REPUTATIONAL PENALTIES AND THE MERITS OF CLASS-ACTION SECURITIES LITIGATION*

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Abstract

If private securities class actions alleging fraudulent behavior by officers or directors of a company are meritorious, directors and officers should pay a reputational penalty when they sit on a board of a company whose officers and directors are accused of fraud. I find little evidence of a negative effect associated with allegations of fraud. Using various definitions of board positions as a proxy for the reputation of directors who are accused of fraud, I find that the net number of board positions is consistently increased. Only in shareholder class actions in the top quartile of settlements or in which the Securities and Exchange Commission has initiated a case do directors appear to suffer a reputational penalty when a board they serve on is accused of fraud. The results call into question the merits of private securities class actions.

I. Introduction

The enforcement of the antifraud provisions of U.S. securities laws creates private attorneys general who enforce public law for private gain (Hensler et al. 2000). The effectiveness of the approach requires that the cases filed by the private attorney are meritorious, that is, that attorneys do not file cases that have a negative expected value at trial but may induce settlement. This dilemma is particularly evident in securities class-action litigation. The primary potential benefit of private securities class actions is that they could deter future corporate misconduct by allowing punishing actions that an individual shareholder would not find cost effective to litigate (Hensler et al. 2000). Such suits have their critics who argue that most of them are

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frivolous and impose a heavy cost on firms while providing little in the way of deterrence.

In this paper I employ a novel approach of assessing the merits of private securities class actions by examining the reputational penalty paid by officers and directors who serve on a board accused of fraud in a secondary market. Given the amount of discretion and hidden information implicit in corporate management, directors have a considerable interest in maintaining a reputation for trustworthiness. If private securities class actions are meritorious, we should see directors and officers pay a reputational penalty for sitting on a board of a company for which a private securities class action alleges that the some of the officers and directors committed fraud (see Black, Cheffins, and Klausner 2004).[1] This method avoids the endogeneity problem present in other studies of shareholder litigation. Finding that a fraud allegation decreases the number of insiders on the accused company's board may indicate that the fraud allegation revealed oversight failures by the board. Alternatively, it may be that the number of insiders can be used as evidence against the firm in any trial that may result, and management wishes to inoculate itself partially from charges of governance failures that might be brought at trial.

In this study I find that for the average case, there is no evidence of a negative effect on reputation associated with allegations of fraud. In fact, directors accused of fraud increase their net number of board positions for almost all measures of new board positions. Only in cases in the top quartile of settlement amounts or in those shareholder class actions in which the Securities and Exchange Commission (SEC) also initiated a case do directors appear to suffer a reputational penalty measured by a decrease in net board positions. The results call into question the merits of the average private securities class actions. If private class actions were on average meritorious, outside directors who served on the corporate board during the period of alleged fraud should suffer some reputational penalty.

[1] There is some anecdotal evidence that directors implicated in fraudulent dealings are punished in the director labor market. Prior to the October 2001 revelations of fraud, the 18 directors of the Enron Corporation sat on an average of 2.27 other boards as outside directors, with a high of 6 and a median of 2. According to theyrule.net (Josh On, TheyRule 2004 [http://www.theyrule.net]), a Web site tracking corporate boards, by 2004 the average had fallen to .16, with a median of zero. In fact, no members of the Enron board had added a new directorship, and only two retained any of the positions they held in 2000.

II. Securities Litigation and Fraud

A. Are Private Securities Actions Meritorious?

Securities cases, whether public or private, typically arise from alleged intentional violations of disclosure regulations.[2] Federal securities laws have two major fraud enforcement methods. The first is for the federal government, under the auspices of the SEC, to file civil charges or recommend that the Department of Justice file criminal charges in a case. Alternatively or simultaneously, private attorneys can file civil actions, usually on behalf of the class of defrauded shareholders, against the company in question and/or its officers and directors. Usually a private attorney brings these actions on behalf of a group of shareholders and forms the injured shareholders into a class action. Individual shareholders rarely initiate a suit. Typically, a private attorney initiates the cases.

The case for the social utility of private litigation ultimately rests on compensating victims and deterring future violations. There is considerable debate as to whether private securities cases are meritorious and therefore able to serve as deterrence to future fraud. Detractors claim that suits are usually without merit and exist to extract legal fees from shareholders (Alexander 1991). Private attorneys do not necessarily have the incentive to be scrupulous because directors and other corporate officers have strong incentives, in terms of litigation costs, to settle rather than go to trial (Bohn and Choi 1996).

Generally, studies of the determinants of suits find that lawsuits are more likely against larger firms (deeper pockets), firms in certain industries, and firms that experience a large decline in stock value. The conclusions range from almost all suits being frivolous (Alexander 1991) to a fair number being frivolous (Bohn and Choi 1996). Critics of the literature argue that it is far from conclusive (Seligman 1994). The basic criticisms are that the sample sizes have been too small to draw general conclusions (Alexander 1991) or that the results are difficult to interpret, as there is no benchmark for what constitutes a meritorious case (Bohn and Choi 1996; Dunbar, Juneja, and Martin 1995).

There is also a small literature looking at the link between corporate

[2] The Securities and Exchange Commission (SEC) administers these requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934, which specify what information corporations are required to disclose to investors. This study does not include derivative suits brought on behalf of all shareholders because they are relatively rare and there are too few in the sample period to estimate the effect on reputation. For evidence on derivative suits, see Ferris, Lawless, and Makhija (2001).

governance and private securities litigation.[3] The difficulty is that turnover and board composition are potentially endogenous. Higher turnover following a fraud allegation could result from a reputational penalty or the additional cost to the director or chief executive officer (CEO) of defending against the allegation. By contrast, the absence of exit may mean that the CEO or directors were too secure to be removed even with the allegation and not the absence of a reputational penalty. The approach taken in this paper avoids this issue, as the repuational penalty is estimated using net board positions where the officer or director is not yet potentially entrenched.

B. The Outside-Director Market

According to a number of scholars in finance, shareholder interests drive the market for outside directors. Most prominently, Fama and Jensen (1983) argue that additional board appointments signal director quality.[4] Further, Klein and Leffler's (1981) assertion that trust is bonded by reputations suggests that outside directors trade on their reputation. It is easy to see why a meritorious allegation of fraud might harm the reputation of an officer or director. Directors are hired by either management or shareholders in order to oversee management. If a director charged with overseeing a company allows management to defraud shareholders of that company, it indicates that either the director is unable to perform the function of creditable overseer or management has co-opted him. A test of the merits of private securities class actions is to examine the reputational penalties associated with a fraud allegation.

Fraud may also reveal that the internal controls of a firm are weak. This reflects poorly on existing directors, but it also causes problems for several existing methods of testing the merits of private litigation because weak internal controls suggest that meritorious cases may not remove bad managers or overseers. As Weisbach (1988) and Warner, Watts, and Wruck (1988) point out, a problem with interpreting the evidence is that poor corporate performance increases the probability of turnover. Since a number of critics have alleged that stock price fluctuations trigger securities class actions, it is difficult to disentangle the effects of poor corporate performance and fraud allegations without some additional evidence on the reputational penalty incurred by an executive or director accused of fraud.

[3] For example, Beasley (1996) and Dechow, Sloan, and Sweeny (1996) find that accounting fraud is less likely when there are more outside directors. In an approach similar to the one taken in this paper, Niehaus and Roth (1998) and Strahan (1998) find that increased turnover is due to securities class actions. Ferris, Lawless, and Makhija (2001) find that derivative suits, brought on behalf of all shareholders, are also associated with increased turnover. Derivative suits are quite rare. Unlike the typical class-action suit addressed in this study, they usually specifically address governance issues rather than allegations of fraud.

[4] Gilson (1990) and Kaplan and Reishus (1990) suggest that the number of outside directorships is a proxy for reputational capital.

III. Data Description

A. Sample Construction

The names of all corporate directors are contained in the firm's proxy statements filed with the SEC. Compact Disclosure maintains an electronic database of all proxy statements. The database contains information from the most current filing for a company and the date of the most recent filing and lists as inactive the companies that have not filed in the previous year. The data contain the name and age of all directors and identify which directors are officers of the company. I created a unique identifier for each company and another unique identifier for each individual director using the director's last name, first initial, and birth year. From these identifiers, I construct the total number of board positions held by each director and the addition of new directorships.

The measure of director reputation used in this study is the change in one of several classifications of net outside directorships over an 8-year period between 1994 and 2002. The period is long enough to pick up changes in directors' reputations because directors' terms typically do not exceed 4 years. This means that any reputational effect of a fraud allegation will have had time to influence renewal decisions as well as other companies' decisions about adding the director to the board.

I construct a measure of change in directorships by subtracting the number of exits from new positions. New positions occur when a company adds a director to the board. I count a directorship as new if an existing company adds a director. I define an exit as a company that continues in the sample but no longer lists an existing director on the board.[5] Although the results are similar if only new directorships are used, the net directorships measure captures the reputation of the director more effectively because an increase in reputation would not include simply replacing an existing board position when a director's term expires. An important restriction on the sample warrants notice. As it is impossible to identify the reputational effect of the fraud allegation from the sanction associated with the SEC's case, I exclude all directors banned from holding outside directorships or imprisoned.

The data on private and public allegations of fraud come from several sources. The primary source for private fraud allegations is Securities Class Action Alert (SCAA). The SCAA is a litigation reporter that contains an exhaustive list of private securities litigation data between 1985 and the

[5] For example, in 1997 Alan Reynolds, a director on the board of Acme Widgets, was added to the board of Microcircuits, a company in the sample since 1993. Thus, he entered the sample in 1994 (with Acme) and had no new directorships until 1997, when he had one net directorship. In 2000, he exited the board of Acme, and his net directorships equaled −1. In 2001, he left Microcircuits but joined the board of Advanced Shoes. In 2001, his net directorships were zero. The later example demonstrates an important feature of the reputation measure—leaving a board to join another by construction does not represent a change in a director's reputation.

present. The SCAA data contain all private securities cases regardless of their disposition. It does not consistently contain pending cases. For this reason, I supplement the SCAA sample with the Securities Class Action Clearinghouse at Stanford University, which maintains a comprehensive list of pending securities class-action cases. Using these sources, I constructed a comprehensive list of all fraud allegations made between 1994, the first year of complete board data, and 2002. I classify cases by the disposition of the case. A case can be unilaterally dropped by the plaintiff, dismissed by a judge, settled (in which case a settlement amount is recorded), or go to trial where the plaintiff can lose or win. Trials are extremely rare. Ninety-five percent of the cases that are not dropped unilaterally or dismissed eventually settle.

The SEC's Accounting and Auditing Enforcement Releases (AAERs) contain data on suits filed by the SEC. Like the SCAA data, the AAER data contain information on cases in which there is an allegation of account fraud. The SEC cases cover fraud charges similar to those in the SCAA sample. I handle the SEC sample in a manner slightly different than the private cases. Almost all SEC allegations receive at least an injunction in which the defendant agrees not to commit fraud again. The case may also result in a disgorgement in which the defendant must return ill-gotten gains, in a civil penalty, or in criminal penalties. The overlap between public and private cases is nearly complete, with almost all public cases having a parallel private class action covering the same fraud allegation.

Several studies have attempted to examine the number of private securities class actions by year. Seligman (1994) has argued that this is inherently misleading, as a number of cases are consolidated or dismissed for technical reasons only to be refiled a short time later. For this reason, I construct a fraud allegation indicator equal to one if a private securities class action accuses a company's officers or directors of fraud during any case in the data that year. I further classify the fraud as public or private and by the outcome of all the cases that alleged fraud during that year. The fraud period for private cases is determined by the class period. The class period is a bracket of time during which an individual must have purchased the stock to be eligible for compensation from the class settlement fund. The SEC's AAERs publish the dates of the alleged fraud. Since I am looking only at year-to-year changes in the board, the dates of the alleged fraud need be accurate only up to a year.

I include a director in the relevant fraud category beginning in the year that the fraud allegation becomes public.[6] Although press reports likely predate filings, I take the filings as the year in which the fraud was revealed. Given the rush to file in private cases, this date usually predates any news

[6] It is possible that private parties (attorneys or the press) or the SEC revealed the fraud after the director left the board of the company accused of fraud.

items on the alleged fraud. A check of several fraud allegations indicates that the newspaper reports identifying fraud appear within the same year as the SEC filing for preliminary injunctions in a case. I list a director as having been accused of fraud by the public (SEC) if he or she served on the board of an accused company and the alleged fraud has been litigated at least as far as the preliminary-injunction stage.

B. Measures of Directorships

A remaining issue is how to best measure reputation using outside directorships because outside directorships vary in value and prestige. Using total net directorships may mask important changes in the composition of outside board positions, so I utilize a number of different measures of quality of outside directorships. The first set of classifications measures the financial value of the director's portfolio of outside directorships. To control for change in the net value of the director's portfolio of board positions, I examine the change in net outside directorships that have a director's pension system, stock options, or director's fees in the top quartile of all companies in ExecuComp.[7] To measure the change in prestige of the director's board-position portfolio, I examine the number of directorships in the top quartile of all companies in Compustat (in the relevant years) for four variables: industry-adjusted returns on equity, top quartile of sales, top quartile of employment, and number of directorships in the Fortune 500. The data for these board classifications come from Compustat or the Center for Research in Securities Prices.

It is possible that some directors who have a reputation for being inattentive to their monitoring duties will be attractive to firms whose managers control the board. To a poorly governed firm, a shareholder suit might perversely signal that a director is a good choice. To capture this possibility, I utilize several measures of quality of board governance for the firms in the director's portfolio of outside directorships. I utilize the change in the director's net outside board positions in the top quartile of block ownership, top quartile of the percentage of insiders serving on the board, top quartile of board size, and top quartile of CEO tenure. I derive the board composition data from Compact Disclosure and the CEO's tenure from ExecuComp. Net directorships in firms that indemnify their directors are also included because directors who have been subject to a suit may seek out boards that protect them financially from future litigation. I derive the indemnity data from the Gompers, Ishii, and Metrick (2003) data set.[8]

[7] Because ExecuComp covers only a subset of firms in the data set, I limit the sample to directors who at some point serve on a company with data in the ExecuComp sample. The motivation is that other directors provide no information for the regressions.

[8] This sample contains a different set of firms and therefore restricts the sample to a different set of directors.

C. Independent Determinants

The literature on the determinants of outside directorships motivates the control variables. Previous studies have utilized several measures of corporate performance and estimated the effect of each measure on future directorships. The study with data most closely resembling the data used in this study is Yermack (2003), which utilizes the average equity performance of directors' boards.[9] I include the average return on equity for the directors' companies lagged by 1 year. Given that directors can serve on multiple boards, I also utilize a slightly different measure. For each director-year, I compute both the portion of the director's companies performing in the bottom 25th percentile of industry-adjusted performance and those in the top quartile of performance for the previous year.

The literature suggests several other determinants of outside directorships. I include a control variable for directors who reach retirement age (over 65). Booth and Deli (1996) suggest that companies are more likely to add CEOs as outside board members, so I include an indicator controlling for whether the director is the CEO or chief financial officer (CFO) of a company. Several studies have suggested that interlock is an important determinant of outside directorships (Booth and Deli 1996). I include an indicator variable for insiders equal to one if the director serves on a board in the sample for which he or she is also an officer or director. Yermack (2003) indicates that CEO turnover is often associated with exit by directors appointed by the CEO. As the Compact Disclosure data do not include the appointing CEO, I include an indicator variable for CEO turnover.

The literature also suggests that the current number of board positions is important in determining the number of board positions the director holds in the future. There are three different but not exclusive rationales for including some measure of the stock of current board positions. The first is that the director's initial reputation is an important determinant of future success in the outside-director labor market. To capture this effect, I include the total number of board position in the previous year.[10] Other studies have suggested the possibility that companies or shareholders discount directors who have a large number of positions. While previous studies have not found having a large number of outside positions detrimental to corporate performance, the mere perception that having a large number of directorships is problematic may harm directors with a high number of outside positions (see Ferris, Jagannathan, and Pritchard 2003). I include a spline for directorships in excess of six outside boards. Finally, I include the number of board po-

[9] Several other studies have also estimated the effect of corporate performance on future outside directorships. See, for example, Ferris, Jagannathan, and Pritchard (2003), Brickley, Linck, and Coles (1999), and Booth and Deli (1996).

[10] The results below are robust to utilizing any of the different measures of board quality noted earlier. Fortune 500 firms were utilized for consistency with previous studies.

sitions to standardize the gain or loss in boards. If a director serves on six boards and is removed from all of them the next year, this is a much larger drop than if the director loses only one board position. By contrast, a director with one board position suffers a larger reputational penalty from losing one outside position.

To control for industry effects, I include indicator variables for Fama and French's (1997) 12 industry classifications. These variables control for the expertise of the director as well as any sectors, such as technology, that may be fashionable to represent on the board. All specifications also include director fixed effects and year fixed effects.

Finally, I include a trend variable for the number of years the director has been in the sample. It is certainly the case that directors who have simply been in the market for a longer period of time are more likely to be sued. Ideally, I would like to have the total number of years in the director labor market for each director. Since this information is not available, I control for the time in the market using director fixed effects plus the number of years the director has been in the market since he or she first entered the sample. Since the history prior to entering the market is constant, the trend measures the incremental effect of 1 more year in the director labor market on the number of net outside board positions. In an alternative specification, I also use only directors who are not serving on boards in 1994, the start of the sample, for whom the trend represents the complete experience in the director market.

IV. Sample Characteristics

Table 1 provides the descriptive statistics of the directors' sample. Table 2 provides two different measures of the scope of both shareholder class actions and SEC cases alleging fraud by the board of directors or management. The first measure is the number of director-years in which a director has at some point between 1994 and 2002 sat on the board of a company accused of fraud during his or her tenure on the board. There are 29,840 director-years in which the director sat on a board accused of fraud in a private securities class action.[11] By contrast, only 3,150 director-year observations are for cases in which a director sat on such a board where the SEC has made the allegation. The picture is somewhat different when we look only at directors. If we treat directors as the unit of observation, then 4,330 directors at some point sat on the board of a company accused of fraud, while only 691 directors sat on such boards accused by the SEC.

[11] Note that a director may have been accused prior to 1994, but fixed effects capture this.

TABLE 1

DESCRIPTIVE STATISTICS

	Mean	SD	Min	Max
Dependent variable: change in directorships:				
All outside	−.1705726	.4806516	−6	3
With pensions	−.018866	.1657114	−5	1
Top quartile of compensation	−.0826445	.3191591	−5	2
With options	−.073992	.3057692	−4	2
Top quartile of value	−.0984925	.3562055	−5	2
Top quartile of sales	−.0846285	.3372159	−6	2
Top quartile of employment	−.0934022	.3519999	−6	2
Fortune 500	−.0122075	.1380086	−5	2
Top quartile of block ownership	−.0904105	.3381627	−4	2
Top quartile of insiders	−.0320854	.2152677	−3	2
Top quartile of board size	−.0426873	.247628	−4	2
Director indemnification	.0140469	.1183	0	2
Top quartile of CEO tenure	−.0876695	.3338758	−4	2
Independent variables:				
Allegation of fraud[a]	.1055248	.307229	0	1
Public allegation of fraud[a]	.0111395	.1049546	0	1
Director served on the audit committee of a board named in a class-action lawsuit	.000099	.0099503	0	1
Director was CEO of a company named in a class-action lawsuit	.0103191	.1010576	0	1
Director was CFO of a company named in a class-action lawsuit	.0006012	.0245117	0	1
Director served on the board of two companies named in different class-action lawsuits	.000046	.0067802	0	1
Number of boards in the top quartile of industry-adjusted returns	.1329462	.3228819	0	1
Number of boards in the bottom quartile of industry-adjusted returns	.0903499	.2747448	0	1
Mean stock return of boards $t-1$	.1827525	.9701447	−8.138741	9.480934
Director age >65 $(=1)$	.2610255	.4391946	0	1
Director is CEO of company in sample $(=1)$	.0606485	.2386849	0	1
Director is CFO of company in sample $(=1)$	.0046927	.0683428	0	1
CEO of one of the director's companies exits	.0062063	.0785354	0	1
Director is officer of a company in the sample	.18336	.3869621	0	1
Total number of boards last year	1.066972	.7260761	0	13
Total number of boards if $t>6$ last year	.0152983	.3239734	0	13

NOTE.—The sample size used in the estimation varies owing to missing data. Data were collected from Compact Disclosure, firm's proxy statements, Compustat, the Center for Research in Securities Prices, and ExecuComp.

[a] Directors has served on a board named in a class-action lawsuit.

TABLE 2

NUMBER OF DIRECTORS AND COMPANIES ACCUSED OF FRAUD BY PRIVATE PARTIES OR THE SECURITIES AND EXCHANGE COMMISSION (SEC), 1994–2002

	Director-Years	Directors
No fraud allegation	250,742	50,476
Class-action fraud allegation	29,840	4,330
SEC suit alleging fraud	3150	691

NOTE.—The private fraud allegations are securities class actions detailed in the Security Class Action Alert between 1994 and 2002. I supplement the data with pending cases from the Stanford Law School's Securities Class Action Clearinghouse. I derive SEC-filed cases from Accounting and Auditing Enforcement Releases between 1994 and 2002.

V. EFFECT OF FRAUD ALLEGATIONS ON FUTURE DIRECTORSHIPS

A. *Estimation Technique*

To explore the effect of fraud allegations on director reputation suppose that the number of outside directorships is given by

$$\text{net\_directorships}_{it} = \beta_1 \text{private\_fraud}_{it} + \beta_2 x_{it} + \lambda_t + \delta_i + \varepsilon_{it},$$

where $\text{net\_directorships}_{it}$ is director i's new directorships minus exits from existing boards. The term $\text{private\_fraud}_{it}$, which equals one if the director sat on the board of a company accused in a private suit filed since 1994, captures fraud allegations. The independent variables, x_{it}, follow the definitions given in Section III*C*. There is one other factor relevant to understanding the model: it is also estimated with director, δ_i, and year fixed effects, λ_t, so the effect of fraud is estimated using within-director and within-year variation.

B. *All Outside Directorships*

The results for all outside directorships are presented in column 1 of Table 3. A fraud accusation in a private securities case has a statistically significant and positive effect on the reputation of outside directors. A fraud allegation increases the net number of outside directorships by .184. This represents a gain of about 17.5 percent in total board positions per year (increasing from the sample average of 1.066 outside board positions). This is a within-director estimate and is driven not by cross-sectional variation but only by a director's company being accused of fraud.

One explanation for a positive effect of a fraud allegation is that critics of shareholder class actions are correct. The average private securities case is a strike suit designed to elicit settlement but is without legal merit; that is, the average case does not actually identify any fraud. If this were the case, one would expect plaintiffs' attorneys to target directors with a high

TABLE 3

FIXED-EFFECTS ESTIMATION OF THE CHANGE IN NET OUTSIDE DIRECTORSHIPS

	All Outside Directorships (1)	Pensions (2)	Top Quartile of Compensation (3)	Options (4)	Top Quartile of Value (5)	Top Quartile of Sales (6)	Top Quartile of Employment (7)	Fortune 500 (8)
Allegation of fraud	.184**	.066**	.107**	.058**	.171**	.086**	.100**	.007
	(.014)	(.011)	(.021)	(.021)	(.023)	(.010)	(.011)	(.004)
Number of boards in the top quartile of industry-adjusted returns	−.101**	−.005*	−.056**	−.059**	−.053**	−.051**	−.055**	−.002^{+}
	(.004)	(.002)	(.005)	(.004)	(.005)	(.003)	(.003)	(.001)
Number of boards in the bottom quartile of industry-adjusted returns	−.057**	−.008**	.002	−.008	−.005	−.006^{+}	−.018**	.000
	(.004)	(.003)	(.006)	(.006)	(.007)	(.003)	(.003)	(.001)
Mean stock return of boards $t-1$	.030**	−.002	.027**	.026**	.025**	.016**	.015**	.001*
	(.002)	(.001)	(.003)	(.003)	(.003)	(.001)	(.001)	(.001)
Director age > 65 (=1)	.013*	.004	−.008	−.001	−.009	−.018**	−.010*	−.009**
	(.005)	(.003)	(.007)	(.006)	(.007)	(.004)	(.004)	(.002)
Director is CEO of company in sample (=1)	−.002	.000	.023**	.011	.033**	.013**	.014**	.010**
	(.007)	(.005)	(.009)	(.009)	(.010)	(.005)	(.005)	(.002)

Director is CFO of company in sample (=1)	−.012	−.005	.025	.023	.026	−.020	−.016	−.001
	(.021)	(.016)	(.032)	(.030)	(.034)	(.015)	(.016)	(.007)
CEO of one of the director's companies exits	.004	−.006	−.002	.009	−.011	.021*	.004	−.008*
	(.013)	(.008)	(.016)	(.015)	(.017)	(.009)	(.010)	(.004)
Director is officer of a company in the sample	−.017**	−.000	.018*	.008	−.014^{+}	.017**	.023**	.008**
	(.005)	(.004)	(.008)	(.007)	(.008)	(.004)	(.004)	(.002)
Total number of boards	−.180**	−.017**	−.059**	−.067**	−.093**	−.071**	−.073**	−.005**
	(.004)	(.003)	(.006)	(.006)	(.007)	(.003)	(.003)	(.001)
Total number of boards in $t>6$	.035**	−.012**	.016^{+}	.025**	.014	.016**	.009**	.007**
	(.004)	(.004)	(.009)	(.008)	(.009)	(.003)	(.003)	(.001)
Observations	250,161	63,977	63,977	63,977	63,977	250,161	250,161	250,161
Directors	59,674	16,369	16,369	16,369	16,369	59,674	59,674	59,674

NOTE.—I construct the change in the number of net directorships by subtracting the number of boards the director exits from in year t from the number of boards that add the director in year t. Observations are for a director-year for all directors holding at least one outside directorship between 1994 and 2002. All models include director, industry, and year fixed effects. Standard errors are in parentheses.

$^{+}$ Significant at 10%.

* Significant at 5%.

** Significant at 1%.

opportunity cost of defending against these cases. Thus, companies with a board made up of directors who are particularly attractive candidates for new outside board positions are also particularly attractive candidates for a suit. An alternative possibility is that the effect of shareholder suits is more direct. Although the cases lack merit, a director who has served on a board defending against such a case is more effective at protecting shareholder interests.

The size of this effect is economically important as well. A 1-standard-deviation increase in the number of boards on which a director served with returns in the top quartile of performance decreases the net number of directorships by 18 percent. The direction of this significant coefficient is surprising, as it suggests that an increase in the number of better-performing boards reduces a director's reputation. The sign on the number of board directorships in the bottom quartile of industry-adjusted performance is more intuitive, with a 1-standard-deviation increase reducing the net number of board directorships by 9 percent. The mean of the return on equity of all a director's companies is also positive and significant. A 1-standard-deviation increase in return causes a 17 percent increase in the net number of directorships. Reaching retirement age increases the net number of board positions by 17 percent. Becoming an insider of a company in the sample reduces the net number of directorships by 9 percent. Increasing the number of boards on which a director served in the previous period causes a reduction in the net number of directorships. Adding a new board position during the last period causes a reduction of .18 of a directorship in the net number of directorships. This decline is mitigated somewhat if a director serves on more than six boards.

Before returning to a discussion of why a private class action improves a director's reputation, it is possible that changes in the total number of outside directorships is the wrong measure because it masks important changes in the composition of a director's portfolio of board positions. It is necessary to consider other measures of outside directorships.

C. Different Types of Outside Directorships

Columns 2–8 of Table 3 contains several alternative classifications of directorships. In column 2, I present the results using only directorships that offer a director's pension plan. Again, the effect of private fraud allegations is positive and significant. The effect is similar in directorships that offer directors stock options and for directorships in the top quartile of director option value. The effect of fraud allegations is also positive and significant for directorships in the top quartile of firm size, measured by either the number of employees or sales. Only in the case of net directorships in the Fortune 500 is the effect of fraud allegations not significant, although it is positive.

Using a number of differing measures, I find that fraud allegations improve the reputation of directors. The magnitude of these effects is similar whether

I measure reputation by the compensation value of the net outside directorships, the size of the companies, or whether the board position is with a large company.

D. Robustness Checks

There are two potential issues not addressed in the preceding results. The first is whether the trend controlling for a director's time in the director labor market after 1994 adequately controls for the role of experience. The first row of Table 4 presents the results using directors added to boards only after 1994. I am able to identify these directors as new at least to the extent that they were not serving on a board in 1994. For these directors, the trend is measuring 1 additional year of experience starting from zero rather than 1 additional year starting from the experience in 1994. Because the model includes fixed effects, these should be identical. With two exceptions, the results are qualitatively identical to the full sample. In the case of net outside directorships with options, the coefficient on a fraud allegation is now negative but not significant, and the coefficient on net outside directorships in a Fortune 500 sample remains positive but is now significant.

A second econometric issue is the use of a dummy variable to capture the effect of a fraud allegation on director reputation. There is an important advantage to using the dummy variable to capture the reputational effect of a fraud allegation: the sample period is only 8 years. While this may seem to be a long time, I date the fraud allegation from the filing of the cases. Given that litigation can take several years, deciding exactly when to begin any trend is difficult. The method pursued earlier simply compares directors before and after the allegation.

In the second row Table 4, I replace the dummy variable with a post-fraud-allegation (that is, filing) trend and trend squared. The results are similar to the results using a dummy variable to capture the effect of a fraud allegation. In all cases, the trend and the trend squared results are significant. Figure 1 presents the trend for all net outside board positions. The results show that the effect of a fraud allegation increases for the first 4 years, after which the effect is mitigated, returning to almost zero after 8 years. The results for other classifications of directorships are similar. While the results are consistent with the theory that the average fraud case does not actually identify fraudulent actions by board members, it is possible that the positive effect of fraud allegations means that the outside-director market rewards not fraud per se but yes men, individuals who do not monitor management closely.

E. Governance Measures and Fraud Allegation

To test the possibility that the director labor market rewards lax oversight and not fraud allegations themselves, I examine the effect of fraud allegations

TABLE 4

CHANGE IN NET NUMBER OF OUTSIDE DIRECTORSHIPS: ROBUSTNESS CHECKS

	All Outside Directorships (1)	Pensions (2)	Top Quartile of Compensation (3)	Options (4)	Top Quartile of Value (5)	Top Quartile of Sales (6)	Top Quartile of Employment (7)	Fortune 500 (8)
Excluding directors serving on boards before 1994:								
Allegation of fraud	.158**	.075**	.186**	−.059	.099+	.067**	.073**	.014+
	(.033)	(.027)	(.054)	(.056)	(.059)	(.022)	(.024)	(.008)
Post-fraud-revelation trend:								
Trend following an allegation of fraud	.039**	.013**	.029**	.019**	.055**	.030**	.035**	.012**
	(.005)	(.003)	(.006)	(.006)	(.006)	(.003)	(.004)	(.002)
Trend squared	−.005**	−.001**	−.004**	−.003**	−.007**	−.005**	−.005**	−.003**
	(.001)	(.000)	(.001)	(.001)	(.001)	(.000)	(.000)	(.000)

NOTE.—Standard errors are in parentheses.
+ Significant at 10%.
** Significant at 1%.

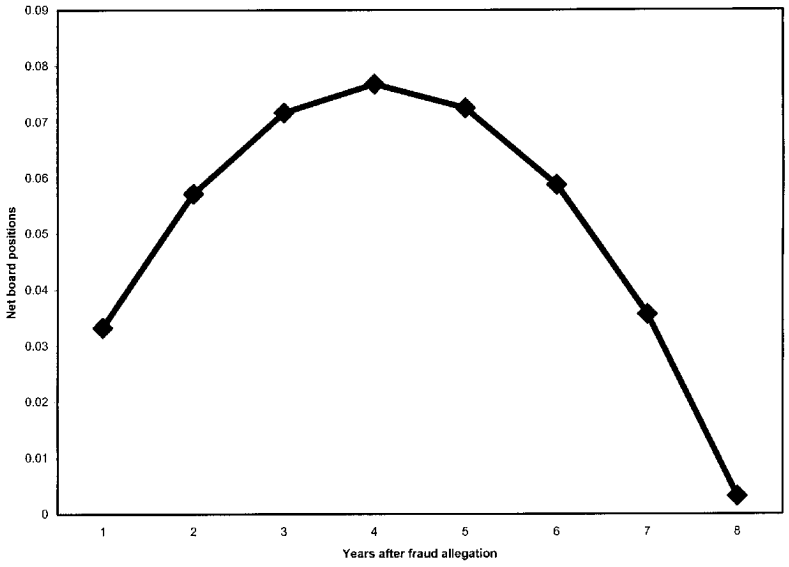

FIGURE 1.—Post-fraud-allegation trend in net new directorships

on net outside directorships using several common governance measures. In Table 5, the result for net outside directorships in firms in the top quartile of block ownership reveals that high levels of block ownership are associated with better oversight, which is consistent with the theory that large block shareholders have a greater incentive to monitor management. The effect of fraud allegations is significant, positive, and of similar magnitude to the other measure of net boards.

Table 5 also presents the results for board positions in the top quartile of insiders as a fraction of board memberships. Insiders are less effective monitors of management given their connection to the firm. For board positions on firms in the top quartile of insiders as a fraction of board membership, the effect is also positive and significant. Very large boards also produce less effective monitoring than do smaller boards. The effect for board positions in the top quartile of board size is positive and significant, with a fraud allegation resulting in an increase in the number of net board positions. Longer-serving CEOs are more entrenched and therefore dominate the board. The effect of a fraud allegation for board positions in the top quartile of CEO tenure is positive and significant. A fraud allegation causes a positive and significant increase in the number of net boards that offer indemnification of directors.

TABLE 5

FIXED-EFFECTS ESTIMATION OF CHANGE IN NET NUMBER OF OUTSIDE DIRECTORSHIPS BY CLASSIFICATION OF OUTSIDE DIRECTORSHIP

	Top Quartile of Block Ownership (1)	Top Quartile of Insiders (2)	Top Quartile of Board Size (3)	Indemnification (4)	Top Quartile of CEO Tenure (5)
Allegation of fraud	.085**	.040**	.061**	.018*	.179**
	(.010)	(.006)	(.008)	(.008)	(.022)

NOTE.—I construct the change in the number of net directorships by subtracting the number of boards the director exits from in year *t* from the number of boards that add the director in year *t*. Observations are for a director-year for all directors holding at least one outside directorship between 1994 and 2002. Model 4 includes only outside directorships on the boards of companies that indemnify their directors against shareholder suits. All models include director, industry, and year fixed effects. Standard errors are in parentheses.

* Significant at 5%.

** Significant at 1%.

F. Differentiating Fraud Allegations Filed by the Securities and Exchange Commission

As noted earlier, one potential difficulty of the test is that if management dominates the director selection process, although fraud allegations in private security class actions are meritorious, the market for outside directors may not value strong monitors and might actually seek out weak monitors identified by such cases. In the previous section, I used several measures and found no evidence to support such a conclusion because directorships in firms with weaker governance follow the same pattern as the other measures of outside directorships. In this section, I turn to another test: I estimate the effect of an SEC-backed fraud allegation on net directorships. Specifically, I examine whether fraud allegations against members of the board or management by the SEC harm the reputation of a director who served on that board. I estimate the model

$$\text{net\_directorships}_{it} = \beta_1 \text{private\_fraud}_{it} + \beta_2 \text{public\_fraud}_{it} + \beta_3 x_{it} + \lambda_t + \delta_i + \varepsilon_{it},$$

where public_fraud_{it} equals one if the director sat on the board of a company accused of fraud by the SEC.

Tables 6 and 7 present the results of the model. The coefficients for the private fraud allegations are largely unchanged when controlling for SEC-filed cases. The one exception is that the positive effect of fraud allegation on net outside directorships in the Fortune 500 sample is now statistically significant.

The effect of SEC-sponsored allegations of fraud is generally negative and in two cases is not significant. Directors serving on a board accused of fraud

TABLE 6

FIXED-EFFECTS ESTIMATION DECOMPOSING PUBLIC AND PRIVATE ALLEGATIONS OF FRAUD, NET OUTSIDE BOARD POSITIONS DEFINED AS ALL OUTSIDE DIRECTORS, BY COMPENSATION AND PRESTIGE MEASURES

	All Outside Directorships (1)	Pensions (2)	Top Quartile of Compensation (3)	Options (4)	Top Quartile of Value (5)	Top Quartile of Sales (6)	Top Quartile of Employment (7)	Fortune 500 (8)
Private allegation of fraud	.186**	.066**	.112**	.059**	.174**	.091**	.104**	.009*
	(.014)	(.011)	(.021)	(.021)	(.023)	(.010)	(.011)	(.004)
Public allegation of fraud	−.044*	.013	−.133**	−.027	−.090**	−.155**	−.137**	−.069**
	(.019)	(.011)	(.022)	(.021)	(.024)	(.014)	(.015)	(.006)

NOTE.—A private allegation of fraud indicated that the director has served on the board of a company accused of fraud in a private securities class action. A public allegation of fraud indicates that the director served on a board accused by the Securities and Exchange Commission of fraud. Standard errors are in parentheses.

* Significant at 5%.

** Significant at 1%.

TABLE 7

FIXED-EFFECTS ESTIMATION DECOMPOSING PUBLIC AND PRIVATE ALLEGATIONS OF FRAUD, NET OUTSIDE BOARD POSITIONS DEFINED BY GOVERNANCE

	Top Quartile of Block Ownership (1)	Top Quartile of Insiders (2)	Top Quartile of Board Size (3)	Indemnification (4)	Top Quartile of CEO Tenure (5)
Private allegation of fraud	.085**	.040**	.064**	.017*	.181**
	(.010)	(.006)	(.008)	(.008)	(.022)
Public allegation of fraud	.002	−.003	−.083**	.030**	−.029
	(.014)	(.009)	(.011)	(.008)	(.023)

NOTE.—A private allegation of fraud indicated that the director has served on the board of a company accused of fraud in a private securities class action. A public allegation of fraud indicates that the director served on a board accused by the Securities and Exchange Commission of fraud. Standard errors are in parentheses.

* Significant at 5%.

** Significant at 1%.

by the SEC experience a decrease of .044 in outside directorships. Serving on a board that is accused of fraud by the SEC results in a relative decrease in net board positions in companies in the top quartile of director compensation. For companies in the top quartile of sales and employment, the effect of a public allegation is a relative loss of .155 and .137, respectively. Finally, the effect is a −.069 relative loss in net outside directorships in the Fortune 500 sample.

Table 7 shows the results using the governance measures to define net board positions. In this case, one coefficient is negative and significant, and one positive and significant. The number of net board positions in the top quartile of board size decreases with an SEC fraud allegation, while the number for boards that indemnify directors increases.

VI. Extensions

A. Alternative Definitions of Fraud Allegation

The results thus far have utilized all shareholder class actions as a fraud allegation regardless of the ultimate disposition of the case. This section utilizes several different measures of a fraud allegation. Panel A of Table 8 presents the results using only those fraud cases that settled out of court, in which the plaintiffs' won at trial, or that are still pending in 2002. In the first three cases, the courts have essentially made rulings because all of the fraud allegations are private securities class actions and the courts must approve all settlements between plaintiffs and defendants, which, in effect, sanction the fraud allegation. In this specification, I do not count cases that are withdrawn or dismissed as fraud allegations. The results are substantively identical to those in the previous section, with all different measures of net number of boards showing a positive and significant increase following a fraud allegation.

The exact method of treating pending cases is debatable. In panel B of Table 8, I estimate the model without counting pending cases as fraud allegations. Again, the results are substantive and identical to those of the previous section, with one notable exception. With this alternative fraud measure, an allegation causes a net reduction in the number of board positions. One possible explanation is that cases that result in a settlement against a large, high-profile company are more meritorious than the average suit.

One major concern with securities class-action cases is that the majority are strike suits: lawsuits that are aimed at extracting a settlement from an opportune target but do not address actual fraud. Since strike suits are of lower value than suits that address actual fraud and therefore would win at trial, an alternative method of evaluating the merits of private fraud allegations is to repeat the analysis using only the top quartile of settlements of any case going to trial. The motivation is that such high-payout cases and

TABLE 8

FIXED-EFFECTS ESTIMATION BY TYPE OF FRAUD ALLEGATION

	All Outside Directorships (1)	Pensions (2)	Top Quartile of Compensation (3)	Options (4)	Top Quartile of Value (5)	Top Quartile of Sales (6)	Top Quartile of Employment (7)	Fortune 500 (8)
A. Excluding dropped or dismissed cases:								
Allegation of fraud	.180**	.067**	.108**	.056**	.172**	.083**	.098**	.008+
	(.014)	(.011)	(.021)	(.021)	(.023)	(.010)	(.011)	(.005)
B. Excluding dropped, dismissed, or pending cases:								
Allegation of fraud	.201**	.054*	.099*	.126**	.162**	.066**	.094**	−.017+
	(.031)	(.021)	(.042)	(.040)	(.045)	(.023)	(.024)	(.010)
C. Top quartile of settlements or awards:								
Allegation of fraud	−.047**	−.027**	−.061**	−.034**	−.049**	−.051**	−.053**	−.028**
	(.008)	(.006)	(.012)	(.011)	(.013)	(.006)	(.006)	(.003)
D. Standard definition of fraud interacted with post-1995 indicator variable:								
Allegation of fraud	.275**	.066**	.160**	.093**	.233**	.129**	.151**	.026**
	(.018)	(.014)	(.027)	(.026)	(.029)	(.013)	(.014)	(.006)
Allegation of fraud, post-1995+	−.103**	−.000	−.068**	−.045*	−.080**	−.048**	−.057**	−.022**
	(.014)	(.010)	(.020)	(.020)	(.022)	(.010)	(.010)	(.004)

NOTE.—Dynamic panel estimates of the change in the net number of outside directorships. In panel A, a fraud allegation does not include any case that a judge eventually dismisses or that plaintiffs drop unilaterally. Panel B uses the same definition of fraud as panel A but also excludes cases that are pending when I created the sample. Panel C classifies only those cases that go to trial or have a settlement in the top quartile of settlements as fraud allegations. Panel D interacts the encompassing definition of fraud allegations with a dummy variable equal to one if the case was filed during or after 1995. All models include industry and year fixed effects. Standard errors are in parentheses.

+ Significant at 10%.

* Significant at 5%.

** Significant at 1%.

trials reflect a creditable allegation of fraud, while low-value cases are ones that result in smaller amounts.

In panel C, I estimate the model counting only settlements in the top quartile of the settlement distribution of real dollar awards, settlements between 1994 and 2002, and cases that go to trial as fraud allegations. The results now change dramatically. In every measure of net directorships, the effect is negative and significant. Moreover, the effect is economically significant. For example, sitting on the board of a company accused of a fraud allegation that results in a settlement in the top quartile of payouts results in a .047 reduction in the net number of board seats for the director.

B. The Private Securities Litigation Reform Act

Panel D addresses a different policy question. It decomposes the effect of private shareholder class actions into those suits filed before 1995 and those filed after 1995. In 1995, Congress overrode President Clinton's veto to pass the Private Securities Litigation Reform Act (PSLRA), which was intended to protect firms and their shareholders from frivolous class-action lawsuits. Concern about nonmeritorious suits motivated Congress's passage of the law.[12] The clear intention of the law was to improve the quality of shareholder class actions by eliminating strike suits designed only to elicit a settlement. In 1998, in response to a perceived end run around the law by filing in state court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which made class actions covered by PSLRA removable to federal court.

The post-1995 control is significant and negative. For example, a post-1995 private fraud allegation causes a .103 reduction in the number of net boards for directors who served on a company's board during the period covered by the allegation. In each case, however, the magnitude of the post-1995 change is smaller than the overall positive effect. One interpretation of this is that the PSLRA and SLUSA improved average case quality but that the average case still did not negatively affect the reputation of directors. The test should be interpreted with caution, however, as cases filed in 1994 represent the only pre-PSLRA cases in the data set.

[12] The law relaxed the joint and several liability standard in effect prior to 1995 and implemented a system of proportional liability based on proximity to the fraud, with less culpable defendants paying a smaller proportion of the damages. The major objective of the provision was to reduce the hunt for deep pockets, that is, filing a case against a defendant with little connection to a fraud in order to increase the overall ability of defendants to pay any settlement or award. The law also limited discovery while motions to dismiss were pending. In addition, the law provided a safe harbor against lawsuits if statements to investors included certain risk disclosures. The act also included provisions for punishing plaintiffs' attorneys who file legally frivolous lawsuits and/or suits that lack any supporting evidence. Finally, the act imposed heightened pleading standards, raising the standard required to prove a fraud allegation.

C. Alternative Definitions and Suits Filed by the Securities and Exchange Commission

Table 9 repeats the earlier estimation and shows the results of estimating the model using the narrow definition of a private fraud allegation defined earlier. In addition, I utilize a narrower definition of all SEC allegations by classifying SEC fraud allegations as only those cases in which the SEC did not settle the case with only an injunction. The results are stronger than those reported earlier, with the majority being negative and significant. All numbers of net outside directorships decline when the director has served on the board of a company accused by the SEC of fraud and that allegation ended in a conviction, fine, or disgorgement.

D. Differential Effect of Fraud Allegations by Position

Not all directors or officers are equally well positioned to know the true state of a corporation's finances. It is possible that the reputational effect of a fraud allegation differs depending on the information available to the director when he or she served on a board accused of fraud. This is problematic if the effects have different signs. Suppose, for example, that directors who were in a position to know about the fraud are punished in the outside-director market, while those directors not privy to this information (possibly the majority of the board) are actually rewarded by the market because they have experience dealing with a troubled company and are untainted by scandal.

Because settlements do not typically reveal which directors are actually accused of fraud, I utilize three proxies for directors who are a position to know (or who should know) the true state of the company's finances. Specifically, I include controls for the directors who served on the companies' audit committee during the period of the alleged fraud and for directors who were the CEO or CFO of the company accused of fraud. The equation estimated is

$$\begin{aligned}\text{net\_directorships}_{it} = {} & \beta_1 \text{private\_fraud}_{it} + \beta_2 \text{audit\_fraud}_{it} \\ & + \beta_3 \text{CEO\_fraud}_{it} + \beta_4 \text{CFO\_fraud}_{it} \\ & + \beta_5 x_{it} + \lambda_t + \delta_i + \varepsilon_{it},\end{aligned}$$

where audit_fraud_{it} equals one if the director served on the audit committee for a company accused of fraud in a private class action, CEO_fraud_{it} equals one if the director served as CEO of a company accused of fraud, and CFO_fraud_{it} equals one if the director served as CFO of a company accused of fraud in a private class action. The other variables retain their meaning from the earlier specifications. In addition, I also decompose the results using each individual classification and creating an indicator variable equal to one

if the director held any of the three positions on a board accused of fraud. I present the results in Table 10. Finally, because these three classifications are rare, I present the results using only overall directorships. The cell sizes are simply too small to provide meaningful estimates for the various classifications of outside directorships.

In each case, the effect of having additional information is positive, although in the case of audit committee membership the effect is not significant. Both CEOs and CFOs experience a relative increase in the number of net outside board positions beyond that experienced by any director serving on the board of a company accused of fraud. The evidence suggests that directors whom we would suspect of having inside information about any fraud perpetrated by the company do not suffer a reputational penalty. In the case of CEOs and CFOs, they appear to actually do better than other CEOs or CFOs in their net outside board positions and better than other outside directors serving on a board accused of fraud.

VII. Conclusions

Before turning to an interpretation of the results, it is useful to review the key findings of the paper. The effect of serving on a board of company charged with fraud in a private securities class action increases the net number of outside directorships for members of that board. The result is robust to several different specifications of outside directorships and several different definitions of which class actions constitute an allegation of fraud. This is consistent with the average case being a strike suit: one that does not identify actual fraud. Because the average private securities class action is a strike suit, it does not convey negative information about the director.

There are two explanations for why the effect on director reputation is positive. One explanation is that a strike suit is more likely to elicit settlement for a director who is more effective and desirable as an outside director because he or she has a higher opportunity cost of time. Given this targeting method of filing suits, the coefficient on fraud allegations is positive. An alternative explanation for the positive coefficient is that directors who serve on the board of a company accused of fraud actually develop useful human capital that is beneficial to other companies, and therefore they are in greater demand.

The positive coefficient is also consistent with the hypothesis that the director labor market actually rewards lax oversight and not being the target of a suit per se. The other results of the paper argue against such an interpretation. The effect is no different when I estimate the repuational effect of a fraud allegation using net outside board positions in companies classified by lax oversight characteristics. When I restrict a fraud allegation to cases in the top quartile of settlements or those that go to trial, the effect of a fraud allegation is negative and significant across different measures of outside

TABLE 9

FIXED EFFECT ESTIMATION OF CHANGE IN NUMBER OF OUTSIDE DIRECTORSHIPS BY TYPE OF FRAUD ALLEGATION, DECOMPOSING PUBLIC AND PRIVATE FRAUD ALLEGATIONS

	All Outside Directorships (1)	Pensions (2)	Top Quartile of Compensation (3)	Options (4)	Top Quartile of Value (5)	Top Quartile of Sales (6)	Top Quartile of Employment (7)	Fortune 500 (8)
A. Excluding dropped, dismissed, or injunctions:								
Allegation of fraud	.182**	.067**	.113**	.056**	.177**	.088**	.102**	.010*
	(.014)	(.011)	(.021)	(.021)	(.023)	(.010)	(.011)	(.005)
Public allegation of fraud	−.058**	.000	−.146**	−.016	−.127**	−.167**	−.157**	−.071**
	(.020)	(.012)	(.023)	(.022)	(.025)	(.015)	(.016)	(.007)
B. Excluding dropped, dismissed no pending, or injunctions:								
Allegation of fraud	.203**	.054*	.106*	.126**	.167**	.073**	.101**	−.014
	(.031)	(.021)	(.042)	(.040)	(.045)	(.023)	(.024)	(.010)
Public allegation of fraud	−.051*	.003	−.142**	−.015	−.122**	−.163**	−.152**	−.070**
	(.020)	(.012)	(.023)	(.022)	(.025)	(.015)	(.016)	(.007)

C. Top quartile of settlements or awards:								
Allegation of fraud	−.047**	−.027**	−.061**	−.034**	−.049**	−.050**	−.053**	−.028**
	(.008)	(.006)	(.012)	(.011)	(.013)	(.006)	(.006)	(.003)
Public allegation of fraud	−.046*	.003	−.141**	−.013	−.120**	−.160**	−.149**	−.070**
	(.020)	(.012)	(.023)	(.022)	(.025)	(.015)	(.016)	(.007)
D. Standard definition of fraud interacted with post-1995 indicator variable:								
Allegation of fraud	.277**	.066**	.164**	.094**	.235**	.133**	.155**	.028**
	(.018)	(.014)	(.027)	(.026)	(.029)	(.013)	(.014)	(.006)
Allegation of fraud, post-1995	−.103**	−.000	−.066**	−.045*	−.078**	−.048**	−.057**	−.022**
	(.014)	(.010)	(.020)	(.020)	(.022)	(.010)	(.010)	(.004)
Public allegation of fraud	−.044*	.013	−.132**	−.026	−.089**	−.155**	−.138**	−.069**
	(.019)	(.011)	(.022)	(.021)	(.024)	(.014)	(.015)	(.006)

NOTE.—In panel A, a fraud allegation does not include any case that a judge eventually dismissed or was dropped by the plaintiffs unilaterally. Panel B uses the same definition of fraud as panel A but also excludes cases that were pending when I created the sample. Panel C classifies only those cases that go to trial or have a settlement in the top quartile of settlements as fraud allegations. Panel D interacts the encompassing definition of fraud allegations with a dummy variable equal to one if the case was filed during or after 1995. The public fraud allegations are constructed using SEC cases that involve a fine, disgorgement, civil penalty and/or a criminal conviction. All models include director and year fixed effects. Standard errors are in parentheses.

+ Significant at 10%.

* Significant at 5%.

** Significant at 1%.

TABLE 10

FIXED-EFFECTS ESTIMATION OF CHANGE IN NET NUMBER OF OUTSIDE DIRECTORSHIPS, DECOMPOSED BY POSITION, FOR ALL OUTSIDE DIRECTORSHIPS

	(1)	(2)	(3)	(4)	(5)
Allegation of fraud	.177**	.184**	.179**	.183**	.178**
	(.014)	(.014)	(.014)	(.014)	(.014)
Audit committee member on a board named in a class-action lawsuit	.074	.071			
	(.293)	(.293)			
CEO of a company named in a class-action lawsuit	.104**		.105**		
	(.027)		(.027)		
CFO of a company named in a class-action lawsuit	.197*			.200*	
	(.082)			(.082)	
Director has been an audit committee member, CEO, or CFO for a company named in a class-action lawsuit					.112**
					(.026)

NOTE.—A fraud allegation is decomposed to identify the differential effect of directors who served on the audit committee, those who were the CEO, CFO, or any of the three during the period of the alleged fraud. Standard errors are in parentheses.

* Significant at 5%.

** Significant at 1%.

directorships. Moreover, when the SEC files a case, the effect is negative and significant. Directors who serve on more than one board accused of fraud also seem to improve their reputation, at least for reputation measures based on company size or outside directorships in Fortune 500 companies. Following the passage of the PSLRA—a 1995 law designed to reduce the ability of plaintiffs' attorneys to file strike suits—the effect on the reputation of directors is reduced, although it is still positive. This is consistent with the law's intended purpose of reducing strike suits. Finally, directors who are the CEO or CFO of a company accused of fraud actually increase their net outside directorships beyond the increase experienced by all directors on boards accused of fraud. This suggests that even directors directly in a position to observe the fraud if it occurred, or who at least had been charged with preventing it, are rewarded in the director labor market. The evidence is consistent with the hypothesis that the average private securities case does not provide evidence of director malfeasance or a failure of oversight. While the evidence is consistent with a number of suits not being meritorious, it also suggests that some suits, those with large settlements, do identify officer or director malfeasance. The policy implication of the results is ambiguous. The results suggest that cases of limited social value are ending up in the courts. At the same time, meritorious cases clearly exist. Whether the social benefit of the meritorious cases is larger than the cost of the nonmeritorious cases is impossible to say. The results do suggest that the PSLRA, which aimed to increase the hurdle necessary to bring a securities case, was at least moving in the right direction. Exactly how restrictive the law should be is, as they say, worth further study but beyond the scope of this paper.

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