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Original Paper

Do Shareholders Prefer Institutional Lead Plaintiffs?

Bruce D. Haslem[1*] & Amanda Wilford[2]

[1] Southern Utah University, Cedar City, UT, USA

[2] IE University, Madrid, Spain

[*] Bruce D. Haslem, E-mail: brucehaslem@suu.edu

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Abstract

Previous research has documented that institutional lead plaintiffs are associated with higher settlements and marginal improvements to governance following securities class action lawsuits. In this study, we examine the market reaction to an institution being named as lead plaintiff to examine whether the market views the improvements in governance to be worth the higher costs. We find that the abnormal returns surrounding the announcement of an institutional lead plaintiff are significantly positive, and significantly larger than the negative market reaction to the appointment of a non-institutional lead plaintiff. However, we find only weak evidence showing that the reaction is more positive for firms in greater need of governance improvement, nor is the quality of governance a consideration in seeking to be lead plaintiff. Instead, our results suggest that the market reaction is more positive when institutions retain ownership in the defendant firm, suggesting that their long-term interests are seen as more aligned with other existing shareholders.

Keywords

PSLRA, institutional lead plaintiffs, corporate governance

1. Introduction

One of the key changes in shareholder litigation created by the Private Securities and Litigation Reform Act of 1995 (PSLRA) was a provision changing the way lead plaintiffs were assigned in securities class action lawsuits. In a class action suit, individual lawsuits that allege the same misconduct are combined into one action, where the class of plaintiffs are represented by a lead plaintiff and their legal representation. Because the lead plaintiff selects the legal team that will represent the class, there is strong economic incentive to become the lead plaintiff. Under the reforms passed as part of PSLRA, preference is given to the plaintiff with the most damages, rather than other criteria for selection. With the reform, Congress was attempting to curb perceived agency problems created by a large group of

potential claimants, each receiving a small portion of any payout, being represented by a legal team that will receive a large payout in a settlement. Small individual investors were thought to lack the coordination and sophistication needed to control the litigation process effectively, and the reform's proponents suggested that having larger claimants serve as lead plaintiffs would create several valuable improvements to the process. These include fewer frivolous filings, larger settlements for the claimants, and less need for plaintiffs to race to the courthouse and file litigation in order to receive better standing to become the lead plaintiff. Most importantly, they expected improved monitoring of the attorneys representing the class along with the ability to negotiate s smaller portion of settlement payouts going to the attorneys. Because the vast majority of equity in U.S. firms is owned by large financial institutions, it was clear that they were being given preference for this role as their damages were likely to dwarf those of individual retail investors.

However, the preference for the shareholder with the largest damages is not absolute when a judge selects a lead plaintiff. The reforms required that whoever is chosen as lead plaintiff must have claims similar to the other claimants in the class, so the plaintiff with the largest claims could be passed over if the court doesn't view their claims as typical. Alternatively, Fisch (2001) and Choi (2011) both describe how courts increasingly select aggregations of potential claimants to serve as lead plaintiff. In this situation, a plaintiff attorney can organize several smaller plaintiffs into a group in order to have the largest amount of potential damages at risk. So as investors anticipate who will be chosen as lead plaintiff, there is uncertainty regarding who will be selected.

Studies examining the effectiveness of the law have reached differing conclusions as to whether it has achieved these goals. Perino (2002) finds that the law was largely unsuccessful in increasing the amount of time between a large decrease in stock price and the filing of a lawsuit, and the number of lawsuits in the most high-risk industries did not decline significantly. On the other hand, it is clear that the number of institutional lead plaintiffs has increased after the reforms. Fisch (2001), Choi, Pritchard and Fisch (2005), and Cox and Thomas (2006) all find an increasing percentage of cases are led by institutional lead plaintiffs, and average settlements increased when institutions served as lead plaintiffs. This was particularly true in those cases when it was public institutions, such as pension funds, representing the class, although this could also be indicative of these institutions selecting the most lucrative cases in which to involve themselves rather than improving oversight of the attorneys negotiating the settlement. Also consistent with the aims of the act, Baker, Perino and Silver (2013) document that the portion of settlements paid to attorneys is lower following the adoption of PSLRA, which should be beneficial to the members of the plaintiff class, while Choi, Erickson and Pritchard (2020) find that scrutiny related to fees paid to attorneys has led to attorneys billing more hours to justify larger fees from these settlements which may also be indicative of greater effort.

While larger settlement amounts might be a downside to having institutional lead plaintiffs for shareholders of the defendant firm, another strand of the literature finds that having an institution as lead plaintiff is also associated with changes in quality of firm governance following the litigation.

While an early study by Agrawal, Jaffe, and Karpoff (1999) finds that there is little change in governance following the revelation of fraud, later papers contradicted that result. Fich and Shivdasani (2007) find that although directors of fraud firms are not necessarily replaced on the board of the defendant firm, they are often removed from directorships in other companies and bear a personal cost for the fraud. Other papers by Ferris, Lawless and Makhija (2007) and Cheng, Huang, Li and Lobo (2010) find evidence that there are improvements in governance of the defendant firm itself following litigation. Cheng et al. (2010) finds these improvements to be greater when an institution serves as the lead plaintiff.

In this paper, we extend this literature by examining the market response around the announcement of the lead plaintiffs in securities class actions to test whether investors would prefer to avoid the higher settlements associated with having an institution as lead plaintiff, or are willing to accept the higher cost in exchange for better future governance. Overall, we find that the average abnormal return at the announcement of an institution as lead plaintiff is significantly positive, and also significantly contrasts with the negative market response to the announcement of a non-institution as lead plaintiff. Based on this result, it appears that the market views institutional lead plaintiffs as value enhancing, despite the evidence that they obtain larger settlements from the defendant firms. This is very relevant to the current debate surrounding the adoption of Federal Forum Provisions, which companies are using to ensure that securities lawsuits must be filed in the federal courts where the PSLRA would apply. Plaintiff attorneys and politicians who push for changes to the PSLRA often point to the heightened pleading standards, safe harbor provisions for forward looking forecasts, and delayed discovery rules as disadvantageous for shareholders. This finding demonstrates that shareholders view this particular provision as beneficial to their interests.

We examine one potential explanation for that positive response by testing whether there is a relationship between the quality of the firm's existing governance structure and how the market responds to the announcement of a lead plaintiff. As the quality of a firm's governance declines, there is a greater benefit that could be achieved given that institutional lead plaintiffs have been associated with improved governance following the litigation. However, we find only weak evidence that the market reaction is related to the existing quality of corporate governance. And in general firms that have better indicators of good governance react more positively to the announcement of an institution as lead plaintiff. Nor do we find that poor corporate governance is an incentive for institutions to take on that role. Instead, factors related to the case itself or the firm's ability to pay are better predictors of an institution becoming a lead plaintiff in a shareholder class action, rather than the greater potential for governance improvements.

Another explanation that is consistent with our results is based on the fact that institutions are very likely to retain shares of the defendant company's stock when the revelation of an actionable event occurs. As pointed out by Heck (1999) and Burch (2011), this means that institutional shareholders are often both plaintiffs in the class and current shareholders in the defendant firm, who may suffer a loss

in market value due to the settlement payout. Institutional ownership is significantly higher in defendant firms where institutions are named as lead plaintiffs, and a positive market response may reflect the potential of a more favorable settlement to a higher percentage of the current shareholders, i.e. other institutional investors. It may simply be the case that institutions prefer having one of their own leading the class as they are more likely than an individual to retain shares in the defendant firm and demand actions to preserve the value of their existing portfolio.

The paper is organized as follows. Section 2 introduces our sample and data selection. Section 3 discusses the empirical methods and hypothesis we test, while the results of our tests are presented in Section 4. Section 5 concludes.

2. Sample Data

To build our sample, we examined cases filed in the U.S. courts between 2005 and 2010. Case information was obtained from the Securities Class Action Clearinghouse at Stanford University, as well as Westlaw. For each case, we searched case records to find the date the lead plaintiff was chosen, as well as whether other parties filed competing motions to become lead plaintiffs. We then record the name of the lead plaintiff, and whether it is classified as an institution for use in our tests. We recognize that this is a relatively short time period, with thousands of cases having been filed since that time. Yet we chose that time period for multiple reasons. First, the time intensive nature of reading all case files to ensure we have identified all potential petitioners to become lead plaintiff and to determine their type made it necessary to limit the size of the sample. Second, we are attempting to examine the market reaction to the announcement of a lead plaintiff at a time when we know that institutional lead plaintiffs were associated with higher damages, as well as improved governance. Therefore, we used cases from the same period as the cases used in the studies finding these prior results. Finally, we chose to use a time period beginning after the changes in corporate governance related to the passage of Sarbanes-Oxley in 2002, as it had a major impact on the numbers and roles of outside directors on corporate boards.

Our initial sample consists of 837 cases that were certified as securities class actions by the courts. Of these cases, 44 were ongoing and were dropped from the sample, as were 86 for which a date could not be ascertained as to when the lead plaintiff was named. Another 242 events were dropped due to the stock being delisted by the time a lead plaintiff was named. This left a final sample of 465 cases that had identifiable dates for when the lead plaintiff was named, as well as returns data available from the Center for Research in Securities Prices (CRSP) that could be used to evaluate the market's response and to estimate potential damages during the class period. In addition to the identity of the lead plaintiff, we also read the consolidated legal complaint to identify (1) whether there were allegations of insider benefits, (2) whether other defendants were charged at the time, and (3) whether there were allegations of accounting misstatements. We also recorded the case outcome and the number of days between the initial filing and when a decision or settlement was rendered in the case.

Along with the case information, we collected additional financial data used as indicators for the quality of firm governance from Compustat. We obtained information related to managerial compensation from Execucomp, and institutional shareholder data from the Thomson-Reuters database of 13-F filings. We also collected information about board of directors from the Investor Responsibility Research Center (IRRC) to estimate the percentage of outsiders on the defendant firms' board.

In Table 1, we compare the differences in firms who have an institutional lead plaintiff versus those who have non-institutions as lead plaintiffs. Overall, cases that have an institution as the lead plaintiff are associated with larger defendants as measured by total assets, and have larger potential damages. The defendant firms also have greater institutional ownership, and a higher number of large blockholders. This is certainly reasonable, as greater institutional ownership should increase the pool of institutional plaintiffs who might be willing to step forward as a lead plaintiff. Also, it is clear that institutions are lead plaintiffs in suits which are more likely to survive the defendant's motion to dismiss, and will end up settling more often. Because there are few shareholder securities class actions that proceed to trial, a settlement represents the best possible outcome for the plaintiff firms as opposed to being dismissed. Again, this could be consistent with institutions selecting the best cases in which to involve themselves, or it could be that they manage the process more effectively. Furthermore, our sample is consistent with prior research in that we find higher settlements and longer litigation when an institution is the lead plaintiff. Finally, institutions are also more likely to be lead plaintiffs in suits involving accounting misstatements or insider trading during the class period, while less likely to be lead plaintiff in suits against firms in the four industries with the highest incidence of securities litigation.

3. Methodology

We begin our study by analyzing the case data to find the date on which a judge released a decision relating to the identity of the lead plaintiff. Typically, this decision will come after a long period of filings and arguments in behalf of all the parties who seek this position. So, it is certainly reasonable to expect that the market partially anticipates who will be named as lead plaintiff. This will bias our results towards not finding a significant market response in the period surrounding the announcement. However, who will be chosen is not known for certain. While the court is required to give preference to the plaintiff who has the greatest potential damages in the suit, there is considerable jockeying in the period leading up to the decision. Some plaintiffs will withdraw their motions, or will combine with other plaintiffs to create a lead plaintiff group that could potentially have greater damages than any one institutional plaintiff. In addition, the lead plaintiff's claims need to be similar to the claims of all the other plaintiffs in the class. Judges have the option to name another lead plaintiff if they feel the plaintiff with the largest damage claims is not typical of the class, or for any other reason that could keep them from being effective advocates for the other plaintiffs in the class.

Table 1 gives summary values for the variables used in our tests, as well as differences between cases involving an institutional lead plaintiff and non-institutional lead plaintiffs. Ln Assets is the natural log of the defendant firms' assets, and Market/Book is based on the market value of the firm at the end of the year prior to the lawsuit filing. Option Percent is the fraction of managerial compensation that is derived from option grants. The % Outsiders is the fraction of the board made up of directors who are not employees of the firm, and High Risk has a value of one for cases involving firms in the four industries with the highest incidence of litigation. Institutional Ownership is the percent of firms shares owned by institutions, while Blocks is how many shareholders own 5% or more of the firm's shares. P-values are estimated based on a two-sided t-test of the difference in means between institutional and non-institutional plaintiff cases.

Table 1. Summary Comparison of Companies and Cases in the Sample

		n	*Overall*	*n*	*Institutional*	*n*	*Non-Inst.*	*P-Value*
Company Variables								
Ln Assets	mean	349	7.7457	258	**8.0061**	91	**7.0074**	0.002
Market/Book	mean	348	4.7195	257	4.6896	90	4.8050	0.966
Debt/Equity	mean	348	5.1706	257	4.6896	91	3.4226	0.557
Agency Variables								
Dividend	mean	348	485.8713	257	474.11	91	519.0837	0.834
Free Cash Flow	mean	306	2206.3705	229	2746.15	77	601.06	0.409
% Outsiders	mean	232	0.743	188	0.7440	44	0.7354	0.311
Institutional Ownership	mean	423	67.51%	303	**73.10%**	120	**53.39%**	0.0001
Blocks	mean	423	1.8213	303	**2.00**	120	**1.38**	0.001
Option Percent	mean	234	49.35%	191	49.12%	43	50.38%	0.832
Case Variables								
Settled	#	429	50.10%	306	52.30%	123	44.70%	
Accounting	#	429	47.10%	306	49.30%	123	41.50%	
Insider	#	429	46.90%	306	49.30%	123	40.70%	
Outside Defendant	#	429	11.90%	306	11.40%	123	13.00%	
High Risk	#	325	37.50%	241	34.90%	84	45.20%	
Ln Damages (millions)	mean	429	18.8904	303	**19.3101**	123	**17.8463**	0.001
Case Length	mean	429	1042.329	306	**1092.74**	123	**916.911**	0.002

We use standard event study methodology as laid out in Campbell, Lo and MacKinlay (1997) to analyze the market's response to these reforms. To calculate the parameters of our model, we use an estimation period that begins 146 days before the date on which the lead plaintiff was named, and

continues until 21 days before the announcement. This estimation period is after the initial filing of the case, ensuring that we are not capturing that news in our estimates. We then use three separate event windows to estimate the difference between the actual returns and what was expected based on the parameters of the model. The first begins two days before the announcement and extends two days after the announcement. The second is one day before to one day after, and the last window includes only the day before the announcement and the day of the announcement itself. We use a value weighted index as our proxy for the market index.

In addition to the market model, we use two other commonly used measures of abnormal returns. The market adjusted model is simply calculated by subtracting the market's return on the event date from the firm's return on the same day. The third model used is calculated by estimating the average return for each firm leading up to the event, and by then subtracting a firm's average return from that firm's realized return for each day in the event windows. In this study, the average return was calculated over the same estimation period as was used in the market model. We also looked at the actual returns on the stock during the event windows. Each of the methods resulted in similar implications as to the significance of the market response, and similar results in the cross-sectional tests. Thus, our cross-sectional tests are conducted using the abnormal returns generated from the standard market model.

Table 2 indicates that the market responded positively to the announcement of an institutional lead plaintiff, although it was only significant in the longest event window as that outcome may have been assumed as the most likely. This was true using each of the event study methods, although we only report the results for the market model and the unadjusted returns. On the other hand, the market responded negatively to the announcement of a non-institution as a lead plaintiff and it seems to be more surprising as the response is found in a shorter time period immediately preceding the announcement date. And in that shorter measurement period, the reaction to the choice of an institutional lead plaintiff resulted in a significantly more positive market response compared to the reaction to the choice of a non-institutional lead plaintiff. To the extent that these outcomes were already anticipated by the market and already reflected in the valuation of these shares, these results represent a lower bound to the market's response. Based on these results, it appears that the market is willing to accept the higher settlement and legal costs associated with having an institution as a lead plaintiff, and it motivates us to run tests related to how the governance quality of the firm affects the market response to the appointment of an institution as lead plaintiff. Because institutions often retain shares of the defendant firm, they will potentially benefit from improved corporate governance within the firm. Improved governance has been associated with higher returns, so our first hypothesis suggests that institutions will be

more willing to become lead plaintiffs when firms have worse governance as there is a greater potential benefit from any improvements for the existing shareholders in the firm.

Hypothesis 1: Institutions are more likely to request being made lead plaintiff in defendant firms with weaker corporate governance.

The market response to the announcement of each type of lead plaintiff is displayed in the table below. The parameters of the market model were estimated during a period of 125 days, ending 21 days before the announcement date. P-values are based on a two-tailed t-test of the null hypothesis that the abnormal returns are equal to zero.

Table 2. Analysis of the Market Response to the Lead Plaintiff Announcement

	Overall	**Institution**	**Non-Institution**	**Inst. - Non**
Raw Returns:				
[-2,+2]	0.80%	**1.1%***	0.07%	1.03%
	(.125)	*(.064)*	*(.429)*	*(.267)*
[-1,+1]	0.40%	0.67%	-0.24%	0.91%
	(.318)	*(.148)*	*(.421)*	*(.224)*
[-1,0]	0.16%	0.53%	**-0.73%****	**1.26%****
	(.623)	*(.162)*	*(.024)*	*(.045)*
Market Model:				
[-2,+2]	0.70%	**1.07%***	-0.22%	1.29%
	(.136)	*(.057)*	*(.325)*	*(.147)*
[-1,+1]	0.20%	0.49%	-0.51%	1.0%
	(.585)	*(.265)*	*(.274)*	*(.182)*
[-1,0]	0.04%	0.48%	**-1.04%****	**1.52%****
	(.444)	*(.179)*	*(.014)*	*(.014)*
n=	544	386	158	

We then examine how the quality of existing corporate governance affects the market response to the announcement of an institution as lead plaintiff. Cheng et al. (2010) document a relationship between having an institution as lead plaintiff and governance improvements following the litigation. Because of this, we expect that the market response to an institution being named as lead plaintiff will be affected by the quality of the firm's governance and hypothesize that firms with bad governance will react more positively to the appointment of an institution as lead plaintiff.

Hypothesis 2: The market reacts more positively to the appointment of an institutional lead plaintiff when the defendant firm has weaker corporate governance.

In each of the models examining these two hypotheses, we measure corporate governance quality along several dimensions using data from the year prior to the filing of the lawsuit. First, we look at the ownership structure of the firm. Prior research by Chung and Zhang (2011) and Holderness (2003) has

shown that firms with better governance attract greater institutional shareholdings and larger block-holding. Thus, we use the percentage of the firm's outstanding shares owned by institutions, as well as the number of shareholders who own more than 5% of the firm as indicators of better corporate governance. The institutional shareholdings variable is important in helping us understand the market response to having an institution appointed as lead plaintiff. If firms with worse governance can benefit more from the improvements that result from having an institutional lead plaintiff, then we expect to find a negative relationship between the current level of institutional shareholdings and the returns surrounding the announcement of the lead plaintiff. On the other hand, if institutional lead plaintiffs are more likely to make changes that would be favorable to other institutional investors, then we would expect a positive coefficient on this variable.

We also control for the availability of free cash flow within the firm. As Jensen (1986) points out, the availability of excess cash can create incentives for the management of the firm to engage in investments that provide them private perquisites, regardless of whether or not the project has a positive net present value. He then shows how debt can be used to force management to disgorge free cash flow. To measure the potential for agency problems within a firm, we estimate the free cash flow generated by the firm in the fiscal year prior to the date the lead plaintiff was announced. Along with this measure of free cash flow, we include the ratio of debt to equity to proxy for the extent management may be constrained in their investment choices. Several papers, such as Jo and Pan (2009) or John, Knyazeva and Knyazeva (2015), have found that firms with worse governance are more likely to issue higher dividends as they benefit more from the commitment to disgorge excess cash flow. Based on this, we include the amount of dividend paid in the year leading up to a lead plaintiff being named, with higher dividends being associated with weaker corporate governance.

An extensive literature has documented the impact outside directors have on the quality of accounting information (Anderson, Mansi, & Reeb, 2004), managerial oversight, and firm performance. We use the percentage of outsiders on the board of directors as a measure of this improved oversight. Finally, we include a variable showing what percentage of the CEO's income comes from option-based compensation, as Johnson, Ryan and Tian (2009) show that this is associated with a greater likelihood of fraud.

Given the impact case details may have on our analysis, we also include these as additional controls in our cross-sectional analysis. We include a dummy variable that takes the value of one if the case was settled, which is the most typical outcome, as well as the case length and amount of damages eventually awarded in the litigation. Assuming that potential plaintiffs have some ability to predict these outcomes given the known facts in the litigation, these variables could affect the attractiveness of becoming lead plaintiff. We also include indicator variables that take a value of one when there is an accusation of accounting misstatements as part of the fraud or insiders being accused individually of fraud. Prior research by Karpoff, Lee and Martin (2008) has shown a relationship between these factors and higher penalties in shareholder litigation. We also include an indicator variable for the presence of

an outside defendant being sued along with the firm as it could result in shared damages and less liability for the firm. Additional variables include measures of firm value and an indicator variable for whether the firm is in an industry that has a higher risk of shareholder litigation. Both have been associated with greater litigation risk and payouts and could affect the incentives of institutional shareholders to become lead plaintiffs.

4. Results

In Table 3, we present the results of a standard probit model, where we examine whether institutions are more likely to request lead plaintiff status when there is weaker corporate governance. Our dependent variable is a dummy variable that takes the value of one when an institution petitioned for lead plaintiff status regardless of whether they were ultimately chosen as the lead plaintiff. Overall, we find that the quality of a company's governance has very little impact on the decision to petition to become lead plaintiff, and that the decision is more highly correlated with case characteristics and potential damages. Institutions are significantly less likely to petition for the lead plaintiff status in industries with higher risk of litigation, while they are more likely to apply for that role in longer lawsuits; although this could reflect institutions wanting to lead more complex litigation or them being the cause of more drawn out lawsuits.

More strikingly, the evidence suggests they are much more likely to petition for the lead plaintiff role when there is greater potential for higher damages and the ability of the defendant firm to pay them. Cases involving defendants that are larger (as measured by assets), and have higher market valuations relative to the book value of their equity are more likely to have institutions petition to become lead plaintiffs. This is also true of cases where the defendant firms have lower debt to equity ratios, which would make it more likely that the firm could pay off the potential damages in any settlement. These results suggest that improving the governance structure of the firm is not a primary motivator for an institution to become the lead plaintiff in shareholder litigation.

Table 3. Factors Leading to an Institution Filing to become Lead Plaintiff

	(1)	(2)	(3)	(4)
Intercept	**0.2970**	**0.8370**	**0.5170**	**0.5160**
	(0.011)	(0.000)	(0.000)	(0.057)
Case Variables				
Settled	0.0370			0.0340
	(0.487)			(0.625)
Accounting	0.0250			-0.0040
	(0.612)			(0.942)
Insiders	0.0650			0.0620

	(0.179)			(0.263)
Outside Defendant	-0.0650			-0.0780
	(0.385)			(0.463)
Ln damages	0.0170			0.0010
	(0.002)			(0.930)
High Risk	**-0.108****			**-0.160****
	(0.050)			(0.006)
Case Length	**0.0001****			**0.001****
	(0.034)			(0.016)
Agency Variables				
Dividend		-0.000008		-0.00002
		(0.603)		(0.251)
Free Cash Flows		-0.0000003		-0.0000003
		(0.822)		(0.812)
% Outsiders		-0.0400		-0.1050
		(0.857)		(0.632)
Institutional Ownership		0.0570		-0.0820
		(0.756)		(0.649)
Blocks		-0.0110		0.0070
		(0.618)		(0.762)
Option Percent		0.0890		0.0730
		(0.255)		(0.384)
Company Variables				
Ln Assets			**0.029****	**0.034***
			(0.003)	(0.079)
Market/Book			0.0100	**0.011***
			(0.115)	(0.068)
Debt/Equity			0.0000	**-0.006***
			(0.907)	(0.078)
n	**324**	**268**	**345**	**215**
R^2	**0.073**	**0.016**	**0.03**	**0.164**

The results of a probit model assessing which factors contribute to institutions filing as lead plaintiffs in a shareholder class action lawsuit. The dependent variable takes the value of one if an institution files to become lead plaintiff, even if not chosen. Settled refers to the outcome of the lawsuit, while case

length is the number of days between the first filing against the defendant and when the class action is resolved. Damages are estimated using a proportional trading model during the class period. Accounting takes the value of one when there is an accusation of fraudulent financial reporting, and the variable insiders equals one if there is an accusation that insiders profited individually from the fraud. Outside defendant equals one if there are multiple defendants in the initial filing, and High Risk is one if the defendant operates in one of the four industries identified as having the highest incidence of shareholder litigation.

However, these results do not preclude other shareholders from benefitting from the improved governance that has been previously documented when cases had institutional lead plaintiffs. In Table 4, we do find significant relationships between measures of corporate governance and the share price reaction to the news of an institution being named as lead plaintiff. However, the results are not supportive of our second hypothesis that shareholders of

Table 4. Marginal Response to Announcement of Institutional Lead Plaintiff Based on Governance Quality

	(1)	(2)	(3)	(4)	(5)
Intercept	-0.003	0.0000	-0.0030	-0.0030	-0.0010
	(0.091)	(0.949)	(0.058)	(0.450)	(0.434)
Institutional Plaintiff	**0.004***	0.001	0.002	0.004	0.003
	(0.058)	(0.520)	(0.849)	(0.117)	(0.743)
Case Variables					
Settled		**-0.003***			-0.0030
		(0.098)			(0.264)
Accounting		0.0010			0.0000
		(0.463)			(0.877)
Insiders		0.0000			0.0000
		(0.898)			(0.965)
Outside Defendant		-0.0030			-0.0010
		(0.239)			(0.718)
Ln damages		0.0000			0.0000
		(0.653)			(0.164)
High Risk		0.0000			0.0010
		(0.500)			(0.854)
Case Length		-0.0020			**-0.0005***
		(0.213)			(0.072)
Agency Variables					

Dividend			**0.000002****		**0.000002****
			(.031)		(0.030)
Free Cash Flows			**-0.00000098***		**-0.00000058****
			(0.094)		(0.033)
% Outsiders			-0.007		-0.0170
			(0.488)		(0.147)
Institutional Ownership			**0.017***		**0.022****
			(0.093)		(0.035)
Blocks			-0.0020		**-0.002***
			(.177)		(0.085)
Option Percent			**-0.008****		-0.0060
			(0.043)		(0.180)
Company Variables					
Ln Assets				0.000	0.000
				(0.813)	(0.871)
Market/Book				0.000	0.000
				(0.582)	(0.532)
Debt/Equity				0.000	0.000
				(0.763)	(0.651)
n	428	324	268	345	215
R^2	0.008	0.029	0.115	0.092	0.164

The results of a model regressing abnormal returns at the announcement of a lead plaintiff in a shareholder lawsuit on proxies for corporate governance, as well as case and firm control variables. Settled equals one if the lawsuit was eventually settled, case length is the number of days between the first filing against the defendant and when the class action is resolved, and damages are estimated using a proportional trading model during the class period. Accounting takes the value of one when there is an accusation of fraudulent financial reporting, and Insiders equals one if there is an accusation that insiders profited individually from the fraud. Outside Defendant equals one if there are multiple defendants in the initial filing, and High Risk equals one if the defendant operates in one of the four industries identified as having the highest incidence of shareholder litigation. Each of the governance variables are multiplied by the Institutional Plaintiff dummy to measure the marginal impact those variables had on the market response at the announcement of a lead plaintiff.

Defendant firms will react more positively to the announcement of an institution being named as lead plaintiff when they have weaker existing governance. Consistent with our hypothesis, we find that the market reaction is significantly more positive for firms that pay a higher dividend as well as a negative relationship between the number of blockholders and firm returns. However, contrary to our prediction,

we find that a higher percentage of institutional ownership is associated with higher returns, and document a more negative response when firms have higher free cash flow, which has been associated with increased potential for agency problems in the firm. Finally, we find that increased option-based compensation is negatively related to the returns at the announcement of an institutional lead plaintiff, which is also contrary to our hypothesis. These mixed results prevent us from being able to accept or reject our second hypothesis.

Another alternative explanation for the share price response may be suggested by the significantly positive relationship observed between the level of institutional ownership and the market response to the announcement of an institutional lead plaintiff. Table 1 indicates that institutions own 73.1% of defendant firm shares when an institution is named as lead plaintiff, versus 53.4% of shares when a non-institution is assigned that role. With a larger proportion of shares owned by institutions, the positive market response to the announcement of an institutional lead plaintiff could reflect the potential for an outcome that is more favorable to institutional owners at the expense of smaller, retail traders. On the other hand, if there is the potential for valuable self-dealing on the part of institutions, we would expect to see increased institutional ownership being a predictor of institutions petitioning the court for lead plaintiff status. But we do not observe any significant relationship between the two in our results.

5. Conclusion

Given these results, it does not appear that the quality of governance can explain the positive market response to the announcement of an institutional lead plaintiff despite the documented increase in settlement amounts associated with institutions in that role. There is no evidence that the potential for governance improvement motivates institutions to become lead plaintiffs, and the market reaction to the announcement of an institution being named lead plaintiff is positively correlated with several variables found in prior research to be indicators of better governance. Because the cost of settlements in shareholder litigation represent a wealth transfer from existing shareholders to prior investors, these results leave an open question as to why current shareholders would react positively to the announcement of an institution as lead plaintiff in a shareholder class action lawsuit. On the other hand, knowing that shareholders view institutional lead plaintiffs as value adding contributes to the current debate regarding potential changes to the new rules created by the PSLRA in managing shareholder litigation.

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