs do so. Third, we show that by naming directors, on average, plaintiffs are able to improve governance.

While others have shown that lawsuits lead to changes in governance (Cheng et al., 2010 and Ferris et al., 2007), we show that these changes are magnified when the full board of directors is named. Brochet and Srinivasan (2014) examine how being named in a lawsuit impacts individual directors, whereas we examine whether the whole board of directors being named impacts the governance and compensation structure of a company. This paper has implications for shareholders to increase the impact of a lawsuit by targeting the full board of directors in poorly governed firms.

We find that directors are less likely to be targeted when the board is more independent and directors own less common stock. Companies with director aimed lawsuits are more likely to have greater CEO total compensation, but lower CEO pay-performance sensitivity prior to the lawsuit. There are also greater changes in board composition and compensation following a director aimed lawsuit than a non-director aimed lawsuit. Boards are more likely to decrease in size and directors become less busy. Further, following the lawsuit, we find that director aimed lawsuits are more likely to result in decreases (increases) in CEO total pay (pay-performance sensitivity), as well as decreases in director pay-performance sensitivity. Moreover, when lawsuits are aimed at directors, the lawsuit is more costly. Shareholders suffer a significantly more negative abnormal stock return at the announcement of the lawsuit. However, returns are higher to shareholders during the announcement and after the settlement. When directors are named, the lawsuit is more likely to be settled and the settlement amount and legal fees are higher.

2. Literature review and hypotheses

2.1. Literature review

Our study contributes to two lines of literature, the analysis of lawsuit costs, and the governance changes that occur following lawsuits. While shareholders expect monetary gains, the lawsuits are costly to both the firm and to the directors and managers of the corporation. In terms of firm value, Gande and Lewis (2009) find that announcements of shareholder initiated lawsuits are associated with a significantly negative stock price reaction. This reduction in share price is costly to shareholders offsetting some of the cash settlement. For a sample of 384 firms with financial reporting violations, Karpoff et al. (2008) find that the aggregate loss in value due to class action lawsuits totals $8.59 billion, or 5.53% of the total dollar loss attributed to the violation. Further, Humphery-Jenner (2012) finds that, in lawsuits based on issuing incorrect information, corporations are more likely to be taken over after

[4] Dynegy said its director and officer insurance policies would cover $150 million of the settlement and another $68 million would come from a stock issue. Dynegy will also make cash payments of $250 million in two series: $175 million in the second quarter and $75 million following federal court approval. Dynegy also agreed to pay $5 million in attorneys' fees and expenses related to litigation (http://securities.stanford.edu/1024/DYN02-01/).

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