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Accountability of independent directors: Evidence from firms subject to securities litigation ☆

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ABSTRACT

We examine which independent directors are held accountable when investors sue firms for financial and disclosure-related fraud. Investors can name independent directors as defendants in lawsuits, and they can vote against their reelection to express displeasure over the directors' ineffectiveness at monitoring managers. In a sample of securities class action lawsuits from 1996 to 2010, about 11% of independent directors are named as defendants. The likelihood of being named is greater for audit committee members and directors who sell stock during the class period. Named directors receive more negative recommendations from Institutional Shareholder Services, a proxy advisory firm, and significantly more negative votes from shareholders than directors in a benchmark sample. They are also more likely than other independent directors to leave sued firms. Overall, shareholders use litigation along with director elections and director retention to hold some independent directors more accountable than others when firms experience financial fraud.

1. Introduction

We examine accountability of independent directors when firms face litigation for corporate financial fraud. Shareholders have two publicly visible means for holding directors accountable: They can sue directors, and they can vote against director reelection. We use the incidence of independent directors being named as defendants in securities class action lawsuits and shareholder votes against those directors to assess which directors are held accountable for the violations that lead to the lawsuits.

Independent directors named as defendants in securities lawsuits (hereafter named directors or named defendants) face the possibility of financial and reputational harm, lost time, and emotional distress.[1] Their personal financial liability from lawsuits is limited in the US (Black,

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[1] This quote by Toby Myerson, partner at Paul, Weiss, Rifkind, Wharton & Garrison LLP, speaking at the 2005 Harvard Law School Symposium on Director Liability, quoted in Bebchuk (2006, p. 1036), reflects this concern: "Most people who consider acting as directors don't want to have their name in the caption of the lawsuit. They don't want to have to establish that they didn't do anything wrong. They don't want to have to be deposed and spend their time dealing with the litigation. Life is too short. People are busy; they have other things to do."

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Cheffins, and Klausner, 2006a). But public pension fund plaintiffs did require personal settlement payments collectively amounting to $13 million and $24.75 million, respectively, from independent directors in high-profile cases relating to the Enron and WorldCom scandals. These plaintiffs aimed to show that directors were accountable for corporate fraud (Office of the New York State Comptroller, 2005). Their efforts, combined with increased duties for independent directors mandated by the Sarbanes-Oxley Act of 2002 (SOX), have caused concern that directors' litigation risk has increased (Bebchuk, 2006; Laux, 2010; Steinberg, 2011).

We expect director accountability to reflect the director's role in the irregularity, the severity of the problem, and the nature of the plaintiff investors. Investors are likely to hold accountable those directors with greater roles in financial oversight and those who appear to have profited from fraud and name them as defendants. We test both suppositions. We identify audit committee directors as the ones with greater oversight of accounting and disclosure issues and directors who sold shares as more likely to have profited from inside information. We also expect more independent directors to be named when the cases are more severe and with greater shareholder losses. Because Section 11 violations allow for a broader inclusion of defendants than Rule 10b-5 lawsuits, we expect a higher incidence of named directors in Section 11 lawsuits.[2] Finally, we expect institutional plaintiffs to be more likely to enforce accountability. Institutional investor plaintiffs are likely among the largest shareholders and have incentives to discipline directors who they could hold accountable for any misrepresentations.

Our sample consists of companies sued for violation of Sections 10b-5 or Section 11 between 1996 and 2010, whose information we collect from the Institutional Shareholder Services (ISS) Securities Class Action Litigation database. When intersected with firms in the Investor Responsibility Research Center (IRRC) Directors database, we get a sample of 921 lawsuits filed against US firms in the Standard & Poor's (S&P) 1500. We find that, conditional on a company being sued, 11% of independent directors are named as defendants. We also find that the likelihood of being named is higher for independent directors who have served on the audit committee (54% of named defendants), have sold shares during the class period (16% of named defendants), or have been on the board for the entire class period. It is also higher when the lead plaintiff is an institutional investor and when the lawsuit is filed under Section 11.

Irrespective of litigation, shareholders can also hold directors accountable by voting against them. Recent research (Cai, Garner, and Walkling, 2009) finds that shareholder votes are significantly related to director performance and that boards act as if they respond, even if the economic magnitude of the negative votes is small.

We expect shareholders to continue their accountability efforts toward named directors by voting against those directors' reelection. We find that ISS, the leading proxy adviser, and shareholders view named directors negatively. These directors have a greater percentage of withheld votes (5.47% greater) compared with directors in a matched sample of non-sued firms. The mean matched firm negative vote (5.03%) is similar to the 5.73% negative vote for the average director shown in Cai, Garner, and Walkling (2009). The mean negative vote for named directors (10.50%) is thus about twice that for matched firm directors and a benchmark from prior research. Non-named directors of sued firms have a modestly greater negative vote (1.10% greater) than directors of non-sued firms.

Accountability can also be reflected in greater turnover for named directors. In our study, these directors are more likely to leave a sued company within two years of the lawsuit than other directors in the same firm and the matched sample. The marginal effect of being named on director turnover is 3.62%, which implies a 30% higher rate than the unconditional probability of turnover in our sample. The propensity of named directors to leave the board is greater in lawsuits that are not dismissed (the settled cases) and for audit committee members. The likelihood of leaving increased for both named and other directors in sued firms after 2002 (post-SOX), which we use as a proxy for greater governance sensitivity.

Naming directors as defendants can also have economic implications for lawsuit outcomes. We expect a positive association between directors being named as defendants and the likelihood that a lawsuit will not be dismissed, reach a settlement faster, and settle for more, based on two non-mutually exclusive hypotheses. First, as the Enron and WorldCom cases suggest, independent directors can be named in more severe lawsuits. Second, plaintiffs' lawyers can strategically name independent directors as a negotiating tactic. Our regression results show that the likelihood of lawsuit dismissal decreases in the number of named directors with a marginal effect of 2.75%, time to settlement is faster when more directors are named, and the settlement amount increases by about 9% for every named director after controlling for the severity of the alleged wrongdoing. Further analysis suggests that independent directors are targeted by plaintiffs employing more strategic negotiating tactics.

Prior literature (e.g., Srinivasan, 2005; Fich and Shivdasani, 2007) suggests that independent directors lose positions on other corporate boards when companies whose boards they serve on experience financial irregularities. These papers interpret the loss of other directorships as a reputational penalty. While these papers examine director reputation, we focus on director accountability. Examining which independent directors are held accountable helps in assessing directors' incentives to function as monitors.[3] Regulatory efforts such as the Securities and

[2] Section 11(a) of the Securities Act of 1933 intends to ensure accurate disclosure to investors during the offer and sale of securities. Rule 10b-5 of the Securities Exchange Act of 1934 pertains to companies listed in the secondary markets and requires accurate representations to existing investors.

[3] We recognize that a lawsuit filed for securities law violation does not imply that a fraud occurred. Consistent with prior research, in the absence of a foolproof way to identify fraud and director intent, lawsuits