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

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ABSTRACT

We examine the relationship between outcomes of securities fraud class action lawsuits (SFCAs) and corporate board turnover rates. Our results indicate that turnover rates for board members are higher when a firm settles a lawsuit than when a suit is dismissed. Outside director turnover is most sensitive to SFCA outcomes, perhaps reflecting reputational effects. Results demonstrate that involvement in securities fraud is costly for corporate board members.

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1. Introduction

What are the consequences of securities fraud for corporate board members? Most public corporations indemnify board members. Board members rarely pay fines or contribute to settlements out-of-pocket (Black et al., 2006).[1] However, the alignment of the interests of board members with those of shareholders requires that board members bear costs from lax monitoring of management or their implication in the underlying wrongdoing. Despite the attention focused on securities fraud in the wake of the corporate scandals of the past decade, relatively little research has addressed the consequences of securities fraud for corporate directors.

Although directors rarely participate in financial settlements, there may be other costs that directors experience as a result of service on the board of a firm in which a fraud occurs. One cost is the loss of their position on the board of directors of the firm that is named as the defendant in a lawsuit. Board service is a source of income for outside directors. Service on the board of directors of a public company carries with it considerable prestige and may be a source of business connections for an outside director. CEO's typically hold a seat on the board. Other senior managers may also hold directorships. For members of the board that are also employees of the firm, loss of a position on the board of directors typically accompanies dismissal from a top management position.

The primary purpose of this paper is to investigate whether the seriousness of the fraud alleged in a securities fraud lawsuit is related to turnover rates among corporate board members of firms subject to a securities fraud class action (SFCA). If the control systems of a firm impose costs on errant board members, board turnover should be higher when a more serious fraud is discovered than when the underlying wrongdoing was less serious or when there is no wrongdoing at all. One difficulty in this line of research is

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[1] Two notable exceptions are the Enron and Worldcom settlements. In the Enron matter, ten outside directors personally contributed $13 million to the settlement. In Worldcom, ten former outside directors contributed $18 million to the settlement.

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that whether a fraud actually occurred or not is not directly observable. However, lawsuit outcomes are observable, and settlement amounts and orders dismissing lawsuits can be obtained from court records. A substantial percentage of SFCAs are dismissed.[2] Most of the remainder are settled, and trials are rare. We use this largely-overlooked aspect of private securities law enforcement to build testable hypotheses linking the seriousness of the allegations of fraud to board turnover. Lawsuit outcomes provide useful information concerning the seriousness of the underlying wrongdoing if courts screen out weak cases, granting a defendant's motion to dismiss if a lawsuit does not meet certain pleading requirements. However, in instances in which the underlying wrongdoing is more serious, plaintiffs should be better able to construct a case that will survive a defendant's motion for dismissal. Similarly, among lawsuits that are not dismissed and are eventually settled, the size of the settlement may also reflect the seriousness of wrongdoing.

If lawsuit outcomes reflect the seriousness of the underlying wrongdoing, we expect that lawsuit outcomes would also be correlated with corporate board turnover. However, if case outcomes are unrelated to the strength of the case and are primarily driven by the plaintiff attorneys' ability to extract rents, we should not expect to detect any systematic relationship between SFCA outcome and board turnover. We test our competing hypotheses on the seriousness of allegations by estimating the *difference* in board turnover propensity between firms that are involved in securities fraud lawsuits that are dismissed and those that are not dismissed. We later extend this strategy of measuring seriousness by estimating the relationship between turnover rates and settlement amounts. Our results have a bearing on the large literature on the efficacy of private enforcement of securities laws.[3]

Our main findings are as follows. First, we find that board turnover rates (specifically, the probability that a board member will leave the board within several years) are significantly related to indicators of the seriousness of SFCA allegations. Turnover rates are higher when a lawsuit is settled than when it is dismissed. These effects for outside and inside directors are both statistically significant and economically meaningful, with the probability of departure increased by 14.0% for outsiders and 15.1% for insiders.[4] Given the role of non-observable factors that might affect departures (Coles et al., 2015), we do not attempt to attribute the departure of specific directors to a particular cause. Departures may be dismissals, but they might also be voluntary departures given reputational considerations and directors responding to outside options. We do not know to what extent departures represent the board's actions rather than individual decisions. That said, our findings that lawsuit outcomes contain important information about the seriousness of allegations are robust and stronger allowing for endogeneity in the relationship.

Second, our finding that lawsuit settlements and settlement amounts have a significantly larger impact on board turnover, relative to lawsuits that are dismissed, have important implications for future research on the effects of managerial opportunism on corporate accounting, investment and financing choices. Researchers have used securities lawsuits to identify periods in which management caused or knew that the value of a firm's equity was inflated.[5] Conditioning on lawsuit outcomes can provide additional precision in these studies of this sort. Plaintiffs in a SFCA must provide evidence of scienter—that the defendants acted with the knowledge that their conduct was wrong or illegal—to survive a motion to dismiss. One should not expect changes in the aftermath of frivolous lawsuits, and any research design utilizing lawsuits as a proxy for managerial opportunism should control for information from lawsuit outcomes.

Third, we find that the observed differences in board turnover rates between settled and dismissed lawsuits remain statistically significant even after we control for abnormal stock returns at the end of the class period. The class period is the period of time during which plaintiffs allege that the price of a security was distorted by fraud. The end of the class period is typically the date on which plaintiffs allege that the true state of the firm was revealed to the marketplace. This finding is consistent with lawsuit outcomes producing valuable information about the extent or wrongdoing, leading to board turnover, that is not publicly available at this event date. This is not surprising, as information on wrongdoing is often slow to emerge, sometimes as a consequence of deliberate legal strategy. As expected, abnormal stock returns at the end of the class period are poor predictors of the outcome of a lawsuit.

Finally, our research design provides a workable methodology for two important empirical issues that are relevant to this line of enquiry: (i) the direction of causality and (ii) benchmarking the control group. For both issues, we provide some innovative ways to circumvent the problems. First, while we find that SFCA outcomes drive director turnover, our result needs to be cognizant of and control for Helland and Sykuta's (2005) finding that board structure may be correlated with SFCA outcomes. We explicitly control for this issue by using a new empirical methodology, Lewbel's special regressor technique, designed to estimate binary outcomes where one or more of the key factors may be binary and endogenous in nature. Our key findings are unchanged after controlling for the possibility of endogeneity.

Much of the previous work on agency costs and fraud relies on the use of matching samples of non-lawsuit control firms. But many of the important predictors of a lawsuit, such as the strength of internal controls, the information content of disclosure policies or the strength of corporate governance, are difficult to quantify. These non-quantifiable firm characteristics may often be correlated with board turnover propensities. Our methodology circumvents some of these issues by evaluating the differential impact of the lawsuit outcome on corporate board turnover. All the firms in our sample have one common characteristic: they have all been sued for alleged fraud via a SFCA. Our estimates highlight the differential impacts of these lawsuits when they have been dismissed versus they were settled. This allows us to reduce the impact of those important but non-measurable firm characteristics that might be important to a firm being sued.

The remainder of the paper proceeds as follows. Section 2 presents an overview of the literature on the connection between securities fraud and corporate board turnover and contains a more detailed discussion of our hypotheses. Section 3 discusses the construction of our data and our modeling approach. Section 4 provides our findings on board turnover and case outcomes. We then consider the implications of our director-level analysis for the firms in our sample in Section 5, which provides evidence on how corporate board structure changes based on resolution of a securities fraud lawsuit. Section 6 concludes.

[2] NERA Economic Consulting reports that approximately 40% of SFCAs are dismissed (National Economic Research Associates, 2007).

[3] For instance, Porta et al. (2006) find that private enforcement of securities laws facilitates financial market development.

[4] Although the estimated impact on CEOs is not precisely estimated, their point estimate has a similar magnitude.

[5] Research utilizing SFCAs to identify periods in which managers knew or caused equity values to be inflated include McTier and Wald (2011)'s study of accounting and investment choices when equity is overvalued, DuCharme et al. (2004) examination of equity issuance and Gong et al. (2008) examination of stock-for-stock acquisition decisions.

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