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Institutional monitoring through shareholder litigation ☆

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ABSTRACT

This paper investigates the effectiveness of using securities class action lawsuits in monitoring defendant firms by institutional lead plaintiffs from two aspects: (1) immediate litigation outcomes, including the probability of surviving the motion to dismiss and the settlement amount, and (2) subsequent governance improvement such as changes in board independence. Using a large sample of securities lawsuits from 1996 to 2005, we show that institutional investors are more likely to serve as the lead plaintiff for lawsuits with certain characteristics. After controlling for these determinants of having an institutional lead plaintiff, we show that securities class actions with institutional owners as lead plaintiffs are less likely to be dismissed and have larger monetary settlements than securities class actions with individual lead plaintiffs. This effect exists for various types of institutions including public pension funds. We also find that, after the lawsuit filings, defendant firms with institutional lead plaintiffs experience greater improvement in their board independence than defendant firms with individual lead plaintiffs. Our study suggests that securities litigation is an effective disciplining tool for institutional owners.

1. Introduction

The monitoring role of institutional investors is essential for investor protection (Shleifer and Vishny, 1997). Prior research (e.g., Carleton, Nelson, and Weisbach, 1998) indicates that institutional investors could use private channels to monitor firms because they have greater access to management.[4] When management does not comply with their demands, institutional investors can exert their monitoring power by publicly filing a proxy resolution (Gillan and Starks, 2000). However, studies generally suggest that this means of resolution is ineffective (Karpoff, 2001).[5] In the case of managerial misconduct, and especially when damages are revealed, securities class action can be an effective mechanism for institutional investors to actively monitor the defendant

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[4] Based on proprietary correspondence between TIAA-CREF and target firms, Carleton, Nelson, and Weisbach (1998) provide evidence that institutional investors with large ownerships can achieve success through private monitoring.

[5] Karpoff (2001) concludes in his survey paper that most research indicates shareholder proposals lead to small changes in target firms' governance structures with negligible impacts on firm valuations.

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firms (Romano, 1991). The effectiveness of monitoring by institutional owners through securities class action could be enhanced by having the institutional owners, instead of individuals, serve as the lead plaintiffs (Weiss and Beckerman, 1995). The Private Securities Litigation Reform Act (PSLRA) of 1995 established a provision requiring lead plaintiff status be granted to the plaintiff with the largest stake in the lawsuit. This provision is intended to encourage institutional owners to lead the lawsuit because it presumes that the largest stakeholders (likely institutional owners) are more capable of seeking better case outcomes for investors (Fisch, 2001).

In this paper, we investigate the use of securities class actions by institutional owners to monitor defendant firms. Specifically, we investigate the determinants for institutional owners to step forward to serve as lead plaintiffs and the monitoring effectiveness of institutional investors (relative to individual investors) in serving as lead plaintiffs in securities class actions. To identify determinants of having an institutional lead plaintiff, we discuss the costs and benefits for institutional owners and develop surrogates for their incentive to serve.[6] For monitoring effectiveness, we examine two aspects: (1) immediate litigation outcomes, specifically, the likelihood of the lawsuit's dismissal and the settlement amount if the lawsuit survives the motion to dismiss, and (2) subsequent governance reform, especially changes in the defendant firm's board independence.[7] Monitoring solutions to the agency problem would be effective if the monitor could present credible threats to management (Denis, 2001). The large financial and reputation penalties associated with successful securities class actions can discipline management and deter it from committing future wrongdoings that could misinform investors and result in misallocation of economic resources (Johnson, Nelson, and Pritchard, 2000). Corporate governance improvement has been deemed an effective monitoring mechanism. For instance, Coffee (1991) states that strengthening the board's monitoring function of the defendant firm is an effective way of disciplining management and preventing future corporate misbehaviors. Thus, we examine institutional investors' monitoring effectiveness by testing whether they can generate better litigation outcomes and improve subsequent corporate governance.

We expect that institutions as lead plaintiffs are more effective than individuals in achieving litigation success in terms of both financial recoveries and governance improvements. The lead plaintiff in a class action lawsuit represents all class members in selecting and retaining the class counsel, monitoring the litigation process, and negotiating with the defendant. Consequently, the lead plaintiff plays a vital role in the class action litigation process. Institutional lead plaintiffs generally have larger financial stakes, stronger litigation support and expertise, and higher public profiles than individual lead plaintiffs who are typically controlled by the class counsel who prefers a quick settlement to aggressively litigating the lawsuit (Weiss and Beckerman, 1995). This suggests that institutional lead plaintiffs are more effective in reducing litigation agency costs by effectively monitoring the class counsel and have stronger incentives and more resources to vigorously seek litigation success than individual lead plaintiffs.[8] Consequently, we expect that institutional owners serving as lead plaintiffs are more likely to increase the success rate of class action litigation and to achieve larger settlements.

Institutional investors with larger than average investments tend to be more active in governance (Coffee, 1991; Black and Coffee, 1994) and long-term shareholders generally are more interested in building a strong governance system (Gillan and Starks, 2000). Institutional lead plaintiffs are more likely to have larger than average investments and to continue holding their investments in the defendant firms' stocks than individual lead plaintiffs.[9] As a result, institutional lead plaintiffs have greater incentives to require defendant firms to build stronger governance systems. Institutional investors, especially those heavily indexed, also have the motivation to pursue governance reform of some firms to encourage other firms to make proactive governance changes (Del Guercio and Hawkins, 1999; Hawley, Williams, and Miller, 1994). Securities class actions could provide these institutional investors a channel to demand governance reform and thereby to achieve the spillover effect of improving the governance quality of overall corporate America. Cox and Thomas (2006) suggest that improving corporate governance is a major incentive for institutional owners to serve as lead plaintiffs. Defendant firms could change their governance practices for at least two reasons. First, the large financial penalty and reputation damage could increase defendant firms' awareness of the importance of corporate governance, and therefore they could voluntarily choose to improve their governance (Ferris, Jandik, Lawless, and Makhija, 2007). Second, institutional lead plaintiffs sometimes explicitly require governance

[6] It is important to investigate the determinants for at least two reasons: (1) to improve understanding of factors that motivate institutional owners to serve as the lead plaintiff as desired by the regulator, and (2) to control for the self-selection problem in our empirical analysis. The free rider problem predicts that institutions will step forward to lead the lawsuits only when their expected benefits exceed their costs. Section 2.2 discusses this in detail.

[7] We also examine institutional lead plaintiffs' ability to prolong or shorten the settlement period. However, it is unclear whether a longer or a shorter settlement period is more beneficial to investors. We do not include the effect on the length of settlement period in our main discussion of better outcomes. However, our empirical results do suggest that institutional lead plaintiffs have the ability to influence the settlement time for the benefit of investors.

[8] Litigation agency cost in securities class actions arises from the divergence of interests between the class members and the class counsel.

[9] Because the Private Securities Litigation Reform Act of 1995 establishes a preference of granting lead plaintiff status to plaintiffs with the largest financial stake in the class action, only institutions with a larger than average investment in the defendant firm likely would be granted the lead plaintiff status. Many institutional investors, such as pension funds, have selling constraints because their portfolios are indexed (Davis and Steil, 2001). In addition, some holdings of institutional investors are so large that selling would lead to further losses (Coffee, 1991).