

**SECURITIES FRAUD CLASS ACTIONS AND CORPORATE GOVERNANCE:
NEW EVIDENCE ON THE ROLE OF MERIT**

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ABSTRACT

We provide new evidence on the efficacy of private enforcement of securities laws through class action lawsuits. We test to determine whether the outcome of the suit is connected to the merit of the allegations and whether involvement in an action has consequences for corporate board members. Our results indicate that board turnover rates for inside directors are significantly higher in the period following the filing of a lawsuit that is not dismissed. Turnover rates are particularly sensitive to outcome for inside directors named as defendants in the action. Turnover propensity is more sensitive to outcome in actions involving restatements and when external equity holdings are more concentrated. Our results suggest that the outcomes of securities class actions are tied to the merit of the allegations and that firms apply sanctions to those individuals connected to the alleged wrongdoing. Our results support the view that private lawsuits with merit affect corporate governance.

1. Introduction

The United States maintains a dual system for the enforcement of securities laws. In addition to the public enforcement efforts of the SEC and Department of Justice, private investors have the right to initiate a lawsuit if they believe that they have been harmed. Recent work on the efficacy of these enforcement mechanisms has provided some important new insights. Highlighting the impact of *public enforcement* efforts, Karpoff, Lee and Martin (2007) note that 93% of individuals identified as closely connected to the alleged wrongdoing by the SEC and Department of Justice enforcement actions lose their jobs by the end of the regulatory enforcement period. Recent evidence concerning *private litigation* is also encouraging. Ferris et al. (2007) report significant improvements in corporate governance from derivative lawsuits. In this paper we provide new evidence for the efficacy of the other avenue of private enforcement: Securities Fraud Class Actions (SFCAs).ⁱ

Private securities fraud class actions are numerous.ⁱⁱ In recent years, the aggregate amount of settlements in SFCAs has exceeded the amount of fines levied by the SEC (Jackson, 2005). The role of SFCAs in the enforcement of the securities laws has been controversial. Ideally, one should observe a significant correlation between seriousness of violation and the subsequent sanctions meted out to perpetrators. However, critics of the private enforcement system argue that the litigation process strongly favors settlement, that the outcome of SFCAs is unrelated to the *seriousness* of the underlying violation (Alexander (1991) and that the SFCA mechanism does little to sanction wrongdoers Coffee (1986, 2006)). In this paper we examine these issues comparing the impact on corporate board members of cases that are dismissed with those that are not. We also look at the defendants named in a lawsuit to provide direct evidence on the sanctions meted out to board members deemed culpable.

A substantial percentage of SFCAs are dismissed. We use this often-overlooked aspect of private enforcement to test our primary hypothesis that class action filings with merit affect corporate governance: in particular, board turnover. We hypothesize that the strength of allegations of wrongdoing affects the outcome of the case as well as subsequent changes in governance. We argue that class action lawsuits in which the underlying wrongdoing is more serious are less likely to be dismissed and are more likely to be associated with larger observed changes in corporate governance.ⁱⁱⁱ Our results indicate that the treatment of lawsuit outcome has important implications for research on the impact of private litigation on corporate governance.

We find that turnover rates of inside board directors following the filing of a SFCA are substantially higher when the action is not dismissed by the court. In the three years following the filing of a lawsuit, turnover rates for inside directors are 10 percentage points higher when a case is settled or remains ongoing than when it is dismissed. The difference in turnover rates is statistically significant. Among insiders, turnover rates for CEOs and directors named as defendants are even more sensitive to outcome of the lawsuit. Insiders that are named as defendants in the action are 17 percentage points more likely to leave the board within three years after filing if the action is settled or ongoing than if dismissed. Because cases that are not dismissed have a larger impact on board turnover, pooling class action lawsuits that are dismissed with those that are not dismissed will dilute the observed impact of the alleged wrongdoing on board turnover.

Our results also suggest that the *nature* of the allegations are also an important determinant of the board turnover rate. We find that the relationship between SFCA outcome and turnover is significant after controlling for the nature of the allegations (restatement or other allegations). Among firms experiencing a SFCA concerning a restatement, inside director turnover rates are 23 percentage points higher among firms with settled or ongoing lawsuits than among firms in which the action is dismissed.^{iv} Although a restatement *per se* is not conclusive evidence of wrongdoing, corporate control systems treat allegations of wrongdoing in restatements much more seriously than other allegations. This suggests that it may be important to control for both the *nature* and

strength of allegations while investigating the impact of litigation on corporate governance.

Unlike previous work on this issue, our research design avoids the drawbacks of creating a matched sample to investigate the efficacy of SFCAs.^v Our sample consists solely of firms that are named as defendants in a SFCA. This design allows us to overcome important drawbacks of a matched sample study and to provide a direct test for the efficacy of private litigation. There are a number of firm-level characteristics that may be associated with the likelihood of a lawsuit but are unobservable.^{vi} Failing to control for relevant firm characteristics will lead to unreliable results if these omitted firm characteristics are correlated with board turnover propensities.^{vii} Our research design sidesteps these issues. All the firms in our analysis exhibit outward indications of a potential fraud that were strong enough to prompt the filing of a complaint by a plaintiff attorney. Our results indicate how the board turnovers of the dismissed SFCAs (violations that are less serious) compare with those that are not dismissed (more serious violations). Second, our methodology provides more direct evidence of the true impact of SFCAs by controlling for the merit in the underlying allegation. Frivolous SFCAs should not impact corporate governance. Our research design allows us to control for this.

The remainder of this paper proceeds as follows. Section 2 of this paper provides a more detailed exposition of our research design and examines previous work on the relationship between securities fraud, corporate governance and turnover. Section 3 discusses our sample and the construction of our empirical tests. Section 4 contains the results of our analyses concerning the turnover rates of outside and inside directors in firms experiencing a SFCA. In section 5, we examine changes in board structure in the period following the action. Section 6 concludes.

2. Filings, Dismissals and the Merit of SFCAs

2.1. Merit and the Outcome of SFCAs

Federal law specifies the procedural requirements for litigants in a SFCA. Figure 1 illustrates the series of events in a typical SFCA. Plaintiffs in federal SFCAs usually allege that the issuer has violated the SEC's Rule 10b-5.^{viii} Rule 10b-5 prohibits the issuance of an untrue fact or failure to disclose a material fact in connection with the purchase or sale of a security. Plaintiffs in a SFCA usually allege that the misleading disclosures caused the securities of the issuer to trade at a higher price than it would have absent the fraudulent disclosures. The period in which the price of the security was allegedly mispriced as a result of the fraudulent disclosures is referred to as the "class period". Plaintiffs must specify in their complaint the beginning and ending dates of the class period. The final day of the class period is the date on which plaintiffs typically claims that the true state of the firm is revealed to the marketplace.^{ix}

The Private Securities Litigation Reform Act of 1995 ("PSLRA") specifies two elements that plaintiffs must offer in their complaint.^x First, plaintiffs must cite the specific statements or omissions that are alleged to be misleading and the reasons that plaintiffs allege them to be misleading. Second, plaintiffs must provide evidence that defendants in the SFCA either willfully sought to deceive investors or were reckless. Merely alleging that defendants were negligent is insufficient. In most cases, defendants will file a motion asking the court to dismiss the action. The pleading requirements under the PSLRA place the court in a screening role by requiring upon a motion to dismiss that the court examine the adequacy of the allegations put forth by plaintiffs. In recent years, roughly 40 percent of SFCAs have ended in dismissal (NERA Economic Consulting, 2007).

We use the outcome of the SFCA – dismissed vs. not dismissed – as a proxy for the seriousness of the violation. If courts screen on the basis of merit, it should be easier for the plaintiffs to construct a complaint that withstands the defendants' motion to dismiss

when disclosure violations are more serious. Such violations are more likely to be the result of purposeful behavior to deceive investors rather than merely a result of negligence. The role of the court in screening class action filings for merit is key to our work. We assume that dismissed cases have less merit than cases that are not dismissed.

Prior work on the role of merit in SFCAs has focused on the relationship between suit outcome and the nature of the allegation. Johnson, Nelson and Pritchard (2007) and Choi (2007) focus on such indicators such as whether the allegations involve a restatement, GAAP violation or insider trading. Here, we construct a joint test for the merit of SFCAs. Our test involves two related hypotheses: (1) that settled actions have greater merit than actions that are dismissed and (2) that firms are more likely to make changes in governance if the underlying wrongdoing alleged in a SFCA is more serious. If either hypothesis is false, we expect no relationship between suit outcome and subsequent change in governance structure.

2.2. Outcome of SFCAs and Corporate Governance

Romano (1991) suggests that securities litigation may provide a means for improving the alignment between the interests of owners and managers. She examines the relationship between the outcomes of securities actions and turnover rates of CEOs and directors to determine whether securities litigation prompts changes in corporate governance. Romano finds increased turnover rates among board members of firms that are defendants in private lawsuits. However, her sample includes both SFCAs as well as other forms of private litigation including derivative suits and actions related to control transactions. Thus it is not clear whether her results can be utilized to the case of SFCAs. In this paper, we extend her reasoning: if there is stronger evidence that fraud has occurred, then we would expect that greater changes in corporate governance occur as a firm takes steps to improve control or to sanction those associated with wrongdoing. Conversely, if there is little or no evidence of fraud, there would be less need for realignment or changes in governance structure. Thus, subsequent change in governance

structure is a reasonable proxy for the seriousness of the disclosure violation, if any, by the firm.

In this paper we test for the merit of SFCA by examining the relationship between the outcome of a class action lawsuit and turnover propensities of board members in the period following the filing of an action. This research differs from prior work on lawsuits and corporate governance in three ways. First, the period that we examine follows the enactment of the PSLRA. Previous work examining inside director and CEO turnover rates following a SFCA examined periods prior to the enactment of the PSLRA (Niehaus and Roth, 1999; Romano, 1991; Strahan, 1998).^{xi} The PSLRA increased the requirements for pleading securities fraud. Given the heightened level of review, it is not clear to what extent results from earlier periods can be generalized to the current environment.^{xii}

Second, our research design avoids issues that arise from the use of matching samples of non-lawsuit control firms.^{xiii} The events that trigger the filing of a SFCA are complex. Filings typically follow the revelation of bad news to the marketplace. However, the revelation of bad news by itself may prompt changes in governance structure apart from any underlying wrongdoing.^{xiv} The challenge that arises from the use of a control sample of non-lawsuit firms is separating the effects on governance of the revelation of bad news from the effects of the wrongdoing alleged in the lawsuit. Unless one constructs a matching samples of non-lawsuit firms that also disclose similar types of bad news, it is difficult to isolate the impact of the lawsuit on subsequent changes in corporate governance.

We avoid issues that arise from the construction of a control sample by focusing only on firms experiencing a SFCA. We condition on the outcome of the lawsuit and control for the nature of the allegations. In each case in our sample, the firm exhibited outward indications that prompted at least one plaintiff attorney to file a complaint alleging securities fraud. As discussed above, settled actions likely involved more serious violations than actions that were dismissed. If firms take actions to improve the strength

of governance systems or dismiss those associated with wrongdoing, turnover rates should be higher among firms that settle SFCAs than among firms that are exonerated. In our multivariate analyses of turnover propensity, we control for the nature of the allegations—accounting restatements and alleged GAAP violations—as well as firm and director-level characteristics.^{xv}

Third, we examine the relationship between turnover propensity and the level of culpability of individual board members. Karpoff, Lee and Martin (2007) in their study of SEC enforcement actions point out that prior work that does not control for culpability may underestimate the effect of a legal intervention on turnover rates. Plaintiffs in SFCAs typically name the corporation as well as certain officers and directors of the firm that they believe have responsibility for the alleged wrongdoing as defendants. We examine whether named defendants have higher turnover rates than officers and directors that were not named as defendants in the action. We control for whether a particular director is named as a defendant in an action. We expect that if subsequent turnover is a result of actions against those associated with the alleged violation, that turnover rates following a settled action should be higher among named defendants than among board members not named as defendants in an action. To the best of our knowledge, this is the only study of private enforcement actions that controls for culpability.

3. Sample Selection and Methodology

Our sample consists of firms that are members of the S&P 1500 that were named as defendants in a SFCA between January 1, 1996 and December 31, 2003. We obtain data on board structure and director demographic characteristics from the Investor Responsibility Research Center (IRRC) corporate directors database. The IRRC compiles board structure and director demographic variables from proxies mailed to shareholders in advance of company annual meetings. The IRRC sample includes most firms appearing in the S&P 1500. We obtain data on SFCA filings from Institutional Shareholder Services (ISS). The ISS database provides information on lawsuit filings as well as the current status of an action. We limit our analysis to actions filed in 1996 or

later to ensure that all actions in the sample are subject to the procedural requirements of the PSLRA. We match the IRRC and ISS data and identify those firms that were named in a SFCA within one year following the date of an annual meeting. We require that the action be filed no more than a year after the meeting to ensure that governance data collected from the proxy is indicative of the governance structure of the firm on the date of filing. We define $T=0$ as the date of the annual meeting that immediately precedes the SFCA filing.

To measure board turnover, we gather data on board structure from proxies filed for the next four annual meetings. We gather this data from the IRRC database and from proxy filings. We used proxy filings for more recent actions for which IRRC data was not available or for firms that were dropped from the S&P 1500 and no longer covered by the IRRC. The next four meeting dates following the filing of the SFCA are denoted as $T=1$ through $T=4$. The period through $T=4$ covers at least three full years past the date that the action was filed. Turnover events are defined as observations where a director that is seated on the board of directors as of the annual meeting at $T=0$ resigns or retires by $T=4$.^{xvi} We refer to the period from $T=0$ through $T=4$ as the analysis period. We focus on annual meeting dates since annual meeting dates typically define the beginning and end of the normal term of a board member. Therefore, annual meeting dates coincide with a disproportionately large amount of turnover activity. We utilize a four-year analysis period for two reasons. First, the litigation process in the typical SFCA evolves over a number of years. The filing of the action is only the first step. A SFCA typically involves a lengthy period of fact discovery and the resolution of many procedural motions before an action is finally resolved. As a result, it may take some time before the strength of the allegations and likely outcome of the action become apparent to the litigants and the court. Second, some firms in our sample have staggered boards. Therefore, the choice of a four-year analysis period ensures that the term of every director in the sample will expire on at least one occasion between the filing date and the end of our analysis period.^{xvii} In the event that a sample firm did not file a proxy for $T=4$, the firm is dropped from the sample. This restriction eliminates firms that either were liquidated or merged prior to the end of the analysis period.^{xviii}

SFCAs come in a variety of different forms. We limit our set of SFCAs to those involving allegations of fraudulent or misleading disclosures while the company is traded in the secondary market. We also screen for previous involvement in a SFCA. Some companies are subject to multiple actions. To ensure that observed changes in board membership are not the result of the fallout of a previous lawsuit, we drop firms that were named as defendant in a SFCA in the previous three years. We classify actions as settled, ongoing and dismissed depending on the status of the action as of April 2007. We use the outcome of an action as a proxy for its underlying merit. Merit is not directly observable, however, actions with greater merit should be more likely to survive a motion by defendants to have the matter dismissed. Class action lawsuits classified as ongoing will ultimately either be settled or dismissed. In our analysis we group together actions that are still ongoing with actions that are settled.^{xix} All of the ongoing actions in our sample have been in litigation for at least three years. If the action were of low merit, defendants would have likely submitted a motion to have the matter dismissed by that time. Since an action that is ongoing after three years has probably survived some level of judicial scrutiny, we conclude that the set of ongoing actions is likely of higher merit than the set of dismissed actions. Table 1 summarizes the distribution of the actions in our sample by year filed and outcome. Of the 243 actions in our sample, 123 were settled, 93 dismissed and 27 remained active as of April 2007.^{xx}

We collect data on the characteristics of the board members of defendant companies. Biographical information is available from the IRRC database on 2,380 directors seated on the boards of defendant companies as of the annual meeting at $T=0$. We define directors as insiders or outsiders based on their affiliation with the firm as of date $T=0$. Inside directors include all directors that were employed by the firm, were former employees, or were otherwise linked to the firm through business dealings. Outsiders are those directors with no link to the firm other than their service on the board of directors. Table 2 contains summary statistics on our director-level variables by type of director. The sample includes 1,538 outside and 842 inside directors.

If a firm's control mechanisms act to apportion liability for wrongdoing, we would expect that turnover rates are higher for directors with greater involvement in the events that

form the basis of plaintiffs' allegations. We develop two measures of culpability. The first is a dummy variable for membership on the audit committee. The audit committee of the board of directors is tasked with oversight of the firm's disclosure practices and internal controls. The SFCAs in our sample allege that the firm's disclosure policies were flawed and resulted in fraudulent or misleading information entering into the marketplace. Therefore, we would expect that to the extent that involvement in a SFCA has an effect on board membership, those effects should be most pronounced among audit committee members. As shown in Table 2, almost half of the outside directors in our sample are members of the firm's audit committee. This is significantly higher than the proportion of inside directors that served on the audit committee. Our second measure of involvement is whether a director was named as a defendant in the SFCA. We determine which directors were named as defendants from complaints, docket sheets and other court filings concerning the action. Inside directors are named as defendants in SFCAs significantly more frequently than outside directors. Half of the inside directors in our sample (and almost all CEOs) were named as defendants compared to less than ten percent of outside directors.

We also control for director-level demographic and ownership characteristics that may affect turnover propensity. Age affects retirement propensity. Following Yermack (2004), we create three indicator variables for the age of the director as of $T=0$ to control for the effect of age on turnover propensity. We also control for years of service on the board (Tenure) and percentage of votes controlled by the director (Voting Share). Tenure measures the number of years of board service. For a director that has just joined the board, we set tenure to 1 since that is her first year of service. We control for the influence of CEOs over the affairs of the board by including an indicator for CEOs that also hold the title of Chairman in our turnover model (Goyal and Park (2002)).

We also examine the effect of the nature of the allegations and strength of external oversight on turnover propensity. We classify actions into those involving financial statement disclosures and those involving other types of allegations. We examine complaints, news reports and company disclosures to determine the nature of the allegations. Allegations concerning misleading financial statements often involve a

restatement or violation of GAAP. We set our restatement indicator variable to one if the allegations concern a financial restatement. “Other GAAP” is set to one if the complaint alleges a technical violation of GAAP but does not include a restatement.^{xxi} We create a third indicator variable for instances in which the complaint cites either a restatement or violation of GAAP accounting. In general terms, in actions involving restatements or misapplication of GAAP it is more likely that plaintiffs will be able to offer objective evidence that the firm’s financial disclosures were incorrect than in actions involving allegedly false forecasts or failure to disclose a material fact. Table 3 contains summary statistics concerning the nature of the actions. Settled and active actions were more likely than dismissed actions to involve restatements or other GAAP violations.

Institutions and large blockholders are generally viewed as having greater incentives to expend efforts to monitor management and the board than individual shareholders (Shleifer and Vishny (1986)). We define institutional holdings as the percentage of shares held by institutional investors as reported by the IRRC or by Value Line.^{xxii} Blockholdings measure the proportion of shares controlled by outside holder of 5% or more of the outstanding shares. Our measure of outside blockholdings includes all shares that are held in 5% blocks that are not controlled by either a member of management or the firm’s ESOP. Our definition of blockholder types is based on Dlugosz, Fahlenbrach, Gompers and Metrick (2006). The proportion of shares controlled by institutions and blockholders does not differ substantially by outcome of the action. Table 3 presents the composition of the board of directors. The average board of a sample firm has 9.794 members of which 3.537 are insiders and 6.154 are outsiders.

Turnover propensity of inside and outside directors may also be influenced by the performance of the firm (Warner, Watts and Wruck (1988), Yermack (2004)). We control for performance using the cumulative abnormal return of the defendant firm’s equity net of the CRSP Value Weighted index. We form the cumulative abnormal return over a twelve-month period ending in the month that the SFCA was filed. The cumulative abnormal return appears in all of our specifications of turnover propensity.^{xxiii}

As a check on our data, we compare the abnormal returns at the end of the class period for actions that are settled or ongoing and those that are dismissed. The end of the class period coincides with the emergence of the truth concerning the alleged fraudulent disclosures. Subsequent changes in corporate governance may be correlated with the outcome of SFCAs if the import of the fraudulent or misleading information in actions that are dismissed is smaller than for actions which are settled. We examine the abnormal returns over a five day window centered on the date of the end of the class period. Using a Wilcoxon rank-sum test we cannot reject the null hypothesis of no difference in the abnormal returns at the end of the class period between the actions that are dismissed and those that are settled or ongoing.

4. Results

4.1 Inside and Outside Director Turnover

If the outcome of SFCAs are not related to the merits of the allegations, we expect to observe no relationship between outcome and the subsequent level of board turnover. However, if it is the case that actions which are not dismissed have greater merit than dismissed actions and that sanctions are applied to those associated with wrongdoing, we expect to observe a relationship between outcome and turnover. SFCAs are a response to failures of members of the board of directors to monitor or act in the interests of shareholders, we would expect to find higher turnover among the boards of firms that settle a SFCA than among firms in which the allegations of fraud are dismissed. Table 4 contains annual retention rates of inside and outside directors of firms subject to a SFCA. The retention rate is defined as the proportion of directors that were seated on the board at $T=0$ that remain on the board of directors as of subsequent annual meeting dates. We report the number of directors remaining and retention rates by the outcome of the action. Settled and ongoing actions are pooled. Panel A contains retention rates for outside directors. Of the 1,538 outside directors in our sample that were seated on the board of sample companies as of the annual meeting prior to the filing of the SFCA, 865 remained on the board at the fourth annual meeting following the SFCA filing. As of $T=4$, the retention rate for outside directors in dismissed SFCAs of 58.0 percent is only slightly

higher than the 55.1 percent retention rate when the SFCA is settled or ongoing. We report the *p*-value of a two-tailed test for differences in retention rates between dismissed and settled/ongoing actions. The retention rate of outside board members in firms in which the SFCA is dismissed is not significantly different from the retention rates of firms that either settled or remain subject to an action. Panel B of Table 4 reports retention rates for inside directors. Of the 842 inside directors in our sample, 389 remain on the board at T=4. Retention rates differ substantially by the outcome of the SFCA. Retention rates are 12 percentage points lower for inside directors of firms that settle or remain subject to a SFCA than for inside directors of firms in which the SFCA is dismissed. The retention rates for these four categories (inside, outside, dismissed vs. non-dismissed actions) are illustrated in the upper panel of Figure 2.

We estimate the determinants of the likelihood of the departure of inside and outside directors. We use a binomial probit model of director turnover where the dependent variable equals 1 if a director departs from the board by T=4 and 0 if the director remains. The model controls for outcome of the action, director involvement, and firm- and director-level characteristics. In each table we report the marginal effects from our probit model of director turnover.^{xxiv} Table 5 contains the marginal effects for outside directors. The coefficient of Settled/Ongoing is small and not significant indicating that the outcome of the action does not have a substantial effect on the likelihood of departure of an outside director. These results are consistent with those of Fich and Shivdasani (2007) who report no abnormal turnover among the outside directors of firms subject to a SFCA.^{xxv} Helland (2006) also notes that the number of outside directorships held is not affected by lawsuits. However, like Srinivasan (2005), we find that turnover rates for outside directors are particularly high following accounting restatements

Table 6 contains the marginal effects for the departure probability of inside directors. The point estimate on Settled/Ongoing is positive and significant indicating that the turnover rate for inside directors is higher when the action is settled or remains ongoing than when it is dismissed. The departure probability of an inside director following settled or ongoing actions is 10% higher than the departure probability following dismissed actions. The positive point estimate indicates that turnover rates are higher when the actions have

higher merit. Turnover rates are higher following SFCAs involving restatement or alleging GAAP violations than those based on other types of allegations. In addition to the controls appearing in Table 5, in Table 6 we also control for whether an insider holds the position of CEO and whether the firm's CEO also holds the position of Chairman of the Board. The latter provides an indication of the level of influence of the CEO over the affairs of the board (Dechow, Sloan and Sweeney (1996)).

We also examine whether allegations concerning the involvement of a particular inside director affect the likelihood of departure from the board. We do not examine the effects of audit committee membership since relatively few inside directors serve on audit committees. Inside directors, however, are commonly named as defendants in SFCAs. The coefficient on defendant status in column [2] is positive and significant indicating that inside directors named as defendants in SFCAs are 15 percent more likely to leave the board than other inside directors.

In column [3] of Table 6, we examine the relationship between culpability and inside director turnover rates. The model includes the interaction of the indicator for the outcome of the action and for named defendants. The point estimate on the interaction term is positive and highly significant. Inside director turnover rates are 17 percent higher among named defendants when an action is settled or ongoing than when it is dismissed. The addition of the interaction term also reduces the point estimate on settled/ongoing from approximately 10 to 2 percent. Turnover rates for inside directors that are not named as defendants are not affected by the outcome of the action. These results are consistent with our joint hypothesis that higher merit actions are associated with settlements and that sanctions are applied to individuals that are more closely associated with the alleged wrongdoing. These results are similar to Karpoff, Lee and Martin's (2007) findings concerning culpability in SEC enforcement actions.

4.2 Restatements Versus Other Types of Actions

We examine the effect of the nature of the allegations on turnover rates for inside directors by partitioning the sample into those actions involving accounting restatements and actions involving other types of allegations. A number of recent studies—Srinivasan

(2005), Desai, Hogan and Wilkens (2005) and Agrawal and Chadha (2005)—have examined the connection between corporate governance and financial restatements. Plaintiffs in SFCAs commonly cite a restatement as an indication of a disclosure violation by the defendant firm. However, restatements by themselves are not evidence of accounting fraud. While a restatement provides *prima facie* evidence of a failure of the accounting system of the issuer, a restatement alone does not provide definitive evidence that a fraud has occurred. We examine the relationship between the outcome of SFCAs and nature of the allegations by partitioning our sample of SFCAs into those involving allegations concerning a financial restatement and actions that do not involve a restatement. If changes in corporate governance are due to the restatement alone, the outcome of the SFCA should have no effect on turnover propensity. However, if turnover is a function of deeper indications of underlying wrongdoing, we would expect that for both the restatement SFCAs as well as the other SFCAs, outcome would have a significant effect on turnover propensity.

Table 7 contains the marginal effects from the model of insider director turnover with the sample partitioned into actions involving a restatement and other actions. The sample in columns [1] and [2] include only SFCAs involving financial restatements. The point estimate on Settled/Ongoing in column [1] is positive and significant. Turnover rates for actions involving restatements are 23 percent higher when a SFCA involving a restatement is settled or remains ongoing than when it is dismissed. The point estimate on the interaction terms between outcome and culpability is also highly significant. These results indicate that it is not simply the restatement itself but also the strength of allegations of any underlying wrongdoing that determines the extent of change in board composition. The sample in columns [3] and [4] includes only actions that do not involve restatements. Inside director turnover rates are significantly higher among named defendants when the action settles or remains ongoing. The significant coefficient estimate of the marginal effect of SFCA outcome in the restatement sample indicates that turnover is not simply the result of an accounting system failure, but the results of deeper indications of fraudulent intent. This is also the case for the set of actions that do not involve restatements. In both cases, the results are consistent with the joint hypothesis

that SFCAs that are higher merit are less likely to be dismissed because the underlying wrongdoing is more serious.

4.3 CEOs versus Other Insiders

A SFCA may have different impacts on inside directors depending on their role in the firm. CEOs are typically viewed as having primary responsibility for the management of the affairs of the firm and for monitoring the actions of subordinates. We expect that CEO turnover would be sensitive to the outcome of a SFCA. Other inside directors play either a subordinate or advisory role for the CEO and board members. To the extent that SFCAs are the result of a failure of a firm's internal control systems, we would expect heightened turnover among other employee and affiliated (*i.e.*, grey) directors as well. We partition our set of inside directors into those holding the title of CEO as of the last annual meeting preceding the filing of the SFCA and other inside directors. Univariate comparisons of retention rates of inside directors by type and outcome appear in Table 8 and the lower panel of Figure 2. Retention rates for CEOs appear in Panel A. Retention rates for CEOs that were involved in SFCAs that settled are lower than for CEOs involved in SFCAs that were dismissed. Fewer than 40 percent of the CEOs of firms that settled or remained subject to a SFCA remained on the board of directors at T=4 compared to 53 percent when the SFCA was dismissed. Retention rates are also higher for other types of inside directors when the SFCA is dismissed.

We estimate the marginal effects of outcome and involvement using a probit model of inside director turnover. As we have for all other types of directors, we define a turnover event as an instance in which the CEO no longer serves on the board of directors by T=4. Our definition of a turnover event differs somewhat from much of the literature on management turnover in that we require that the CEO both no longer maintains his top management role and no longer maintains a seat on the board of directors. Results for the CEO's in our sample appear in column [1] of Table 9.^{xxvi} Turnover rates for CEOs in settled or ongoing actions are 15.9 percent higher than for CEOs in settled or ongoing actions than for dismissed actions. This is consistent with the notion that greater discipline is applied to CEOs in higher merit actions. Almost every CEO in our sample

was named as a defendant in the SFCA. Therefore, we do not control for defendant status for CEOs. Approximately one in three other inside directors (inside directors that do not hold the title of CEO) are named as defendants in SFCAs. Turnover rates for other inside directors reported in columns [2] and [3] of Table 9 are also higher when the SFCA is settled or ongoing than when the action is dismissed. Turnover rates for other insiders that were named as defendants are 18.5 percent higher than for non-CEO inside board members that were not named. The turnover rate for other insiders in column [3] is 23.4 percent higher when a director is named as a defendant and the action is settled or ongoing than when dismissed. These results provide further evidence that the outcome of SFCAs is connected to merit and that firms apply sanctions to those individuals most closely connected to the alleged wrongdoing.

4.4 External Monitoring and Turnover Propensity

We also examine the impact of external ownership concentration on the turnover propensities of inside and outside directors of firms involved in a SFCA. Denis, Denis and Sarin (1997) argue that internal control mechanisms are stronger in firms with more concentrated external equity ownership. Large external equity holders have a greater incentive to invest resources in monitoring the performance of managers and board members (Shleifer and Vishny (1986)). If securities fraud is the result of insider opportunism and/or lax monitoring by outsiders, then we expect that firms with more concentrated external ownership structures will be more effective at disciplining errant board members.

We augment our turnover model with two measures of external equity ownership concentration: the proportion of equity held by institutions and the proportion of equity held by outside blockholders. We construct interaction terms between these two measures of ownership concentration and the outcome of the SFCA. We expect that turnover propensity will be more sensitive to the outcome of a SFCA when external equity ownership is more concentrated. Therefore, we expect a positive sign on the interaction term between external equity ownership levels and our indicator for settled and ongoing actions. Table 10 contains the results of our turnover models, which include measures of

external equity ownership concentration. The models in columns [1] and [2] use the set of inside directors while the models in columns [3] and [4] use the set of outside directors. The first model for each category of directors uses institutional holdings as the measure of equity concentration (columns [1] and [3]), while the second uses outside blockholder ownership (columns [2] and [4]).

The results are suggestive of a relationship between the turnover sensitivity and external equity ownership concentration. The coefficient estimate on the interaction term between SFCA outcome and institutional holdings in column [1] is positive and significant. This is consistent with the application of greater pressure for change by institutions among inside directors when institutions have a larger ownership share. However, when the turnover model is estimated using outside blockholder ownership the point estimate in column [2] is smaller and not significant. For outside directors, the point estimate of the interaction term using outside blockholdings in column [4] is positive and significant. This indicates that turnover is more sensitive to outcome of the SFCA when outside blockholders hold a larger share of the equity in a firm. Among outside directors, when in column [3] institutional ownership is used as the measure of external equity ownership concentration, the point estimate on the interaction term is negative and not significant. These results, while somewhat sensitive to definition of equity concentration, suggest that turnover propensity is more sensitive to the outcome of the SFCA when external equity ownership is more concentrated. It is consistent with the notion that institutional investors and blockholders are sensitive to indications of fraud among companies in their portfolio and that they exert some influence to effect changes in corporate governance when there is an indication of wrongdoing. However, the results of our analysis do not provide insight into what form this pressure may take.

5. Changes in Board Composition Following a SFCA

Prior work on corporate litigation has provided mixed results on whether firms take measures ex post to improve corporate governance. Agarwal et al. (1999) find little evidence of a change in governance structures following accusations of fraud. In contrast, Ferris et al. (2007) find that the firms named as defendants in derivative lawsuits

increase the proportion of board seats held by outsiders. They also find that firms that settle actions increase the level of board independence relative to firms that have their actions dismissed. Farber (2005) finds that firms involved in SEC investigations increase the proportion of outside directors on their board of directors relative to a control sample. We examine two indicators of movement towards improved governance: board independence and board size.^{xxvii}

There is movement towards greater board independence among both firms with settled or ongoing actions and firms with dismissed actions. The movement towards greater board independence is more pronounced among firms with settled or ongoing actions. At T=0, insiders had an average of 37.2 percent of board seats among firms with settled or ongoing actions. Insider representation fell to 23.8 percent at T=4, a decline of 13.4 percentage points. Among firms with dismissed actions, the percentage of seats held by insiders declined from 34.9 percent to 25.3 percent, a decrease of 9.6 percentage points. These differences in the change in composition are significant at the 5 percent level using a one-sided t-test or a Wilcoxon rank-sum test.^{xxviii} The greater increase in outside representation among firms with settled or ongoing SFCAs is consistent with the notion that the outcome of SFCAs is a function of their underlying merit. This finding is also consistent with firms that discover evidence of wrongdoing taking steps ex post to improve the strength of corporate governance mechanisms.

We find no evidence that ex post changes in board size are related to the strength of the allegation of wrongdoing. The change in board size in the analysis period is similar for firms with settled or ongoing actions and those with dismissed actions. Among firms with settled or ongoing SFCAs, average board size decreases by 0.340 seats compared to a decrease of 0.543 seats for firms with dismissed actions. The difference is not significant.

6. Conclusions

Whether SFCAs serve as an effective sanction on firms associated with fraud and wrongdoing has been the subject of considerable controversy. Critics argue that the outcomes of SFCAs are unrelated to the merits of the actions and these lawsuits primarily

serve as rent extraction mechanisms for plaintiffs' attorneys. An examination of the role of the strength of allegations of wrongdoing on corporate governance faces serious hurdles. The merit of such a lawsuit is not directly observable, very few cases are resolved through trial, and the court record in SFCAs that are settled remains sealed.

This paper provides a new approach to examine the role of merit. We argue that class action lawsuits with higher merit are less likely to be dismissed. We expect and show that lawsuits that are not dismissed are associated with larger changes in corporate governance than lawsuits that are dismissed. Our measure of the extent of governance change is the turnover among members of the board of directors in the period following the filing of a SFCA. We find higher turnover rates among the boards of directors of firms that are the subject of SFCAs that are not dismissed. The most pronounced increase in turnover rates occurs among inside directors, particularly CEOs. Turnover rates are also higher for directors that are more closely tied to the alleged wrongdoing and in firms in which outside equity ownership is more concentrated. These results support the view that firms act to impose sanctions on those individuals associated with fraudulent activities. In particular, the higher turnover rate observed among named defendants suggests that internal control mechanisms specifically serve to discipline those board members most closely related to the alleged wrongdoing.

Our findings have implications for future work in this area. We find that both the strength and the nature of allegations of wrongdoing are important determinants of board turnover. This suggests that it may be important to control for both the strength and nature of allegations of wrongdoing while investigating the impact of litigation on corporate governance. Pooling across allegations of wrongdoing without any screens for merit in these actions will dilute the true scope of changes in corporate governance ushered by SFCAs.

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ⁱ For public corporations, common forms of private actions include security fraud class action suits (SFCA) and derivative suits. Derivative actions have their origin in state corporate law and are filed on behalf of the corporation. As discussed below, most SFCA's arise under federal securities law and involve allegations of fraudulent corporate disclosures and are filed on behalf of investors in a firm's securities.

ⁱⁱ Over the past decade, the annual number of companies named as defendants in federal securities class actions has ranged from a low of 109 in 2006 to a high of 271 in 1998 (NERA Economic Consulting, 2007).

ⁱⁱⁱ Lawsuits in which plaintiffs' loose might also have some effects on governance. These lawsuits may help publicize some of the sued firms' shortcomings and elicit corrective changes. We argue that the corrective measures are larger from non-dismissed lawsuits.

^{iv} Srinivasan (2005) and Desai, Hogan and Wilkens (2006) provide more detailed research on restatements.

^v For instance, Agrawal, Jaffe and Karpoff (1999). An exception is Romano (1991), whose study involves actions filed prior to the enactment of the PSLRA and involves both class actions as well as other types of securities litigation. As a result, her findings may not be applicable to securities actions in the past decade or to SFCAs in particular.

^{vi} Characteristics such as size, industry classification and relative performance are quantifiable and are commonly used for matched sample construction. Other relevant characteristics such as the effectiveness of a firms' internal control are difficult to quantify and are not used to create matched sample.

^{vii} For instance, firms experiencing a SFCA are more likely to have more volatile returns and to experience large drops in stock prices than other firms. However these characteristics may in turn reflect the threat posed by a *potential* SFCA, rendering the use of these criteria as the basis for a matched sample problematic.

^{viii} Rule 10b-5 was issued by the SEC in 1942 under Section 10b of the Securities Exchange Act.

^{ix} SFCAs are subject to a statute of limitations. The beginning of the class period may be either the date that the allegedly fraudulent information entered the marketplace or a date determined by a statute of limitations.

^x 15 U.S.C. § 78u-4(b)(1) and 15 U.S.C. § 78u-4(b)(2).

^{xi} The PSLRA applied to SFCAs filed after December 22, 1995

^{xii} Research examining the period following the passage of the PSLRA has focused on the reputational consequences for outside directors of service on the board of a company experiencing a SFCA (Helland (2006); Fich and Shivdasani (2007)).

^{xiii} Romano (1991); Neihaus and Roth (1999) Strahan (1998); Agrawal, Jaffe and Karpoff (1999) and Fich and Shivdasani (2007) each utilize matching samples of firms that did not experience a lawsuit.

^{xiv} Warner, Watts and Wruck (1988) show that top management turnover rates are higher in firms experiencing poor stock price performance. Srinivasan (2005) and Desai, Hogan and Wilkens (2006) find that board and management turnover increases following accounting restatements.

^{xv} As discussed in greater detail below, there is no significant difference between the average abnormal return surrounding the end of the class period for the between the

settled or ongoing actions in our sample and the actions in our sample that were dismissed.

^{xvi} We examine the robustness of our results to alternate definitions of the turnover window. The use of a turnover window from T=0 to T=2 and from T=0 to T=3 does not have a material impact on our results.

^{xvii} Staggered terms typically involve terms of no more than three years. The term of any director serving on the board at the time an action is filed will have expired by the end of our observation period.

^{xviii} As a result our sample does not include some of the more prominent firms involved in securities actions. Neither Enron nor WorldCom are part of our sample. It may be the case that instances in which the defendant firm is delisted in the period following the SFCA represent more severe disclosure violations. If so, the sample in this study would represent less egregious violations which would tend to bias our analysis against finding any relationship between SFCA involvement and turnover.

^{xix} The qualitative results of our analysis remain unchanged if the sample is limited to actions that have been resolved in either settlements or dismissals.

^{xx} We group the right-censored cases that are still outstanding with the settled cases considering that a lawsuit that has not been successfully dismissed after several years remains consequential to the firm. The number of actions exceeds the number of firms because two firms were involved in action filed more than three years apart.

^{xxi} Our definition of the controls for type of allegation were chosen to capture the specificity of the accounting issues laid out in the complaint. Restatements provide *prima facie* evidence that there were problems with a firm's financial statement

disclosures and an indication as to whether the information restated was material. In contrast, if the complaint only alleges a GAAP violation, it remains to be shown whether the financial statements were in error and whether the information was material.

^{xxii} Institutional holdings were not available for some of the early years in the IRRC database. The level of institutional holdings reported in the IRRC and Value Line are similar.

^{xxiii} We also examine other specifications of the cumulative abnormal returns. Alternate specifications of stock price performance did not have a substantial effect on our parameter estimates.

^{xxiv} Powers (2005) shows that the point estimates of the interaction terms in logit and probit models may be misleading. He recommends the use of marginal effects for hypothesis testing.

^{xxv} Fich and Shivdasani (2007) report turnover rates of the outside directors of lawsuit firms are commensurate with observed turnover rates for large firms.

^{xxvi} The number of CEOs is slightly smaller than the number of firms in our sample. In five cases, firms were engaged in the search for a CEO at the time that the SFCA was filed.

^{xxvii} The level of board independence has been associated with the strength of corporate governance (Weisbach (1988); Rosenstein and Wyatt (1990); Byrd and Hickman (1992)). Smaller board size has also been associated with stronger oversight and improved decision making (Yermack (1996)).

^{xxviii} The difference among the two samples is not driven by broader changes in corporate governance practices such as the enactment of Sarbanes-Oxley. The timing of the

initiation of settled suits in our sample is not significantly different from the timing of the initiation of the settled or ongoing suits. The average date of the initiation of the sample lawsuits that are settled or ongoing differs from the average date of initiation of dismissed suits by only 90 days.

Figure 1: Typical Series of Events in a SFCA

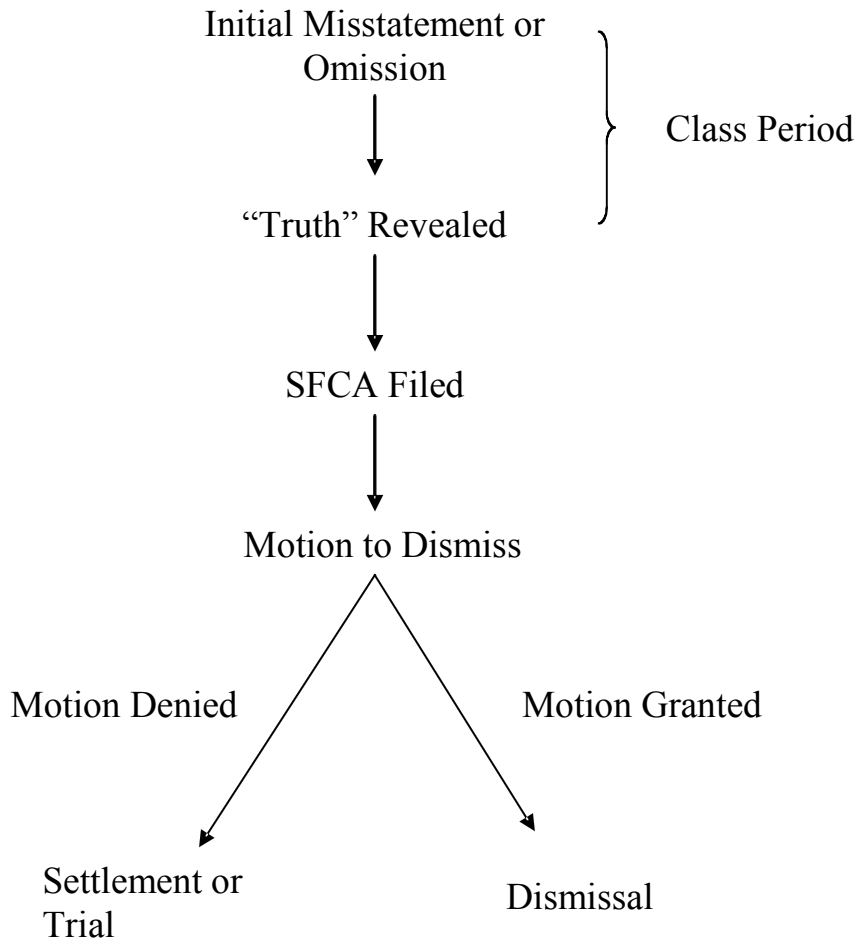


Table 1: **Securities Fraud Class Actions**

Year filed and outcome of 243 securities fraud class actions. Actions classified as settled, dismissed or ongoing based on their status as of April 2007.

Year Filed	Outcome			Total No.
	Dismissed No.	Ongoing No.	Settled No.	
1996	2	0	2	4
1997	6	1	21	28
1998	8	0	15	23
1999	21	2	22	45
2000	18	2	19	39
2001	18	7	16	41
2002	20	15	28	63
Total	93	27	123	243

Includes actions filed within one year following the annual meeting of a firm appearing in the IRRC corporate directors database. Excludes instances in which another securities fraud class action was filed against the firm in the preceding three years. Actions may involve multiple classes of plaintiffs. Actions in which a settlement has been reached with one or more class but not all classes are classified as settled.

Table 2: Director-Level Variables

Descriptive statistics for director-level variables. P-values are for two-sided tests of the difference in sample means of the inside and outside director samples.

Variable	Outside	Inside	P-value of Difference		
	Directors	Directors	N	t-test	Mann-Whitney
Observations (N)	1538	842	2380		
<i>Involvement</i>					
CEO (0/1)	N/A	0.283	842		
Member Audit Committee (0/1)	0.495	0.143	2380	0.000	0.000
Defendant (0/1)	0.095	0.495	2354	0.000	0.000
<i>Outcome</i>					
Departed (0/1)	0.390	0.504	2380	0.000	0.000
<i>Demographics</i>					
Age (Years)	59.742	54.999	2380	0.000	0.000
Board Tenure (Years)	7.654	9.348	2380	0.000	0.001
Voting Share (%)	0.172	2.553	2380	0.000	0.000

Inside directors are defined as directors that are linked to the firm. Linked directors include current and former employees of the firm, relatives and directors with business dealings with the firm. Outside directors include all other board members. Directors are classified as insiders or outsiders based on designations appearing in the IRRC corporate directors database. *CEO* indicates that a director served as CEO of the firm at the last meeting before the action was filed, 0. *Member Audit Committee* indicates that the director served on the audit committee at the time the action was filed. *Defendant* indicates that a director was named as a defendant in the action. We were unable to locate court documents or complaints to establish *Defendant* status for 26 directors. *Departed* indicates that the director does not serve for three full years after the date the action was filed. *Age* is the age of the director as reported in the last proxy prior to the date the action was filed. *Board Tenure* is the length of a director's board service, in years, as of the last proxy before the action is filed. *Voting Share* is the percentage of equity shares controlled by the director of the total number of shares.

Table 3: **Firm-Level Variables**

Sample means for firm-level variables by status of the action. Actions classified as settled, dismissed or ongoing based their status as of April 2007.

Variable	Dismissed Actions	Ongoing Actions	Settled Actions	All Actions	N
Number of Actions	93	27	123	243	
Settlement Amount (million \$)			120.394		123
Total Assets (billion \$)	28118.747	29122.064	15272.183	21727.645	243
<i>Allegations</i>					
Restatement (0/1)	0.129	0.185	0.301	0.222	54
Other GAAP (0/1)	0.258	0.296	0.268	0.267	65
Hard Evidence (0/1)	0.387	0.481	0.569	0.490	119
<i>Ownership Structure</i>					
Institutional Holdings (%)	65.343	60.144	60.672	62.408	242
Block Holdings (%)	20.528	20.489	26.587	23.566	239
<i>Board Structure</i>					
Board Seats	10.022	9.481	9.691	9.794	243
Insider Seats	3.495	3.037	3.537	3.465	243
Outsider Seats	6.527	6.444	6.154	6.329	243
<i>Performance</i>					
Cumulative Abnormal Returns	-0.035	-0.001	-0.188	-0.109	243

Settlement Amount is the mean dollar amount of settlements in the 115 actions where settlement data is available. *Total Assets* are the total assets of the firm at the end of the fiscal year prior to the date that the action was filed. *Restatement* indicates that the action concerns a restatement. *Other GAAP* indicates that the action involves a technical violation of GAAP accounting other than a restatement. *Hard Evidence* indicates that the allegations concern either a restatement or other GAAP violation. *Institutional Holdings* is the proportion of a firm's equity held by institutions. *Block Holdings* is the percentage of the firm's shares held by outside 5% blockholders. *Board Seats* is the total number of directors elected or continuing to serve on the board as of the annual meeting immediately preceding the date the action was filed. *Insider Seats* and *Outsider Seats* are the number of inside and outside directors elected or continuing to serve on the board as of the annual meeting preceding the date the action was filed. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed

Table 4: **Outside and Inside Director Retention Rates**

Panel A: Outside director retention rates by outcome of the action.					
Year	Dismissed Actions		Settled/Ongoing Actions		p-value
	Number Directors	Retention Rate	Number Directors	Retention Rate	
0	607	100.00	931	100.00	
1	538	88.63	796	85.50	0.077
2	461	75.95	681	73.15	0.220
3	402	66.23	599	64.34	0.448
4	352	57.99	513	55.10	0.265

Panel B: Inside director retention rates by outcome of the action.					
Year	Dismissed Actions		Settled/Ongoing Actions		p-value
	Number of Directors	Retention Rate	Number of Directors	Retention Rate	
0	325	100.00	517	100.00	
1	275	84.62	390	75.44	0.001
2	218	67.08	312	60.35	0.049
3	196	60.31	259	50.10	0.004
4	174	53.54	215	41.59	0.001

Reported P-values of two-sided tests for differences in retention rates for outside directors between dismissed and settled/ongoing actions. Settled/Ongoing actions are sample actions that were either settled or remained active as of April 2007. Dismissed actions are sample actions that were dismissed by April 2007. N in year 0 is the number of directors of a given type elected to or continuing to serve on the board at the annual meeting immediately preceding the date the action was filed. N in years 1 to 4 is the number of those directors that continue to serve on the board. Retention rate is defined as the proportion of directors seated on the board of the firm as of the annual meeting immediately preceding the filing of the action that continue to serve on the board at year t.

Table 5: **Outside Director Turnover**

Marginal effects of a probit model of outside director turnover. Models [3] and [5] include measures of director culpability interacted with suit outcome. Dependent variable is 1 if an outside director remains on the board for at least three years after an action is filed, 0 otherwise. Positive point estimates indicate that an increase in the independent variable increases the likelihood of departure. All models include control variables for the year the action was filed.

Variable	[1]	[2]	[3]	[4]	[5]
Age 61-65 (0/1) +	-0.002 (0.032)	-0.002 (0.032)	-0.002 (0.032)	-0.005 (0.032)	-0.004 (0.032)
Age 66-70 (0/1) +	0.304 (0.036)***	0.304 (0.036)***	0.304 (0.036)***	0.300 (0.036)***	0.300 (0.036)***
Age >70 (0/1) +	0.376 (0.043)***	0.374 (0.043)***	0.377 (0.042)***	0.370 (0.043)***	0.369 (0.043)***
Suit Settled/Ongoing+	0.008 (0.025)	0.009 (0.025)	0.002 (0.030)	0.012 (0.026)	0.007 (0.026)
Restatement of financials (0/1) +	0.082 (0.032)**	0.082 (0.032)**	0.082 (0.032)**	0.080 (0.032)**	0.076 (0.032)**
Other GAAP (0/1) +	-0.001 (0.029)	-0.001 (0.029)	-0.001 (0.029)	-0.004 (0.029)	-0.006 (0.029)
Log(Board Tenure)	-0.024 (0.016)	-0.023 (0.016)	-0.025 (0.016)	-0.024 (0.016)	-0.024 (0.016)
Voting Share (%)	0.001 (0.008)	0.001 (0.008)	0.001 (0.008)	0.001 (0.008)	0.002 (0.008)
Proportion of Outside Directors	0.039 (0.079)	0.034 (0.080)	0.041 (0.079)	0.033 (0.080)	0.038 (0.080)
Cumulative Abnormal Returns	-0.023 (0.017)	-0.023 (0.017)	-0.023 (0.017)	-0.024 (0.017)	-0.024 (0.017)
Log(Total Assets)	0.000 (0.007)	-0.000 (0.007)	0.001 (0.007)	0.000 (0.007)	-0.000 (0.007)
Member Audit Committee (0/1) +		-0.017 (0.024)			
Settled/Ongoing x Audit Comm. (0/1) +			0.012 (0.031)		

continued on next page

Table 5: *continued*

Variable	[1]	[2]	[3]	[4]	[5]
Named as Defendant (0/1) +				0.029 (0.044)	
Settled/Ongoing x Named Def. (0/1) +					0.073 (0.051)
Number of Observations	1736	1736	1736	1716	1716
Pseudo- R^2	0.066	0.066	0.066	0.065	0.066

Cluster-robust standard errors in parentheses, with clustering at the firm level to adjust for intra-firm correlation. Significance at the * 10%, ** 5% and *** 1% levels (two-tailed). + denotes the marginal effect for discrete change of dummy variable from 0 to 1. *Age 61-65*, *Age 66-70* and *Age > 70* are indicators that the director's age as reported in the last proxy prior to the date the action was filed. *Suit Settled/Ongoing* indicates that the action is settled or remains ongoing as of April 2007. It equals 0 if the action was dismissed. *Restatement of Financials* indicates that the action concerns a restatement of financial statements. *Other GAAP Violation* indicates that the action involves a violation of GAAP accounting other than a restatement. *Log(Board Tenure)* is the natural logarithm of the number of years that a director served on the board of directors as appears in the proxy statement for the annual meeting immediately preceding the date the action was filed. *Voting Share* is the percentage of shares controlled by the director relative to the number of shares outstanding. *Log(Total Assets)* is the natural logarithm of the total assets of the defendant firm as of the end of the fiscal year preceding the filing of the action. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed. *Member Audit Committee* indicates that the director sat on the audit committee of the firm in the period preceding the filing of the action. *Named as Defendant* indicates that the director was named as a defendant in the action. *Settled/Ongoing x Audit Comm.* is the interaction of the indicators *Suit Settled/Ongoing* and *Member Audit Committee*. *Settled/Ongoing x Named Def.* is the interaction of the indicators *Suit Settled/Ongoing* and *Named as Defendant*.

Table 6: **Inside Director Turnover**

Marginal effects of a probit model of inside director turnover. Model [3] includes measures of director culpability interacted with suit outcome. Dependent variable is 1 if an inside director remains on the board for at least three years after an action is filed, 0 otherwise. Positive point estimates indicate that an increase in the independent variable increases the likelihood of departure. All models include control variables for the year the action was filed.

Variable	[1]	[2]	[3]
Age 61-65 (0/1) +	-0.130 (0.046)***	-0.097 (0.047)**	-0.103 (0.046)**
Age 66-70 (0/1) +	-0.083 (0.069)	-0.071 (0.070)	-0.072 (0.070)
Age >70 (0/1) +	0.295 (0.072)***	0.319 (0.070)***	0.316 (0.069)***
Suit Settled/Ongoing+	0.095 (0.035)***	0.101 (0.035)***	0.015 (0.042)
Restatement of financials (0/1) +	0.180 (0.041)***	0.177 (0.041)***	0.171 (0.041)***
Other GAAP (0/1) +	0.101 (0.040)**	0.103 (0.041)**	0.101 (0.041)**
Log(Board Tenure)	-0.018 (0.021)	-0.025 (0.022)	-0.023 (0.022)
Voting Share (%)	-0.005 (0.002)***	-0.006 (0.002)***	-0.006 (0.002)***
CEO (0/1) +	0.121 (0.062)*	0.036 (0.068)	0.061 (0.066)
CEO and Chairman (0/1) +	-0.125 (0.068)*	-0.120 (0.069)*	-0.120 (0.070)*
Proportion of Outside Directors	0.052 (0.114)	0.018 (0.115)	
Cumulative Abnormal Returns	-0.071 (0.022)***	-0.069 (0.022)***	-0.068 (0.022)***
Log(Total Assets)	0.000 (0.010)	0.002 (0.010)	0.001 (0.009)
Named as Defendant (0/1) +		0.147 (0.041)***	
Settled/Ongoing x Named Def. (0/1) +			0.172 (0.046)***

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Table 6: *continued*

Variable	[1]	[2]	[3]
Number of Observations	984	978	978
Pseudo- R^2	0.073	0.082	0.083

Cluster-robust standard errors in parentheses, with clustering at the firm level to adjust for intra-firm correlation. Significance at the * 10%, ** 5% and *** 1% levels (two-tailed). + denotes the marginal effect for discrete change of dummy variable from 0 to 1. *Age 61-65*, *Age 66-70* and *Age > 70* are indicators that the director's age as reported in the last proxy prior to the date the action was filed. *Suit Settled/Ongoing* indicates that the action is settled or remains ongoing as of April 2007. It equals 0 if the action was dismissed. *Restatement of Financials* indicates that the action concerns a restatement of financial statements. *Other GAAP Violation* indicates that the action involves a violation of GAAP accounting other than a restatement. *Log(Board Tenure)* is the natural logarithm of the number of years that a director served on the board of directors as appears in the proxy statement for the annual meeting immediately preceding the date the action was filed. *Voting Share* is the percentage of shares controlled by the director relative to the number of shares outstanding. *Log(Total Assets)* is the natural logarithm of the total assets of the defendant firm as of the end of the fiscal year preceding the filing of the action. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed. *CEO* indicates that the director holds the title of CEO. *CEO and Chairman* indicates that the director holds the titles of both CEO and Chairman. *Proportion Outside Directors* is the ratio of outside directors to board seats at T=0. *Named as Defendant* indicates that the director was named as a defendant in the action. *Settled/Ongoing x Named Def.* is the interaction of the indicators *Suit Settled/Ongoing* and *Named as Defendant*.

Table 7: **Inside Director Turnover by Type of Alleged Violation**

Marginal effects of a probit model of inside director turnover. Actions grouped into those involving restatements of financial statements and those that do not involve restatements. Dependent variable is 1 if a outside director remains on the board for at least three years after an action in filed, 0 otherwise. Negative point estimates indicate that an increase in the independent variable increases the likelihood of departure. All models include control variables for the year the action was filed.

Variable	Restatements		Other Actions	
	[1]	[2]	[3]	[4]
Age 61-65 (0/1) +	-0.136 (0.119)	-0.107 (0.118)	-0.091 (0.059)	-0.108 (0.058)*
Age 66-70 (0/1) +	0.056 (0.142)	0.037 (0.140)	-0.044 (0.089)	-0.044 (0.089)
Age >70 (0/1) +	0.153 (0.140)	0.185 (0.118)	0.426 (0.075)***	0.415 (0.077)***
Suit Settled/Ongoing+	0.228 (0.097)**	0.106 (0.105)	0.076 (0.044)*	-0.007 (0.053)
Other GAAP (0/1) +			0.128 (0.046)***	0.125 (0.046)***
Log(Board Tenure)	-0.076 (0.049)	-0.074 (0.048)	0.004 (0.027)	0.008 (0.027)
Voting Share (%)	-0.008 (0.002)***	-0.008 (0.002)***	-0.006 (0.003)*	-0.006 (0.003)*
Proportion of Outside Directors	-0.342 (0.260)	-0.393 (0.259)	0.127 (0.142)	0.135 (0.142)
Cumulative Abnormal Returns	-0.221 (0.055)***	-0.221 (0.055)***	-0.021 (0.029)	-0.021 (0.028)
Named as Defendant (0/1) +	0.136 (0.093)		0.167 (0.053)***	
Settled/Ongoing x Named Def. (0/1) +		0.250 (0.089)***		0.155 (0.064)**
CEO (0/1) +	-0.059 (0.168)	-0.096 (0.170)	0.026 (0.082)	0.072 (0.078)
CEO and Chairman (0/1) +	0.061 (0.155)	0.074 (0.156)	-0.157 (0.080)*	-0.160 (0.081)**

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Table 7: *continued*

Variable	Restatements		Other Actions	
	[1]	[2]	[3]	[4]
Log(Total Assets)	0.006 (0.025)	0.007 (0.025)	0.019 (0.011)*	0.017 (0.011)
Number of Observations	195	195	598	598
Pseudo- R^2	0.198	0.215	0.072	0.067

Cluster-robust standard errors in parentheses, with clustering at the firm level to adjust for intra-firm correlation. Significance at the * 10%, ** 5% and *** 1% levels (two-tailed). + denotes the marginal effect for discrete change of dummy variable from 0 to 1. *Age 61-65*, *Age 66-70* and *Age > 70* are indicators that the director's age as reported in the last proxy prior to the date the action was filed. *Suit Settled/Ongoing* indicates that the action is settled or remains ongoing as of April 2007. It equals 0 if the action was dismissed. *Restatement of Financials* indicates that the action concerns a restatement of financial statements. *Other GAAP Violation* indicates that the action involves a violation of GAAP accounting other than a restatement. *Log(Board Tenure)* is the natural logarithm of the number of years that a director served on the board of directors as appears in the proxy statement for the annual meeting immediately preceding the date the action was filed. *Voting Share* is the percentage of shares controlled by the director relative to the number of shares outstanding. *Log(Total Assets)* is the natural logarithm of the total assets of the defendant firm as of the end of the fiscal year preceding the filing of the action. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed. *CEO* indicates that the director holds the title of CEO. *CEO and Chairman* indicates that the director holds the titles of both CEO and Chairman. *Proportion Outside Directors* is the ratio of outside directors to board seats at T=0. *Named as Defendant* indicates that the director was named as a defendant in the action. *Settled/Ongoing x Named Def.* is the interaction of the indicators *Suit Settled/Ongoing* and *Named as Defendant*.

Table 8: **Inside Director Retention Rates**

Panel A: CEOs					
Year	Dismissed Actions		Settled/Ongoing Actions		p-value
	Number	Retention Rate	Number	Retention Rate	
0	90	100.00	148	100.00	
1	77	85.56	109	73.65	0.031
2	63	70.00	87	58.78	0.083
3	57	63.33	68	45.95	0.009
4	48	53.33	58	39.19	0.033

Panel B: Other Inside Directors					
Year	Dismissed Actions		Settled/Ongoing Actions		p-value
	Number of Directors	Retention Rate	Number of Directors	Retention Rate	
0	235	100.00	369	100.00	
1	198	84.26	281	76.15	0.017
2	155	65.96	225	60.98	0.217
3	139	59.15	191	51.76	0.076
4	126	53.62	157	42.55	0.008

Reported P-values of two-sided tests for differences in retention rates for outside directors between dismissed and settled/ongoing actions. Settled/Ongoing actions are sample actions that were either settled or remained active as of April 2007. Dismissed actions are sample actions that were dismissed by April 2007. N in year 0 is the number of directors of a given type elected to or continuing to serve on the board at the annual meeting immediately preceding the date the action was filed. N in years 1 to 4 is the number of those directors that continue to serve on the board. Retention rate is defined as the proportion of directors seated on the board of the firm as of the annual meeting immediately preceding the filing of the action that continue to serve on the board at year t.

Table 9: **Inside Director Turnover by Position**

Marginal effects of a probit model of inside director turnover. Model [1] includes only directors holding the title of CEO. Models [2] and [3] includes all other inside directors. Dependent variable is 1 if a outside director remains on the board for at least three years after an action in filed, 0 otherwise. Negative point estimates indicate that an increase in the independent variable increases the likelihood of departure. All models include control variables for the year the action was filed.

Variable	CEOs	Other Insiders	
	[1]	[2]	[3]
Age 61-65 (0/1) +	0.005 (0.104)	-0.123 (0.059)**	-0.128 (0.059)**
Age 66-70 (0/1) +	-0.031 (0.434)	-0.023 (0.080)	-0.028 (0.080)
Age >70 (0/1) +	0.000 (0.331)	0.376 (0.071)***	0.377 (0.069)***
Suit Settled/Ongoing+	0.159 (0.073)**	0.092 (0.047)**	0.019 (0.050)
Restatement of financials (0/1) +	0.203 (0.086)**	0.219 (0.053)***	0.208 (0.053)***
Other GAAP (0/1) +	0.105 (0.086)	0.122 (0.054)**	0.117 (0.054)**
Log(Board Tenure)	0.041 (0.054)	-0.039 (0.027)	-0.035 (0.027)
Voting Share (%)	-0.011 (0.006)**	-0.005 (0.003)*	-0.005 (0.003)*
CEO and Chairman (0/1) +	-0.176 (0.081)**		
Proportion of Outside Directors	0.165 (0.228)	-0.132 (0.154)	-0.140 (0.155)
Cumulative Abnormal Returns	-0.046 (0.045)	-0.079 (0.030)***	-0.079 (0.030)***
Log(Total Assets)	0.015 (0.018)	0.013 (0.011)	0.012 (0.011)
Named as Defendant (0/1) +		0.185 (0.049)***	
Settled/Ongoing x Named Def. (0/1) +			0.234 (0.059)***

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Table 9: *continued*

Variable	CEOs	Other Insiders	
	[1]	[2]	[3]
Number of Observations	226	570	570
Pseudo- R^2	0.106	0.107	0.107

Cluster-robust standard errors in parentheses, with clustering at the firm level to adjust for intra-firm correlation. Significance at the * 10%, ** 5% and *** 1% levels (two-tailed). + denotes the marginal effect for discrete change of dummy variable from 0 to 1. *Age 61-65*, *Age 66-70* and *Age > 70* are indicators that the director's age as reported in the last proxy prior to the date the action was filed. *Suit Settled/Ongoing* indicates that the action is settled or remains ongoing as of April 2007. It equals 0 if the action was dismissed. *Restatement of Financials* indicates that the action concerns a restatement of financial statements. *Other GAAP Violation* indicates that the action involves a violation of GAAP accounting other than a restatement. *Log(Board Tenure)* is the natural logarithm of the number of years that a director served on the board of directors as appears in the proxy statement for the annual meeting immediately preceding the date the action was filed. *Voting Share* is the percentage of shares controlled by the director relative to the number of shares outstanding. *Log(Total Assets)* is the natural logarithm of the total assets of the defendant firm as of the end of the fiscal year preceding the filing of the action. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed. *CEO* indicates that the director holds the title of CEO. *CEO and Chairman* indicates that the director holds the titles of both CEO and Chairman. *Proportion Outside Directors* is the ratio of outside directors to board seats at T=0. *Named as Defendant* indicates that the director was named as a defendant in the action. *Settled/Ongoing x Named Def.* is the interaction of the indicators *Settled/Ongoing* and *Named as Defendant*.

Table 10: **Director Turnover and Ownership Structure**

Marginal effects of a probit model of director turnover. Dependent variable is 1 if a director remains on the board for at least three years after an action is filed, 0 otherwise. Negative point estimates indicate that an increase in the independent variable increases the likelihood of departure. All models include control variables for the year the action was filed.

Variable	Inside		Outside	
	[1]	[2]	[3]	[4]
Age 61-65 (0/1) +	-0.140 (0.051)***	-0.131 (0.052)**	-0.027 (0.035)	-0.018 (0.035)
Age 66-70 (0/1) +	-0.033 (0.079)	-0.030 (0.080)	0.324 (0.040)***	0.333 (0.040)***
Age >70 (0/1) +	0.310 (0.078)***	0.321 (0.075)***	0.397 (0.048)***	0.408 (0.048)***
Suit Settled/Ongoing+	-0.076 (0.078)	0.089 (0.047)*	0.011 (0.063)	-0.042 (0.034)
Proportion of Outside Directors	-0.013 (0.127)	-0.048 (0.128)	0.024 (0.091)	-0.002 (0.090)
Restatement of financials (0/1) +	0.202 (0.045)***	0.205 (0.045)***	0.078 (0.035)**	0.088 (0.035)**
Other GAAP (0/1) +	0.110 (0.046)**	0.097 (0.047)**	-0.033 (0.032)	-0.011 (0.033)
Log(Board Tenure)	-0.009 (0.024)	-0.018 (0.024)	-0.033 (0.018)*	-0.032 (0.018)*
Voting Share (%)	-0.004 (0.002)*	-0.005 (0.002)**	0.001 (0.008)	0.001 (0.008)
Cumulative Abnormal Returns	-0.071 (0.025)***	-0.073 (0.025)***	-0.035 (0.018)*	-0.033 (0.019)*
Log(Total Assets)	0.012 (0.010)	0.013 (0.010)	-0.007 (0.007)	-0.002 (0.007)
Settled/Ongoing x Inst.Holdings	0.003 (0.001)***		-0.000 (0.001)	
Settled/Ongoing x Blockholdings		0.001 (0.002)		0.003 (0.001)**
Number of Observations	794	776	1467	1448
Pseudo- R^2	0.084	0.084	0.076	0.081

Cluster-robust standard errors in parentheses, with clustering at the firm level to adjust for intra-firm correlation. Significance at the * 10%, ** 5% and *** 1% levels (two-tailed). + denotes the marginal effect for discrete change of dummy variable from 0 to 1. *Age 61-65*, *Age 66-70* and *Age > 70* are indicators that the director's age as reported in the last proxy prior to the date the action was filed. *Suit Settled/Ongoing* indicates that the action is settled or remains ongoing as of April 2007. It equals 0 if the action was dismissed. *Restatement of Financials* indicates that the action concerns a restatement of financial statements. *Other GAAP Violation* indicates that the action involves a violation of GAAP accounting other than a restatement. *Log(Board Tenure)* is the natural logarithm of the number of years that a director served on the board of directors as appears in the proxy statement for the annual meeting immediately preceding the date the action was filed. *Voting Share* is the percentage of shares controlled by the director relative to the number of shares outstanding. *Log(Total Assets)* is the natural logarithm of the total assets of the defendant firm as of the end of the fiscal year preceding the filing of the action. *Cumulative Abnormal Returns* is the cumulative abnormal return of equity net of the return on the CRSP value-weighted index in the year ending on the month the action was filed. *CEO* indicates that the director holds the title of CEO. *CEO and Chairman* indicates that the director holds the titles of both CEO and Chairman. *Proportion Outside Directors* is the ratio of outside directors to board seats at T=0. *Institutional Holdings* is the percentage of shares held by institutions. *Outside Blockholdings* is the percentage of shares held by outside 5% blockholders. *Settled/Ongoing x Blockholdings* is the interaction of the indicator *Settled/Ongoing* with *Outside Blockholdings*. *Settled/Ongoing x Inst.Holdings* is the interaction of the indicator *Suit Settled/Ongoing* with *Institutional Holdings*.