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Financial fraud, director reputation, and shareholder wealth ☆

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Abstract

We investigate the reputational impact of financial fraud for outside directors based on a sample of firms facing shareholder class action lawsuits. Following a financial fraud lawsuit, outside directors do not face abnormal turnover on the board of the sued firm but experience a significant decline in other board seats held. This decline in other directorships is greater for more severe allegations of fraud and when the outside director bears greater responsibility for monitoring fraud. Interlocked firms that share directors with the sued firm also exhibit valuation declines at the lawsuit filing. Fraud-affiliated directors are more likely to lose directorships at firms with stronger corporate governance and their departure is associated with valuation increases for these firms.
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1. Introduction

The recent wave of corporate financial scandals has raised substantial concerns about the effectiveness of corporate governance in the US. A commonly held view is that financial scandals are symptomatic of, and result from, massive deficiencies in corporate governance. This view has prompted widespread changes, including the Sarbanes-Oxley Act, new Securities and Exchange Commission (SEC) regulations, and governance requirements adopted by the NYSE and NASDAQ. Additionally, organizations such as Institutional Shareholder Services, the Council of Institutional Investors, and The Corporate Library, among many others, have been actively promoting extensive agendas aimed at reforming the quality of corporate governance in public corporations.

There is broad agreement that financial fraud leads to significant valuation losses for investors, as has been apparent in numerous recent governance failures. These losses appear to result primarily from reputational costs borne by firms as a result of the financial fraud. However, relatively little is known about the reputational costs for outside directors of firms that are involved in fraud and the penalties suffered by these directors. In this paper, we examine the role of reputation in the market for directorships as an incentive mechanism for monitoring fraudulent behavior. Until the recent settlements in which outside directors at Enron and WorldCom personally paid over $10 million, outside directors appear to face few consequences for preventing financial misconduct. In this paper, we study whether outside directors suffer reputational penalties if the firms they serve on were accused of financial fraud.

We study a sample of firms facing shareholder class action lawsuits alleging financial misrepresentation under rule 10(b)-5 of the 1934 Securities and Exchange Commission Act. We find no evidence of abnormal turnover of outside directors on the boards of sued firms following such lawsuits. However, there is a dramatic decline in the other directorships held by these outside directors. On average, outside directors of sued firms experience a reduction of about 50% in the number of other directorships held, and 96% of outside directors who sit on another board lose at least one directorship within three years following the lawsuit. The reductions in directorships are greater for more serious cases of alleged fraud, as measured by subsequent SEC enforcement actions or settlement amounts following the lawsuit.

We study three hypotheses to understand the reduction in directorships following class action lawsuits. The reputation hypothesis holds that outside directors bear personal costs in the form of fewer board seats if their firms are involved in financial misconduct. An alternative (but not mutually exclusive) hypothesis is that the structure and composition of boards is determined endogenously to reflect the monitoring and operating environment. According to this endogenous board hypothesis, a lawsuit can signal that a firm is in a fraud-prone environment, leading its outside directors to spend more time monitoring this firm and to cut back on their other board seats. Finally, we consider the legal liability hypothesis which posits that outside directors cut back on board seats following a lawsuit in an attempt to minimize their future legal exposure.

We conduct several tests to explore these hypotheses. We examine how news of a lawsuit affects other firms that are linked to the outside directors of sued firms (i.e., director-interlocked firms). We find that interlocked firms experience significant negative abnormal returns at the time of the lawsuit filing, a finding consistent with all three of the hypotheses that we study. We uncover support for the endogenous board hypothesis when we examine

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