Derivative Litigation and Board Effectiveness: Evidence from Delaware's Judicially-led Reforms in 2003

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Motivation

- In literature, we are not clear about whether shareholder derivative litigation is an effective corporate governance mechanism.

- Delaware's judicially-led reforms in 2003 provide an opportunity to study the "shareholder litigation mechanism".

Institutional Background on Delaware's Judicially-led Reforms in 2003

- Lowered the procedural hurdles to derivative litigation.

    - The demand requirement
    - The special litigation committee

- Liberalized Section 220 of the Delaware General Corporation Law.

- Imposed stricter judicial standards for evaluating director and officer fiduciary duties.

    - *In re Walt Disney Co. Derivative Litigation*
    - *In re Oracle Corp. Derivative Litigation*

Hypothesis Development

Derivative litigation may affect board of director incentives and behavior through a "reputation" channel.

- Reputation concern motivates directors to be effective monitors.

    Fama and Jensen (1983), Hermalin and Weisbach (2010)

- Shareholder litigation can severely damage directors' reputation and career opportunities.

    Fich and Shivdasani (2007), Brochet and Srinivasan (2014)

Hypothesis

Higher likelihood of derivative litigation leads to a more effective Board of Directors.

Hypothesis 1: Higher likelihood of derivative litigation leads to higher CEO pay-for-performance sensitivity.

Hypothesis 2: Higher likelihood of derivative litigation leads to greater CEO turnover-performance sensitivity.

Data

The sample consists of 2153 publicly-traded firms from 1999 to 2007.

- CEO compensation: salary, bonus, stock granted, stock options, other long-term incentive payouts.

- CEO turnovers: forced turnovers

- Firm performance: stock returns adjusted by value-weighted industry (3-digit SIC) returns.

- CEO characteristics, board and governance characteristics, firm characteristics

Summary Statistics

Variables	25%	Median	75%	Mean	SD
CEO Compensation (in Thousands)	1410	2953	6700	5693	11602
CEO Turnover	0	0	0	0.036	0.186
Industry-adjusted Stock Return	-0.201	-0.022	0.181	0.040	0.502
CEO Ownership	0.001	0.003	0.012	0.023	0.060
CEO Tenure	2	5	9	6.890	7.241
CEO Chairman	1	1	1	0.767	0.423
Board Size	7	9	11	9.432	2.726
Fraction Independent Directors	0.571	0.714	0.818	0.682	0.166
Classified Board	0	1	1	0.601	0.490
Average Director Tenure	5.778	8	10.692	8.926	22.317
Average Director's Outside Seats	0.364	0.727	1.182	0.823	0.605
Fraction Female Directors	0	0.100	0.154	0.099	0.007
Fraction Interlocking Directors	0	0	0	0.007	0.030
Fraction Former Employee Directors	0	0	0.100	0.049	0.078
G Index	7	9	11	9.313	2.610

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Model Specification

$$\text{COMP}_{i,t} = \beta_0 + \beta_1 \times RET_{i,t} + \beta_2 \times RET_{i,t} \times DELAWARE_i +$$
$$\beta_3 \times RET_{i,t} \times POST_t + \beta_4 \times RET_{i,t} \times DELAWARE_i \times POST_t +$$
$$\beta_5 \times DELAWARE_i \times POST_t + \gamma X_{i,t} + \nu_i + \mu_t + \eta_k + \epsilon_{i,t}$$
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Pre-event: $\frac{\partial COMP}{\partial RET} = \beta_1 + \beta_2$

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Pre-event: $\frac{\partial COMP}{\partial RET} = \beta_1$

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Delaware (Post-Pre) - Non-Delaware (Post-Pre) = β_4

Model Specification

Prob(TURNOVER$_{i,t}$) =
$\beta_0 + \beta_1 \times RET_{i,t} + \beta_2 \times RET_{i,t} \times DELAWARE_i + \beta_3 \times RET_{i,t} \times POST_t + \beta_4 \times RET_{i,t} \times DELAWARE_i \times POST_t + \beta_5 \times DELAWARE_i \times POST_t + \gamma X_{i,t} + \nu_i + \mu_t + \eta_k + \epsilon_{i,t}$

(2)

Empirical Results

Table 3: The Effects of Delaware's Judicially-led Reforms in 2003 on Board Effectiveness

Variables	CEO Compensation OLS (1)	CEO Turnover LPM (2)
Stock Return	0.077**	-0.022***
	(0.032)	(0.008)
Stock Return × Delaware × Post	**0.317***	**-0.077***
	(0.091)	(0.029)
Stock Return × Delaware	-0.106**	-0.001
	(0.042)	(0.011)
Stock Return × Post	-0.215***	0.010
	(0.070)	(0.023)
Delaware × Post	0.032	0.014
	(0.037)	(0.010)
Constant	4.917***	0.382
	(1.207)	(0.351)
Control Variables	Yes	Yes
Firm FE, Year FE, Industry FE	Yes	Yes
Observations	6228	7353
Adjusted R^2	0.727	0.083

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Table 4: Dynamic Analysis of the Effects of Delaware's 2003 Judicially-led Reforms

Variables	CEO Compensation OLS (1)	CEO Turnover LPM (2)
Stock Return	-0.104	-0.022
	(0.069)	(0.018)
Stock Return × Delaware × Before(−3)	-0.087	0.019
	(0.109)	(0.028)
Stock Return × Delaware × Before(−2)	-0.051	-0.039
	(0.103)	(0.026)
Stock Return × Delaware × Before(−1)	-0.156	-0.002
	(0.134)	(0.038)
Stock Return × Delaware × After(+1)	-0.107	**-0.126****
	(0.146)	(0.058)
Stock Return × Delaware × After(+2)	**0.361****	-0.064
	(0.158)	(0.042)
Stock Return × Delaware × After(+3)	0.207	-0.075*
	(0.170)	(0.040)
Stock Return × Delaware × After(+4)	-0.199	-0.056
	(0.200)	(0.070)
Stock Return × Delaware	0.014	0.013
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Table 5: Placebo Tests

Variables	CEO Compensation OLS 1999-2002 Placebo event in 2001 (1)	CEO Compensation OLS 2003-2006 Placebo event in 2005 (2)	CEO Turnover LPM 1999-2002 Placebo event in 2001 (3)	CEO Turnover LPM 2003-2006 Placebo event in 2005 (4)
Stock Return	-0.077	-0.050	-0.033**	-0.025
	(0.053)	(0.064)	(0.014)	(0.026)
Stock Return × Delaware × PostPlacebo	**-0.017**	**-0.041**	**-0.020**	**-0.009**
	(0.093)	(0.133)	(0.028)	(0.051)
Stock Return × Delaware	0.002	-0.024	0.013	-0.032
	(0.059)	(0.085)	(0.016)	(0.033)
Stock Return × PostPlacebo	0.174**	0.210**	0.026	0.022
	(0.071)	(0.101)	(0.017)	(0.038)
Delaware × PostPlacebo	-0.090*	-0.023	-0.002	0.009
	(0.053)	(0.036)	(0.013)	(0.011)
Constant	5.185***	5.884***	0.967***	0.313
	(1.860)	(1.305)	(0.314)	(0.444)
Control Variables	Yes	Yes	Yes	Yes
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Observations	3982	4316	4783	5044
Adjusted R^2	0.707	0.784	0.082	0.095

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Conclusion

- Delaware's judicially-led reforms in 2003 significantly affect board decisions in CEO compensation and CEO replacement.

- Shareholder derivative litigation is an effective corporate governance mechanism.