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How do legal standards matter? An empirical study of special litigation committees[☆]

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ABSTRACT

We examine how legal standards affect outcomes in shareholder lawsuits where the defendants create Special Litigation Committees (SLCs). We compile a hand-collected sample of SLC associated lawsuits spanning a 26-year period from Jan 1, 1990 through Dec 31, 2015. We produce extensive descriptive statistics on the utilization, role and effect of SLCs. We find evidence that law matters for SLC outcomes: case dismissals are the lowest in Delaware jurisdiction where the courts apply stricter standards of judicial review. But in states with the weakest legal standards for SLC judicial review, SLC cases are more likely to be dismissed. Defense lawyers appear to exploit these differences to obtain dismissals at a higher rate, potentially impacting shareholder value. Our results have implications for the legal standard of review for SLC cases.

1. Introduction

Special litigation committees (SLCs) are controversial. They are supposed to dispassionately consider the merits of derivative litigation brought by shareholders against the company and management, but they are composed of board members from the same company. This inherent “structural bias” has led to complaints that SLCs are rubber stamps operating solely to protect directors and management from liability (Cox, 1982).

We examine the role and effectiveness of SLCs using a hand collected sample of 384 publicly available SLC events spanning the 26-year period Jan 1, 1990 through Dec 31, 2015 – almost four times the size of the samples used in earlier work (Myers, 2009). More specifically, we analyze the efficacy and use of SLCs by examining how legal rules on the judicial review of their recommendations affect case outcomes.

We begin with descriptive analysis, providing comprehensive statistics on SLCs' utilization and role. While fiduciary litigation is ubiquitous, we find that SLCs are uncommon. In our sample, we find that there are on average approximately 15 SLCs deployed per year, of which 75% involve public company lawsuits. The overwhelming majority of SLC cases (87%) are derivative lawsuits, alleging harm to the company that was caused by its officers and directors. Moreover, while a high percentage of SLCs are used in cases alleging generalized director breaches of fiduciary duty, about one third of cases allege a specific breach of the duty of loyalty (DOL),

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and another third allege corporate waste.

After providing a descriptive look at SLC utilization, we next examine what SLCs actually do. SLCs file a report with the court in a majority (60%) of all of the cases in which they are involved. In about 43% of all cases (73% of the cases in which an SLC report is filed), the SLC recommends dismissal of the litigation. In 12% of all cases (20% of the cases in which a report is filed), the SLC recommends either pursuing the case, settling the case, or pursuing some claims while settling others. Defendants also separately filed a motion to dismiss in 51% of all the cases in the sample.

Finally, we present descriptive statistics comparing SLC recommendations to case outcomes. On average, 46% of all SLC-associated suits are dismissed by the court, which is roughly comparable to the percentage of cases in which the SLC recommends dismissal. In comparison, we find an SLC recommends settlement, pursuit of litigation, or both, in only 12% of all cases. However, despite the low rate of SLC report recommendations to settle/pursue litigation, in 40% of all cases the parties actually settle. The average value of a settlement is approximately \$24.5 million (median about \$6 million).

This descriptive portrait of SLCs shows a tendency for them to side with management but it also shows the heterogeneity of SLC decisions. To further explore the role of SLCs, we examine cases filed in differing jurisdictions and under different legal standards. We do so in order to highlight the role of legal standards in SLC decisions and the effect of judicial review. If some type of settlement between the parties is routine even before a case gets adjudicated by court, then the canonical [Priest and Klein \(1984\)](#) model does suggest a selection bias problem. Recent work has argued that, both theoretically and empirically, selection effects are not as significant as the Priest-Klein framework suggests, which mitigates the need for selection-bias control analysis (see, e.g., [Klerman and Alex \(2014\)](#); [Lee and Klerman \(2016\)](#); [Helland et al., \(2018\)](#)). Nevertheless, our approach addresses selection effects by examining SLC decisions and case outcomes under differing legal standards and jurisdictions.

We exploit the differing standards for judicial review of SLCs' actions by categorizing SLC cases under the different legal standards: Delaware, and three standards utilized by other states. We find that in states applying the lowest level of judicial review, SLCs are more likely to recommend dismissal of a case, are more likely to have a case dismissed as opposed to settled, and are less likely to have a settlement resulting in a high settlement value. In univariate results, both the rates of SLC reports recommending case dismissal and actual case dismissals are the lowest among all jurisdictions in the Delaware standard cases. These results provide evidence that judicial scrutiny matters for SLC outcomes.

Nevertheless, the presence of an SLC still affects dismissal and settlement rates, even in Delaware court cases. To further illustrate the effects of SLCs, we compare outcomes in derivative suits in Delaware court involving SLCs with outcomes in a matched sample of Delaware court derivative suits without an SLC. A matched sample analysis is important because it can help isolate the effect of an SLC on case outcome. Using a randomly drawn sample, we match our Delaware court SLC sample cases with Delaware court derivative cases without SLCs, matched by year of case filing, type of claims made in the case, and the filing of multiple suits. We find that the proportion of cases dismissed is significantly higher when an SLC is involved in a case as compared cases where no SLC is involved. Conversely, the proportion of cases settled, and cases settled with high settlement value, are significantly lower in SLC cases as compared to the non-SLC cases. Given the important case characteristics employed in constructing our matched sample, these results are further evidence of SLC bias in favor of defendants.

We also calculate the announcement period return accompanying the lawsuit filing where an SLC is expected to be involved, and compare it to the lawsuit announcement response where no SLC is expected to be involved. We find that expected SLC cases are associated with significantly lower (and negative) returns. This provides evidence that the stock market anticipates that SLC cases are unlikely to result in positive outcomes for shareholders.

We conclude by looking at Delaware court cases before and after the *Oracle* case, which ostensibly tightened the standards for director independence and resulted in more critical judicial review of SLC recommendations by the Delaware courts. We conduct a difference-in-difference analysis and find that overall an SLC report recommending case dismissal is significantly and positively associated with case dismissal. However, an SLC report recommending case dismissal in Delaware court in the post-*Oracle* period is significantly and negatively associated with the probability of a case dismissal. Thus, the change in the legal standard appears to have made the Delaware courts more skeptical of SLC recommendations calling for case dismissals.

Our findings indicate that legal standards matter - in states with the lowest level of judicial review, outcomes are more likely to be favorable for defendants. Defense lawyers appear to exploit these differences to obtain dismissals at a higher rate in multi-jurisdictional litigation, potentially impacting shareholder value. Our results are consistent with commentators' skepticism concerning the role of SLCs and, to the extent SLCs are utilized, provide evidence for enhancing judicial review of SLC conduct and reports.

1.1. Background on SLCs

SLCs originated in the 1970's when, after several U.S. corporations and their directors paid bribes to third parties, the Securities and Exchange Commission (the "Commission") created a voluntary compliance program under which corporations that conducted internal investigations, made disclosures, and developed procedures for managing possible illegal payments, would receive less severe punishment from the Commission. In response to the program, defendant corporations began using committees formed of outside directors and external legal counsel following these Commission procedures. Corporations also began to use the same technique to respond to shareholder derivative suits ([Davis and Kenneth, 2008](#); [Pollman, 2009](#)).

In a derivative suit, shareholders sue, on behalf of the corporation, seeking to challenge a board of directors' decision, or failure to take action, that has allegedly caused harm to the company. Shareholders are required either to make a demand on the corporation's board of directors to pursue the alleged claim before filing the derivative suit, or to establish that making such a demand is futile. In order to bring a suit on behalf of the corporation, shareholders have to allege that the incumbent board of directors is incapable of, or

unwilling to, bring suit against the named defendant directors, managers, other shareholders, or even third parties who have injured the corporation. If the plaintiff shareholder is able to establish that the board of directors of the company is conflicted, or has failed to make a valid business judgment, then demand on the board is said to be futile and the shareholder will be able to bring the suit on behalf of the company. (Hazard et al., 2004).

In order to reclaim the power to direct the course of a derivative suit where the plaintiff has established demand futility, a corporation's board of directors can create a special litigation committee to decide how to manage the litigation. SLCs are generally formed only of directors that: (i) are not personally interested in the transaction at issue; and (ii) are independent (Myers, 2009). If none of the directors are personally disinterested in the litigation, the board can appoint one or more new disinterested directors so they can be part of the special litigation committee. To complete the process of forming an SLC, after selecting its members, the corporation's board of directors will pass a resolution whereby it formally: (i) appoints the SLC; and (ii) empowers the SLC to fully investigate, evaluate and make a binding determination as to whether it is in the best interests of the corporation to pursue, settle or dismiss the derivative claim, including the power to establish the terms of a possible settlement. (Brown, 1998). In our sample, the average number of independent directors who sit on the SLC is between 2 and 3.

Once the board of directors gives the SLC the authority to recommend the direction a corporation should take in the derivative lawsuit, it will ordinarily hire independent legal counsel and engage in an investigation of the merits of the case. These investigations are frequently quite extensive and can create substantial records of the underlying events related to the derivative suit. The SLC members know that the courts are likely to carefully determine whether the SLCs' investigations were adequate, appropriate and conducted in good faith, including scrutinizing the procedures and methods that they followed to collect the information to make their judgment. Courts will also determine if the SLC directors are independent. Finally, when special litigation committees finish their investigations, they usually issue a report summarizing their conclusions and the basis and reasons for their findings. These reports are frequently filed with the court and, if they contain negative recommendations, may be accompanied by a motion by the SLC seeking to dismiss the litigation (Rudolph and del Puerto, 1998). The defendants in the litigation may also separately file a motion to dismiss.

Once such a report is filed with the court that has jurisdiction over the litigation, the court must decide how to treat it. The two major judicial decisions on this issue employ different standards: the business judgment rule approach and the Delaware model. The New York Court of Appeals articulated the business judgment rule approach in *Auerbach v. Bennett*.¹ Under this approach, courts can inquire into the SLC's independence, procedures employed, and good faith of directors, but must defer to the business judgment of the SLC in regards to the substantive decision (Murdock, 1993). However, in Delaware, a two-step judicial review process is used in reviewing a decision of a special litigation committee. The corporation must first prove the independence, proper procedures, and good faith of the directors, and then the court may apply its' business judgment to determine whether to dismiss the litigation. Some other states have adopted alternative standards mainly falling into two categories: 1) a business judgment "plus" rule²; or 2) a distinct statutory standard, substantially similar to those found in the Model Business Corporation Act §7.44.³ A final set of jurisdictions have yet to decide this issue.

The principal objection to the use of SLCs is that the process by which their members is selected is subject to "structural bias." (Davis, 2005). This term was developed in the 1980s when courts and commentators began challenging the objectivity of SLCs. It was used to describe factors which could compromise a director's capacity to make a fair evaluation of a derivative suit against the other members of the board. These factors encompass the mutual background and social bonds that directors may have, the role that incumbent directors have in selecting SLCs' members, and the business ties that may exist between outside directors and corporations.

Advocates of the structural bias theory assert that since committee members share common cultural bonds and have empathy and collegiality, they are systematically biased in favor of management and that therefore, they are not truly independent (Swanson, 1993). They claim that taking action against a board colleague is viewed as undesirable, and that management will appoint those committee members who will be more willing to support them. While the bulk of the academic commentary has for many years endorsed the structural bias hypothesis and viewed the SLC with suspicion (Davis, 2005), in recent years Myers (2009) has expressly rejected this thesis based on his empirical analysis discussed in the next section.

1.2. Literature review

While there are numerous articles that have been written about SLCs and the potential problems or advantages of using them (Cox, 1982; Davis, 2005), there is only one other empirical study that has examined their impact (Myers, 2009). Using data collected from company securities law filings with the Commission, Myers finds that SLCs choose to pursue claims more frequently than had previously been thought. He argues that most shareholder claims that are reviewed by SLCs end up being settled and not dismissed. He concludes that SLCs are more responsive to the merits of shareholder claims than prior literature recognizes. However, Myers' claim rests on the assumption that all settlements in cases where an SLC was formed are the desired result of the SLC's actions and ignores that in many of those cases the SLC did not recommend in its report that the case be settled. We find that the SLC files a report only in 60% of all cases, in 43% of all cases the report recommends dismissal, and in only 12% of all cases recommends settlement, pursuit or settlement. We find that the differences in the SLC report recommendations are an important determinant of the actual outcome in a case.

¹ *Auerbach v. Bennett*, 393 N.E.2d 994, 994 (N.Y. 1979).

² See, e.g., *Alford v. Shaw*, 358 S.E.2d 323, 325–26 (N.C. 1987); *Houle v. Low*, 556 N.E.2d 51, 84 (Mass. 1990).

³ See, e.g., ARIZ. REV. STAT. ANN. § 10–744 (2015); HAW. REV. STAT. ANN. § 414–175 (2015).

Myers (2009) is an important study, but does not examine the effect of legal standards on SLC outcomes. Myers also acknowledges that his data suffers from “notable limitations,” including that the amount of detail is limited by data included in the securities law filings, which do not “reliably disclose” information about “the identity and holdings of the plaintiff, the defendants, and the committee members; the conduct giving rise to the derivative claim; whether the plaintiff made a prior demand upon the board; and the source of funds for any settlement.” (Myers, 2009 at 1311–1312). He further notes that “the filings do not usually present a fine-grained description of how the SLC resolved the claims in the particular case” (Myers, 2009 at 1312). He modestly adds that his paper is “just a preliminary picture of contemporary SLC behavior, and future research drawing upon other sources like court filings may be able to present a more complete picture.” (Myers, 2009 at 1312).

In this paper, we take him up on his invitation to look more deeply into SLC actions and to assemble a richer data set. As we discuss in the next section, our data set is significantly more complete and based on both securities law filings and the court filings in the cases filed. As a result, this paper is the first analytical paper that empirically describes what occurs in SLC-related suits and examines how legal standards affect outcomes of SLC recommendations.

2. Data

Our data collection begins with the corporate disclosure data from EDGAR filings with the Commission (the same data set that Myers (2009) uses). The EDGAR system first became available in April 1993 but filings were not mandatory until May 6, 1996.⁴ We searched the entire EDGAR database which includes all registered companies' federal securities law filings, such as their Form 10-K, Form 10-Q, Form 8-K, tender offer filings, proxy statements, merger filings and a host of other required disclosure documents. We searched using a variety of terms, including “Special Litigation Committee,” “Special Committee,” “Litigation Committee,” and “Independent Committee.” We pull all documents in which any of these terms appeared.

We then read the filings to identify all cases in which an SLC was formed and given the power to review the pending litigation. As Myers (2009) notes, this process results in many false positives (which we discard), in part because the rules concerning the disclosure of SLCs are silent on the topic and case law on their disclosure is mixed. We initially identify 519 possible SLC cases, but through hand review find that many are not cases that involve SLCs.

We use the available information to locate the names and civil action numbers where the underlying litigation was filed. In some cases, the securities disclosures are incomplete and so we cross reference several different commercial data bases.⁵ Where we are able to locate the cases, we then search for the actual court filings in the cases identified. The electronic records for these court filings are available in all federal courts, Delaware court, and a small number of other state courts. For some of these jurisdictions, it is also possible to search key words, such as “Special Litigation Committee” and the same variations discussed earlier, and thereby supplement the disclosure filing data with additional cases that were electronically available but which were either not disclosed, or incompletely described, in the company's securities filings. We then review the electronic court filings and docket sheets to determine the course of any SLC litigation and the actions of the SLC.

For those courts without electronic filing databases, our process is more limited. As with the other jurisdictions, we assemble information about the court where the case was filed and the civil action numbers from the company's securities filings. We supplement this using electronic databases containing court *decisions* in these jurisdictions (this is a subset of all court filings). We further supplement the court decision data using actual paper court filings that we hired private court document retrieval services to pull together from the physical copies in the court archives.⁶ We wind up with a final sample containing 384 SLC cases.

Defendant companies may be sued in more than one jurisdiction. If they employ an SLC to consider the merits of cases in more than one jurisdiction, then we code the data for all of the jurisdictions where the cases were filed and treated each case as separate for purposes of our analysis.

3. Descriptive statistics

3.1. Defendant firm features

Table 1 reports the period-by-period descriptive statistics of our final sample of 384 SLC cases spanning the 26-year period Jan 1, 1990 through Dec 31, 2015, for which we have complete data on all the needed variables for analysis. Panel A examines the defendant firms' features. Around 45% of the defendant firms are incorporated in Delaware, while roughly 75% of the firms are publicly traded firms; the remaining cases involve privately held corporations, LLCs and other alternative entities. In untabulated results, we also find that approximately 52% of public firms in our sample are incorporated in Delaware.

⁴ Because we used electronic court filing data bases that predated 1996, our data collection begins as of January 1, 1990. Since EDGAR was not fully functional until 1996, we may have missed some SLC cases during this early time period. We acknowledge (as does Myers) that there are missing cases, but “there is no reason to believe that SLC decisions...” during these early years...”are biased in favor of any particular SLC behavior.” *Id.* at 1333.

⁵ There were a significant number of cases mentioned in the securities filings where the disclosures were so incomplete that we were not able to identify the civil action number or court where the cases are filed. While we attempted to locate all cases using the other available databases, there were still many cases that could not be included in our analysis because of incomplete identifying data.

⁶ We ran into some problems with court document retention policies for some of the older cases in our sample that resulted in incomplete or deleted filings. As a result, in 17 cases in the data set, we have incomplete information about outcomes.

Table 1
Sample descriptive statistics.

| Panel A: Firm features | | | | | |
|------------------------|------------------------|--|------------------|--|--------|
| Periods | Number of observations | | DE incorporation | | Public |
| 1990–1995 | 28 | | 0.43 | | 0.79 |
| 1996–2000 | 38 | | 0.32 | | 0.53 |
| 2001–2005 | 118 | | 0.54 | | 0.81 |
| 2006–2010 | 128 | | 0.51 | | 0.75 |
| 2011–2015 | 72 | | 0.29 | | 0.76 |
| Overall | 384 | | 0.45 | | 0.75 |

| Panel B: Public firm features | | | | | |
|-------------------------------|---------|------|--------|------|-------|
| Periods | Finance | MVE | Assets | MB | ROA |
| 1990–1995 | 0.23 | 0.8 | 1.8 | 2.68 | 0.9% |
| 1996–2000 | 0.35 | 4.7 | 11.7 | 2.62 | –2.6% |
| 2001–2005 | 0.12 | 15.4 | 22.7 | 2.34 | –9.9% |
| 2006–2010 | 0.24 | 9.7 | 28.6 | 2.23 | –0.2% |
| 2011–2015 | 0.27 | 8.8 | 22.1 | 3.32 | –3.2% |
| Overall | 0.21 | 10.4 | 22.5 | 2.53 | –3.9% |

This table reports the period-by-period descriptive statistics of our final sample of 384 SLC events spanning the 16-year period Jan 1, 1990 through Dec 31, 2015, for which we have all the needed variables for analysis. Panel A examines firm features, and Panel B public firm features. All variables are defined in Table A of the Appendix.

In Panel B we gather accounting variables for the publicly traded firms in our sample from the quarterly Compustat database. These variables are: (a) Market Value of Equity, MVE, defined as the defendant firm size as measured by the market value of equity as of the end of the quarter immediately before the event date; (b) Assets as measured by the total asset value as of the end of the quarter immediately before the event date; (c) Market to Book, MB, defined as defendant firm market value of equity divided by book value of equity as of the end of the quarter immediately before the event date⁷; (d) Return on Assets, ROA, defined as defendant firm profitability as measured by the Return on Assets, computed as Net Income divided by Total Assets as of the end of the quarter immediately before the event date; and (e) whether the corporation is in the finance industry.

We find that for these public firms, total assets are about twice the market value of equity. This may imply that these firms are overinvested with room to improve efficiency. The average MB is around 2.5, showing that, on average, these firms have future growth potential. As a baseline, this ratio is also around the S&P 500 average in the 2000's and a little below the average for all firms in 2018. However, on average, these firms are currently not profitable, as measured by the return on assets, and their market value on average is less than the value of assets.

3.2. Lawsuit types

Panel A of Table 2 examines the type of lawsuits which lead a corporate board to form an SLC. As expected, the vast majority (87%) of the cases contain allegations of derivative claims, while only 18% include class action claims, with some cases alleging both types of claims. Roughly 35% of all cases in the sample are filed in federal court, while 16% are brought in the Delaware Chancery Court.

Overall, our data show a large number of multijurisdictional suits (35% of total sample), where suits arising out of the same set of facts are filed in more than one jurisdiction. Moreover, in 47% of the sample there are multiple complaints filed in the same jurisdiction, each alleging wrongdoing out of the same set of facts. In these cases, courts in a single jurisdiction will normally consolidate all of the complaints into one case, so we treat the consolidated case as the unit of analysis. The incidence of multi-jurisdictional litigation and multiple suits in the same jurisdiction both show substantial increases since 2000.

3.3. Reasons for lawsuits

Table 2 Panel B breaks out the causes of action alleged in each of these lawsuits. There are usually multiple claims in a lawsuit. The most common claim is a generic claim of breach of fiduciary duties (present in 70% of the cases) where the complaint generically alleges that the directors and officers of the corporation breached their fiduciary duties without specifying the exact type of duty violated (e.g., breach of duty of loyalty (DOL) or breach of duty of care (DOC)). About a third of lawsuits allege a specific breach of

⁷ The market value of equity is calculated as the number of shares outstanding times the closing price at the end of the relevant quarter, while the book value of equity is stockholders' equity, plus balance sheet deferred taxes and investment tax credit (if available), minus the book value of preferred stock.

Table 2
Lawsuit types and reasons.

| Panel A: Lawsuit type | | | | | | | | |
|-----------------------|-----------------|-------------------|---------------------|----------------|-----------------------|--|--|--|
| Periods | Derivative suit | Class action suit | Delaware court case | Multiple suits | Multiple jurisdiction | | | |
| Total N | 333 | 69 | 61 | 180 | 133 | | | |
| 1990–1995 | 0.86 | 0.21 | 0.18 | 0.32 | 0.14 | | | |
| 1996–2000 | 0.87 | 0.16 | 0.11 | 0.16 | 0.13 | | | |
| 2001–2005 | 0.81 | 0.22 | 0.18 | 0.56 | 0.37 | | | |
| 2006–2010 | 0.92 | 0.09 | 0.16 | 0.52 | 0.45 | | | |
| 2011–2015 | 0.86 | 0.26 | 0.14 | 0.46 | 0.32 | | | |
| Overall | 0.87 | 0.18 | 0.16 | 0.47 | 0.35 | | | |

| Panel B: Lawsuit reason | | | | | | | | |
|-------------------------|------------|------------|-----------------|-------|-------|--------------------|------------------------------------|-----------------------|
| Periods | Breach DOC | Breach DOL | Breach Contract | Fraud | Waste | Options Backdating | General breach of fiduciary duties | Breach related to M&A |
| Total N | 67 | 133 | 40 | 73 | 139 | 57 | 267 | 51 |
| 1990–1995 | 0.07 | 0.14 | 0.07 | 0.25 | 0.18 | 0.00 | 0.86 | 0.18 |
| 1996–2000 | 0.16 | 0.32 | 0.21 | 0.32 | 0.13 | 0.00 | 0.61 | 0.13 |
| 2001–2005 | 0.09 | 0.19 | 0.08 | 0.15 | 0.31 | 0.04 | 0.74 | 0.07 |
| 2006–2010 | 0.23 | 0.49 | 0.13 | 0.23 | 0.48 | 0.39 | 0.66 | 0.09 |
| 2011–2015 | 0.25 | 0.44 | 0.05 | 0.08 | 0.42 | 0.03 | 0.67 | 0.29 |
| Overall | 0.17 | 0.35 | 0.10 | 0.19 | 0.36 | 0.15 | 0.70 | 0.13 |

This table reports the period-by-period descriptive statistics of our final sample of 384 SLC events spanning the 16-year period Jan 1, 1990 through Dec 31, 2015, for which we have all the needed variables for analysis. Panel A examines lawsuit type, and Panel B lawsuit reasons. All variables are defined in Table A of the Appendix.

the DOL, and roughly another third allege a claim of waste. Breaches of the DOC, breaches of contract, and fraud, are alleged in a significant number of cases (each at least in 10% of sample cases). Cain et al. (2018) document high rates of litigation related to acquisitions, but only 13% of the sample includes allegations related to M&A activity. This rate of merger lawsuit activity is not significantly different than the number of cases in our sample related to options backdating (15% of all cases).⁸

Lawsuits related to options backdating - a phenomenon which was discussed in Davis, 2005 –are perhaps the plaintiffs' strongest cases due to the widespread civil and criminal scrutiny of this clearly illegal practice. For example, several lawsuits raising these issues against *Mercury Interactive Corporation* were filed in October–November, 2005, in multiple jurisdictions. Mercury's SLC report in June 2006 recommended that the corporation pursue the litigation. The SLC separately pursued claims related to options backdating. Without admitting or denying the Commission's allegations, Mercury agreed to pay a \$28 million civil penalty to settle the Commission's charges. We have 57 cases of options backdating cases in our sample (15% of the total sample), most of which occurred in the 2006–2010 period. Surprisingly, in only 6 of these cases did the SLC recommend settlement and/or pursuit of the option backdating claims.

3.4. Defendant type

We next look at the type of defendants named in SLC-associated litigation. Table 3 shows that for more than half of the SLC associated cases (63%) some defendants are directors and others are only officers. An additional 13% of cases target only current and/or former directors of the company. Only 2% of cases name defendants who are directors and include other defendants such as non-employees. Finally, about a fifth of the SLC cases, on average, involve a defendant that is an entity other than the defendant firm. This could occur, for example, in related party transactions where a corporate director has an ownership interest in a second firm which is engaged in a transaction, or that does business with, the first corporation.

3.5. SLC features and activity

Panel A of Table 4 looks at SLC lawsuit activity variables. The SLC files a motion to stay on average in 38% of all cases. The motion to stay is an intermediate step in litigation that has little impact on the outcome of the case but is made to permit the SLC to complete its work without competing activity from the plaintiffs' law firms. Given the economies that could result from such action, it is not surprising that a motion to stay was filed in 146 cases and in 114 of those, the motion to stay is approved (30% of all cases in our dataset).

Panel A further shows that the defendants file a motion to dismiss in slightly more than half of SLC cases. In addition, the SLC files its own motion to dismiss in about one-fifth of all of the cases. Together, in slightly less than 70% of all SLC cases, there is a motion to dismiss filed by either the defendants or the SLC itself.

⁸ It must be noted that these lawsuit reason categories are not mutually exclusive.

Table 3
Defendant details.

| Periods | Number of observations | All defendants are current or former directors | Some defendants are directors and others are only officers | Some defendants are directors but others are not even employees | Any defendant is entity other than the Defendant firm |
|-----------|------------------------|--|--|---|---|
| 1990–1995 | 28 | 0.25 | 0.54 | 0.07 | 0.11 |
| 1996–2000 | 38 | 0.11 | 0.50 | 0.11 | 0.37 |
| 2001–2005 | 118 | 0.12 | 0.60 | 0.00 | 0.23 |
| 2006–2010 | 128 | 0.08 | 0.78 | 0.00 | 0.10 |
| 2011–2015 | 72 | 0.18 | 0.53 | 0.00 | 0.26 |
| Overall | 384 | 0.13 | 0.63 | 0.02 | 0.20 |

This table shows the period-by-period details of the defendants, in particular whether the defendants were only directors or others.

Table 4
Lawsuit and SLC activity.

| Panel A: Lawsuit activity | | | | | |
|---------------------------|----------------|-------------------------------|--------------------------|--------------------------------|--|
| Periods | Motion to stay | Preliminary injunction motion | Motion to dismiss by SLC | Motion to dismiss by defendant | |
| 1990–1995 | 0.29 | 0.00 | 0.25 | 0.57 | |
| 1996–2000 | 0.21 | 0.21 | 0.21 | 0.55 | |
| 2001–2005 | 0.39 | 0.04 | 0.16 | 0.53 | |
| 2006–2010 | 0.45 | 0.05 | 0.20 | 0.48 | |
| 2011–2015 | 0.38 | 0.10 | 0.19 | 0.50 | |
| Overall | 0.38 | 0.07 | 0.19 | 0.51 | |

| Panel B: SLC report | | | | | |
|---------------------|------------------|-----------------------|----------------------|----------------------|---------------------------------|
| Periods | SLC report filed | SLC report to dismiss | SLC report to settle | SLC report to pursue | SLC report to pursue and settle |
| 1990–1995 | 0.64 | 0.43 | 0.18 | 0.00 | 0.04 |
| 1996–2000 | 0.68 | 0.45 | 0.11 | 0.08 | 0.03 |
| 2001–2005 | 0.54 | 0.41 | 0.07 | 0.03 | 0.02 |
| 2006–2010 | 0.59 | 0.43 | 0.08 | 0.01 | 0.02 |
| 2011–2015 | 0.62 | 0.49 | 0.04 | 0.01 | 0.03 |
| Overall | 0.60 | 0.43 | 0.08 | 0.02 | 0.02 |

| Panel C: SLC dispositions | | | | | | |
|--------------------------------------|------------|-------------|------------------------|------------------------|-----------------------------|------------------------------|
| SLC action | Dismissals | Settlements | Judgment for plaintiff | Judgment for defendant | In progress/outcome missing | Total number of observations |
| Report Recommends Dismissal | 105 | 45 | 2 | 3 | 12 | 167 |
| Report Recommends Pursuit/Settlement | 14 | 27 | 3 | 0 | 3 | 47 |
| SLC Report exists but is unavailable | 9 | 3 | 0 | 1 | 2 | 15 |
| No SLC Report Created | 48 | 78 | 4 | 0 | 25 | 155 |
| Total Number of Observations | 176 | 153 | 9 | 4 | 42 | 384 |

This table reports the period-by-period descriptive statistics of our final sample of 384 SLC events spanning the 16-year period Jan 1, 1990 through Dec 31, 2015, for which we have all the needed variables for analysis. The 3 panels examine lawsuit and SLC activity. All variables are defined in Table A of the Appendix.

Panel B analyzes the frequency of filing and content of the SLC report. We find that the SLC files a report with the court in a majority (60%) of all cases, and that in 43% of all of the cases, the SLC's recommendation is dismissal of the litigation. By comparison, an SLC report recommends that the company pursue or settle the lawsuit 12% of the time.

We find that SLC reports recommending dismissal show a slightly increasing trend over the years, from 43% in the period 1990–1995 to 49% in the period 2011–2015. Conversely, SLC reports recommending settlement, pursuit or pursuit and settlement show a decreasing trend from 22% in the period 1990–1995 to 8% in the period 2011–2015. In contrast, Table 5 Panel A shows that SLC cases settle or result in judgment for the plaintiff 42% of the time. This difference between report recommendations and actual case outcomes suggests that the SLC report is negatively-biased in its analysis of plaintiffs' cases.

One commentator on this paper suggested that the apparent biases we document in Panel B are irrelevant. This commentator argued that the SLC report recommended dismissal in 43% of observations (167/384), while the court ultimately dismissed the lawsuit in 45% of observations (176/384), but that “there are type 1 and type 2 errors in comparing the SLC's report to the judicial

Table 5
Lawsuit outcomes.

| Panel A: Lawsuit outcomes | | | | | | | |
|---------------------------|-------------------------|----------------------------------|----------------|------------------------|------------------------|--------------|----------------------------------|
| Periods | Motion to stay approved | Judge accepted report to dismiss | Case dismissed | Judgment for plaintiff | Judgment for defendant | Case settled | Average settlement value (\$ mn) |
| 1990–1995 | 0.25 | 0.25 | 0.43 | 0.04 | 0.04 | 0.43 | 4.8 |
| 1996–2000 | 0.21 | 0.26 | 0.55 | 0.03 | 0.00 | 0.32 | 16.4 |
| 2001–2005 | 0.33 | 0.18 | 0.46 | 0.04 | 0.01 | 0.40 | 19.1 |
| 2006–2010 | 0.32 | 0.17 | 0.44 | 0.01 | 0.01 | 0.45 | 44.6 |
| 2011–2015 | 0.31 | 0.24 | 0.46 | 0.01 | 0.01 | 0.33 | 7.7 |
| Overall | 0.30 | 0.20 | 0.46 | 0.02 | 0.01 | 0.40 | 24.5 |

| Panel B: SLC report's consequence | | | | |
|-----------------------------------|---|---|---|---|
| Periods | Case dismissed when SLC recommended dismissal | Case settled when SLC recommended dismissal | Case settled when SLC recommended settlement, pursuit or settlement | Case dismissed when SLC recommended settlement, pursuit or settlement |
| 1990–1995 | 0.67 | 0.17 | 0.83 | 0.00 |
| 1996–2000 | 0.71 | 0.24 | 0.62 | 0.38 |
| 2001–2005 | 0.65 | 0.23 | 0.45 | 0.36 |
| 2006–2010 | 0.55 | 0.40 | 0.57 | 0.29 |
| 2011–2015 | 0.68 | 0.17 | 0.50 | 0.50 |
| Overall | 0.63 | 0.27 | 0.58 | 0.31 |

This table reports the period-by-period descriptive statistics of our final sample of 384 SLC events spanning the 16-year period Jan 1, 1990 through Dec 31, 2015, for which we have all the needed variables for analysis. Panel A examines lawsuit outcomes, and Panel B outcomes conditional on SLC report. All variables are defined in Table A of the Appendix.

outcome[which] seem to more or less balance out.” We would argue that the best measure of what the SLC wants the court to do, and therefore the SLC's intent, is the recommendation that it makes in its report after investigation. While it may be true that courts acts as an ultimate arbiter and corrects the biases of the SLC report, the fact remains that the SLC has made a recommendation which reflects its biases and there is a sizable discrepancy between the number of recommendations to dismiss and the number of recommendations to settle.

The second issue raised by this commentator is how to interpret the SLC's failure to file a report. This commentator suggested that the SLC's failure to file a report is tantamount to a decision to seek a settlement in the action. We find that cases without an SLC report do settle at a higher rate ($78/155 = 50\%$) than cases where there is an SLC report filed ($75/229 = 33\%$) or than cases in the sample as a whole ($153/384 = 40\%$).

While this is an interesting point, we also highlight that 50% of the cases without an SLC report do not settle. Panel C shows that a substantial number of these cases are ones for which we lack complete information (25) in which an SLC may well have filed a report which we unable to locate. If we assume that even a small number of the cases with incomplete information did in fact have an SLC report filed, then only a minority of the cases with no SLC report result in a settlement. Based on this information and assumptions, we would assert that the failure to file a report reflects the SLC's ambivalence about the merits of the case rather than a decision to seek a settlement.

We next compare our results to those in Myers (2009). He compiles a sample of 97 SLCs and finds that in 60% of those cases an SLC “decision” leads to a dismissal of the case, 10% of the time the SLC decides to pursue the case, and 30% of the time the SLC decides to settle. Myers codes SLC decisions to dismiss, settle or pursue litigation using a variety of factors, some explicit and some inferential (Myers, 2009, at 1335–1336). It appears from the examples he provides that whatever the final outcome is in the case he assumes that it reflects the SLC's decision about the case. He concludes that “further research involving court filings will resolve whether SLCs were involved in these particular settlement decisions.”⁹

Our data set includes information about settlement and dismissal taken from court filings as well as data on SLC report recommendations gleaned from reports. To illustrate some of the differences between Myers' method and ours, we compare SLC recommendations with case outcomes using all of the Delaware court cases in our sample because Delaware has an electronic filing system which enables us to see all of the case filings and outcomes. In untabulated results, we calculate the dismissal and settlement statistics for our sample for the Delaware court cases only ($n = 61$). We find that in 22 of the 61 Delaware court cases (36%), the case is dismissed by courts. When we look at settlements, in 26 out of 61 Delaware court cases the case is settled and 4 result in judgment for plaintiffs. In total, 30 of 61 cases (49%) are either settled or result in a judgment for the plaintiff. This shows an imbalance between dismissals and settlements/plaintiff judgments.

Turning to report recommendations, we were able to determine the SLC recommendation in only 31 of the 61 cases, and the SLC report recommends dismissal in 16 of 31 cases (51.6%). If we examine the SLC report, and count both recommendations to pursue

⁹ We would add that the same could be said about dismissal decisions.

claims as well as recommendations to settle them or both, then the SLC only recommends settlement/pursuit/both settle and pursuit of the claim in a total of 15 of the 31 cases. Overall it seems there is a reasonably equal distribution of dismissal and settle/litigate recommendations for this sample of Delaware court cases.

In sum, examining the SLC report recommendation separately from case outcomes provides greater insight into the role of the SLC in the litigation process. Our findings support the conclusion that, at least in Delaware court, SLCs recommendations to seek settlement/pursuit of the litigation appear to underestimate the likelihood of a settlement eventually being obtained. This is evidence that SLCs reports may underestimate the value of these cases.

3.6. Lawsuit outcomes

Next, we scrutinize case outcomes. In Table 4, Panel C we examine the substantive disposition of all the SLC cases in the sample.¹⁰ We find that there are final dismissals by the court in 176 cases (45.8% of the sample), settlements in 153 (39.8%), a judgment for the plaintiff in 9 (2.3%), and a judgment for the defendant in 4 (1%). In addition, 25 cases (6.5%) are continuing as at the time we collected the data and we cannot determine outcomes in 17 (4.4%) cases.

We present a further break out of this outcome data in Table 5. Panel A examines case outcomes. The court dismisses the case in 46% of all cases. As previously noted, the SLC report recommends dismissal of the case in 43% of the time. However, these are not always the same cases: in only 63% of the cases where the SLC recommended dismissal did the judge dismiss the case. Another 40% of the cases were settled by the parties, at an average full value of settlement award of around \$24 million, and a median value of settlement of around \$6 million. These figures highlight the value of these cases to plaintiffs and their attorneys. The proportion of SLC cases dismissed or settled has been relatively stable over the years. Consistent with other types of litigation, there are very few cases that go to a judgment, either for the plaintiffs or for the defendants.

In untabulated results, we compare the use of SLCs in public company versus private company cases. We find that 29% of SLC-associated private company cases are eventually settled, significantly lower than the 43% for public firms (the rate for the full sample is 40%). However, 54% of SLC-associated cases are dismissed for private firms, significantly higher than the 43% for public firms, (overall rate is 46%). The statistically significantly greater (lower) likelihood of dismissal (settlement) of private cases may indicate a fundamental difference between the strength of the claims in public cases versus those in private cases. It may also reflect agency costs and the willingness of public company firms to risk litigating claims.

In Table 5 Panel B we examine outcomes conditional on SLC report recommendations for the entire sample (including the non-Delaware-court cases). We find that an SLC recommendation does not automatically translate into the same decision by the judge. Table 5, Panel B shows that in 63% of all the cases, when SLCs recommended dismissal, the court dismissed the case. Additionally, in 27% of cases, when the SLC recommended dismissal, the case was ultimately settled. In 58% of cases, the case settled when the SLC recommended settlement, pursuit or pursuit and settlement. Finally, in 31% of the cases, the SLC recommended settlement, pursuit or pursuit and settlement of the claim, but the court dismissed the case anyway.

Our figures again contrast with Myers (2009) who found that when the SLC recommended to dismiss, 34% of cases resulted in a dismissal, while 53% of cases still settled, with the rest having other outcomes. Myers (2009) also found that in 97% of cases where the SLC recommended settlement, there was a settlement. For comparison purposes, if we confine our sample to Delaware court cases only, we find that in 31% of cases (5 out of 16) where the SLC recommended to dismiss the case, the case was dismissed, while in 44% (7 out of 16) the cases where the SLC recommended to dismiss the case settled. These slightly differing figures may be attributable to the different sample in Myers (2009).

Thompson and Thomas (2004) report on the disposition of all derivative lawsuits (only a few of which involved SLCs) filed in Delaware during 1999 and 2000 thus providing another touchstone for comparison. They find that of the 57 public company derivative suits filed during those two years, 60% are dismissed with no relief for the plaintiffs, while another 28% are settled and the remaining 12% remained unresolved at the time that article was written.¹¹ The percentage of dismissed cases in their sample is higher than in ours, while the number of settlements in their sample is lower than in our sample. We note that this comparison does not take into account the presence of an SLC, the time period, types of claims or number of suits filed as we do in our matched sample analysis in Section 4.5.

3.7. Case activity and outcomes by jurisdiction

Table 6 compares the key lawsuit activity features and case outcomes by jurisdiction and legal standard used in SLC review.¹² Delaware Standard suits are classified as a separate group, given its relatively strong form of judicial review in SLC cases of defendant corporations incorporated in Delaware (these include cases filed in federal courts and in states other than Delaware, when the defendant corporation is incorporated in Delaware). Legal standard 1 suits denote cases applying a business judgment standard of review, used to review the actions of SLCs of defendant corporations incorporated in New York, Alabama, Alaska, California,

¹⁰ Note that in multijurisdictional cases, each jurisdiction where a suit is being considered by the SLC is a separate case.

¹¹ For private company derivative actions, Thompson and Thomas (2004) report that approximately half were dismissed, around one third resulted in relief for the plaintiffs and the remainder were unresolved at the time the article was published.

¹² We have previously explained the nature of the variables relating to defendant type (Table 3) and the defendant company's financial performance (Table 1 panel B).

Table 6
Case activity and outcomes by jurisdiction.

| | Delaware standard | Legal Standard 1 | Legal Standard 2 | Legal Standard 3 |
|------------------------|-------------------|------------------|------------------|------------------|
| N | 174 | 101 | 59 | 50 |
| SLC Report to Dismiss | 0.33*** | 0.53** | 0.52* | 0.50 |
| Case Dismissed | 0.35*** | 0.69*** | 0.46 | 0.36 |
| Case Settled | 0.51*** | 0.19*** | 0.39 | 0.44 |
| Judgment for Plaintiff | 0.03 | 0.00 | 0.05 | 0.02 |
| High Settlement Value | 0.28*** | 0.06*** | 0.08* | 0.12 |

This table compares key lawsuit activity features and case outcomes by jurisdiction, where Legal Standard 1 denotes defendant corporations incorporated in New York, Alabama, Alaska, California, Colorado, Indiana, Kentucky, Louisiana, Minnesota, Ohio, and Pennsylvania; Legal Standard 2 denotes defendant corporations incorporated in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Rhode Island, South Dakota, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia; while Legal Standard 3 denotes defendant corporations incorporated in all other states. Federal suits are re-classified as Delaware standard case, or as Legal Standard 1, 2 or 3 cases based on the state of incorporation of the defendant corporation.

*, **, and *** denote significantly different from the rest of the cases, at the 10%, 5% and 1% levels respectively.

Colorado, Indiana, Kentucky, Louisiana, Minnesota, Ohio, and Pennsylvania; Legal standard 2 suits are those applying the Model Business Corporation Act standard, used to review the actions of SLCs of defendant corporations incorporated in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Rhode Island, South Dakota, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia; and Legal standard 3 suits are those that review the actions of SLCs of defendant corporations incorporated in all other states.

The three groups of legal standards are substantially different. In Delaware, a two-step process occurs in reviewing a decision of a special litigation committee (Murdock, 1993). The SLC must first prove its directors' independence, adequate procedures, and good faith of the directors, and then the court will apply its own business judgment in deciding whether to dismiss the case. Legal standard 1 jurisdictions adopt the rule put forth in *Auerbach v. Bennett*.¹³ Under this approach, courts can inquire into the SLC directors' independence, whether the SLC employed adequate procedures, and the good faith of the SLC directors, but must defer to the business judgment of the SLC in regards to the substantive decision (Murdock, 1993). SLC reports in legal standard 1 cases will be subject to the lowest level of judicial scrutiny.

Legal standard 2 states follow the Model Business Corporation Act section on SLC dismissals. The Model Business Corporation Act (MBCA) §7.44 provides procedures courts should follow in responding to directors' action in shareholder derivative suits.¹⁴ If a majority vote in a committee consisting of two or more qualified directors occurs, the court must dismiss the derivative suit if that committee determined in good faith after a reasonable inquiry that the action was not in the best interest of the corporation. SLC reports in legal standard 2 cases will be subject to intermediate scrutiny, lower than the scrutiny applied in Delaware but higher than the scrutiny applied in Standard 1 cases.

Federal courts hearing a case involving an SLC would apply the law of the state of incorporation of the defendant company. So, we recoded all federal cases as Delaware standard cases, or as legal standard 1, 2, or 3 cases.

Table 6 shows that the incidence of SLC reports recommending case dismissal is highest in jurisdictions applying legal standard 1 and lowest for Delaware standard. If we look at actual case dismissals, a similar pattern exists: dismissals are highest in jurisdictions applying legal standard 1 and lowest for Delaware standard. This is not surprising given that legal standard 1 is the most favorable standard for defendants and the Delaware standard is the most preferable for plaintiffs.

Settlements show a slightly different relationship. We see that case settlement rates are highest for Delaware Standard suits and the lowest for legal standard 1 cases, as compared to the rest of the cases. The probability of high value settlements (those more than a million dollars) are significantly higher for Delaware Standard suits but significantly lower for legal standard 1 cases, as compared to the rest of the cases. The high rates of settlements in Delaware Standard suits may stem from its relatively plaintiff-friendly standard of review. The relative paucity of high value settlements in legal standard 1 cases probably reflects the application of the defendant favorable business judgment standard of review. Judgments for plaintiffs are relatively infrequent.

3.8. Effects of SLC report to dismiss

What are the effects of an SLC report and how does it affect litigation outcomes? We examine this question in Table 7 by comparing important future lawsuit outcome features where (1) the SLC compiled a report to dismiss, and (2) the SLC may have filed a report recommending some other course of action or not filed a report at all. We hypothesize that an SLC's report recommending dismissal would increase the likelihood that a court would order dismissal of the lawsuit, reduce the likelihood of a settlement in the case, lower the probability that a high settlement would be achieved in the case, reduce the chances that the plaintiffs' attorneys would obtain a high fee (more than \$1 million dollars), increase the likelihood that the plaintiff would appeal the trial court's decision, and reduce the chances that the appeal would be successful.

¹³ See *Auerbach v. Bennett*, 393 N.E.2d 994, 994 (N.Y. 1979).

¹⁴ Model Business Corp. Act. Ann. §7.44 (2013).

Table 7
SLC report to dismiss.

| | SLC report to dismiss | No SLC report to dismiss | No SLC report filed |
|-----------------------------|-----------------------|--------------------------|---------------------|
| Case Dismissed | 0.63 | 0.43*** | 0.31*** |
| Case Settled | 0.27 | 0.42*** | 0.50*** |
| Settlement Value High | 0.05 | 0.16** | 0.29*** |
| Plaintiffs' Lawyer Fee High | 0.31 | 0.47** | 0.53*** |
| Shareholder Appeal | 0.29 | 0.22* | 0.12** |
| Appeal Outcome Affirmed | 0.20 | 0.16* | 0.07** |

This table compares outcomes associated with SLC report to dismiss versus cases where SLC did not file report to dismiss. For comparison, outcomes when SLC filed no report at all, are also shown. All variables are defined in Table A of Appendix.

*, **, and *** denote significantly different from outcomes when SLC report to dismiss is filed, at the 10%, 5% and 1% levels respectively.

All of these predictions are borne out in the data shown in Table 7. In the third column of Table 7, we compare cases where no SLC report was filed with those where an SLC filed a report to dismiss. Cases were dismissed (settled) at a significantly higher (lower) rate where the SLC compiled a report recommending case dismissal as compared to cases where the SLC did not file a report. Table 7 also shows that a negative SLC report also reduces settlement rates, lowers the probability of high settlement, reduces plaintiffs' attorneys' fees, increases appeal rates and reduces the success rates of appeals.

4. The effect of legal standards on SLC formation, SLC recommendations, and SLC case outcomes

Having provided a data overview using descriptive statistics, we next examine the effect of differing legal standards on SLC formation, SLC report recommendations, and SLC case outcomes.

4.1. SLC formation and legal standards

In order to further examine the role and usage of SLCs we examine whether the differing legal standards for judicial review of SLC actions, and the varying levels of judicial oversight that these standards imply, are associated with higher or lower incidence of SLC usage by defendant corporations. In other words, if a particular jurisdiction, such as Delaware, has a stronger standard of judicial review of SLC action than a second jurisdiction, such as New York, does this difference affect the likelihood that the defendant corporate board will create an SLC? The hypothesis here is that stricter judicial review should lead firms to be less likely to employ an SLC since they cannot be used to rubberstamp lawsuit dismissals.

In Panel A of Table 8 we find evidence of relationships between legal standards with reasons for SLC formation. Specially, we examine cases with and without breach of fiduciary duties allegations (the majority of cases), cases with and without breach of DOL allegations (a third of the cases), and case with and without options backdating allegations (the strongest cases comprising 15% of the sample).

Delaware Standard suits data yield the most intuitive results. Reading across the top row of the table, we see that SLCs are more

Table 8
Reasons for SLC usage.

| | Breach DOL | No Breach DOL | General breach of fiduciary duties | No General breach of fiduciary duties | Options Backdating | No Options Backdating |
|--|------------|---------------|------------------------------------|---------------------------------------|--------------------|-----------------------|
| Panel A | | | | | | |
| Delaware Standard | 0.41 | 0.29** | 0.64 | 0.74** | 0.27 | 0.05*** |
| Legal Standard 1 | 0.27 | 0.37* | 0.69 | 0.70 | 0.06 | 0.18*** |
| Legal Standard 2 | 0.32 | 0.35 | 0.80 | 0.68 | 0.02 | 0.17*** |
| Legal Standard 3 | 0.32 | 0.35 | 0.78 | 0.68 | 0.06 | 0.16* |
| Panel B | | | | | | |
| E-Index | 2.33 | 2.57 | 2.44 | 2.50 | 2.18 | 2.63* |
| Average tenure of directors on the board (years) | 7.94 | 8.55 | 7.94 | 8.36 | 8.14 | 8.39 |
| % of independent directors on the board | 71.0 | 74.1 | 78.5 | 68.8** | 72.7 | 71.6 |

Panel A (B) compares associations of legal standard (defendant firm governance features) with different law suit reasons for which the SLC was formed, where Legal Standard 1 denotes defendant corporations incorporated in New York, Alabama, Alaska, California, Colorado, Indiana, Kentucky, Louisiana, Minnesota, Ohio, and Pennsylvania; Legal Standard 2 denotes defendant corporations incorporated in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Rhode Island, South Dakota, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia; while Legal Standard 3 denotes defendant corporations incorporated in all other states. Federal suits are re-classified as Delaware standard case, or as Legal Standard 1, 2 or 3 cases based on the state of incorporation of the defendant corporation.

*, **, and *** denote significantly different from the other cohort at the 10%, 5% and 1% levels respectively.

frequently found in cases with allegations of DOL breach than in cases without such claims. Intuitively this is because fiduciary duty cases with a specific breach of DOL claims are likely to be stronger than those without specific allegations. SLCs are also significantly more common in cases that do not involve alleged generic breaches of fiduciary duties (such as breach of contract cases) and those detailing options backdating violations. This result is likely because such cases are likely to be stronger cases based on the underlying claims and defendants might be more likely to respond by forming an SLC.

A similar analysis of the legal standard 1 cases shows some remarkable differences from Delaware standard cases: SLCs are most common in cases without DOL breach allegations (weaker cases) and more common in cases without options backdating allegations (also weaker cases). Legal standards 2 and 3 show qualitatively similar results to those for the legal standard 1 cases in that SLCs are more common in cases without options backdating allegations (weaker cases).

Examining the numbers of [Table 8A](#) vertically down columns, we look at cases involving allegations of breach of the DOL (the first column of the table) to determine whether the incidence of SLC formation differs across legal standards. We find that the incidence of SLC formation is significantly greater in Delaware Standard suits than in any of the other three legal standards suits. For options backdating cases (perhaps the strongest cases), the incidence of SLC formation is also significantly greater in Delaware Standard suits than in any other jurisdiction.

[Table 8](#), Panel B examines certain governance features in order to determine whether facets of corporate governance affect SLC usage. We look at several types of corporate governance measurements; specifically, the [Bebchuk et al. \(2009\)](#) entrenchment index or the *E-Index*, the average tenure of directors on the board (in years), and the percentage of independent directors on the board of a firm at the year of the law suit. We look at the *E-Index* because, despite criticisms (see [Bhagat et al., 2008](#)), it is a general measure of governance. The other two variables of average tenure of directors on boards, and the percentage of independent directors are designed to capture whether the board is *ex ante* more favorable to officers and directors due to either relationships built up over time or from the board composition itself.

Governance data of this type is available in full only for public companies generally in the S&P 1500; hence we have the data for only 90 cases in our full sample. We find that only general breach of fiduciary duties allegations (i.e., weaker allegations) occur more when more independent directors are present. Options backdating allegations occur with more frequency when the *E-index* is lower (i.e., with less entrenched directors). But, in general, we find no evidence that better governance features lead to different levels of SLC usage.

4.2. Case outcomes and legal standards

Next, we shift to an analysis of the effects of legal standards on case outcomes. We use the following regression model to explore associations in the data:

$$\begin{aligned}
 Y = & \beta_Y + \beta_1 \times \text{Public Firm} + \beta_2 \times \text{Class Action Suit} + \beta_3 \times \text{Delaware Standard} + \beta_4 \times \text{Legal Standard 1} + \beta_5 \\
 & \times \text{Legal Standard 2} + \beta_6 \times \text{Legal Standard 3} + \beta_7 \times \text{Multiple Suits} + \beta_8 \times \text{Multiple Jurisdictions} + \beta_9 \times \text{Breach DOL} \\
 & + \beta_{10} \times \text{General breach of fiduciary duties} + \beta_{11} \times \text{Options Backdating} + \beta_{12} \times \text{SLC report to dismiss} \\
 & + \beta_{13} \times \text{SLC report to dismiss} \times \text{Legal Standard 1} + \beta_{14} \times \text{SLC report to dismiss} \times \text{Legal Standard 2} \\
 & + \beta_{15} \times \text{SLC report to dismiss} \times \text{Legal Standard 3} + \varepsilon,
 \end{aligned} \tag{1}$$

where *Y* is Case Dismissed, Case Settled, or High Settlement Value (of more than a million dollars). [Table 9](#) reports the regression coefficients and in parenthesis, heteroscedasticity-consistent firm-clustered standard errors.

In Panel A, we find that legal standard 1 is significantly and negatively associated with case settlements and high value settlements, but significantly and positively associated with case dismissals. This provides some evidence that the business judgment standard of review applied in legal standard 1 cases is defendant friendly. The Delaware standard is negatively associated with case dismissals although this association is not statistically significant at the 10% level. We interpret this as weakly consistent with the claim that Delaware's judicial standard of review is more plaintiff friendly than the other legal standards.

We also find that the issuance of an SLC report recommending dismissal is significantly and positively associated with the underlying case being dismissed and significantly and negatively associated with settlements and high value settlements. In addition, option backdating cases are significantly and positively associated with high value settlements (consistent with the widely held belief that they are stronger cases), while non-specific allegations of general breach of fiduciary duties are significantly and positively associated with dismissals (in accordance with our view that they are weaker cases). Perhaps surprisingly, DOL cases are significantly associated with higher rates of case dismissal. The interaction terms of SLC report recommending dismissal and each of the legal standards are not significant.

Examining the marginal significance of the issuance of an SLC report recommending dismissal (our first main variable of interest) on case dismissal, settlement, and high value settlement, we find that the probability of case dismissal increases by about 42%, the probability of settlement decreases by about 43%, while the probability of high value settlement decreases by about 68% (when an SLC report recommends dismissal as compared to all other cases with no SLC report recommending dismissal). The marginal effect of case in Legal Standard 1 (the other main variable of interest) is that the probability of case dismissal increases by about 17%, the probability of settlement decreases by about 47%, while the probability of high value settlement decreases by about 45% (for Legal Standard 1 cases, as compared to cases not in Legal Standard 1 jurisdictions). Thus, both legal standard and SLC report recommending dismissal has economically significant effects on case outcomes.

Table 9
Determinants of case outcomes.

| | Case dismissed | Case settled | High settlement value |
|--|-------------------|---------------------|-----------------------|
| Panel A: SLC Sample | | | |
| Public Firm | -0.29 (-1.03) | 0.31 (1.05) | 0.05 (0.12) |
| Class Action Suit | 0.11 (0.37) | 0.47 (1.47) | 0.56 (1.50) |
| Delaware Standard | -0.66 (-1.17) | 0.10 (0.22) | 0.42 (0.78) |
| Legal Standard 1 | 1.32** (2.23) | -1.72*** (-2.68) | -0.77* (-1.77) |
| Legal Standard 2 | 0.18 (0.27) | -0.47 (-0.82) | -0.59 (-1.23) |
| Legal Standard 3 | -0.30 (-0.29) | 0.11 (0.16) | 0.12 (0.14) |
| Multiple Suits | -0.28 (-0.92) | 0.32 (1.10) | 0.32 (0.81) |
| Multiple Jurisdictions | -0.31 (-0.97) | 0.25 (0.81) | -0.45 (-1.12) |
| Breach DOL | 0.63** (2.21) | 0.10 (0.40) | 0.19 (0.52) |
| General breach of fiduciary duties | 0.48** (2.02) | -0.11 (-0.41) | -0.15 (-0.45) |
| Options Backdating | -0.02 (-0.05) | 0.68 (0.88) | 0.97** (2.14) |
| SLC report to dismiss | 1.52*** (2.73) | -1.45** (-2.04) | -1.49*** (-3.04) |
| SLC report to dismiss x Legal Standard 1 | 0.48 (1.40) | -0.32 (-0.94) | -0.20 (-0.39) |
| SLC report to dismiss x Legal Standard 2 | 0.98 (1.45) | -0.19 (-0.76) | -0.21 (-0.10) |
| SLC report to dismiss x Legal Standard 3 | 0.72 (0.97) | -0.07 (-0.11) | -0.54 (-0.44) |
| Period Dummies | Yes | Yes | Yes |
| Pseudo R ² | 12.24 | 11.72 | 11.84 |
| Panel B: SLC Sample | | | |
| Delaware Standard | -0.62 (-1.02) | 1.45 (0.92) | 0.37 (0.75) |
| Legal Standard 1 | 1.48** (2.31) | -2.06*** (-2.69) | -1.63* (-1.75) |
| Multiple Suits | -0.13 (-0.65) | 0.41 (1.21) | 0.32 (0.81) |
| Options Backdating | -0.06 (-0.04) | 0.78 (1.39) | 0.95** (2.33) |
| SLC report to dismiss | 1.89*** (2.88) | -1.38** (-2.02) | -1.49*** (-3.04) |
| SLC report to dismiss x Legal Standard 1 | 0.33 (1.15) | -0.34 (-1.00) | -0.25 (-0.40) |
| E-Index | -0.44 (-0.83) | 0.65 (0.99) | 1.10 (1.35) |
| average tenure of directors on the board | -0.29* (-1.86) | 0.50* (1.83) | 0.07 (0.22) |
| % of independent directors on the board | 1.37 (0.41) | -3.41 (-0.92) | -0.28 (-1.05) |
| Period Dummies | Yes | Yes | Yes |
| Pseudo R ² | 11.37 | 11.07 | 10.85 |

This table reports the regression coefficients, and in parenthesis, heteroskedasticity-consistent firm-clustered standard errors, of regressions explaining lawsuit outcomes. The lawsuit outcomes are (1) case dismissed, (2) cases settled, and (3) high settlement value cases. In each regression, if the outcome category (e.g., case dismissed) being examined is set to be equal to 1, the other categories (e.g., case settled, and high settlement value) set to be equal to 0. Included in the regressions as controls are β_{γ} , a vector of time-period fixed effects. The different legal standards are the key explanatory variables. Delaware Standard cases are those examining the actions of SLC of defendant corporations incorporated in Delaware. Legal Standard 1 denotes defendant corporations incorporated in New York, Alabama, Alaska, California, Colorado, Indiana, Kentucky, Louisiana, Minnesota, Ohio, and Pennsylvania; Legal Standard 2 denotes defendant corporations incorporated in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Rhode Island, South Dakota, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia; while Legal Standard 3 denotes defendant corporations incorporated in all other states. In Panel A, the regressions are run over 384 observations in our final sample. Of these, Cases Dismissed = 176, Cases Settled = 153, and High Settlement Value cases = 65. In Panel B, the regressions are run over 90 observations for which we have the corporate governance variables data from out of our public firm sample of 288 observations. All variables are defined in Table A of Appendix.

*, **, and *** denote significantly different from zero at the 10%, 5% and 1% levels respectively.

Table 9, Panel B examines regression results after including the 3 governance variables –E-Index, the average tenure of directors on the board (in years), and the percentage of independent directors on the board of a firm at the year in question. Given the smaller sample size, we drop some of the variables that were found to be insignificant in Panel A. The regression specification is:

$$Y = \beta_Y + \beta_1 \times \text{Delaware Standard} + \beta_2 \times \text{Legal Standard 1} + \beta_3 \times \text{Multiple Suits} + \beta_4 \times \text{Options Backdating} \\ + \beta_5 \times \text{SLC report to dismiss} + \beta_6 \times \text{SLC report to dismiss} \times \text{Legal Standard 1} + \beta_7 \times \text{E - Index} \\ + \beta_8 \times \text{Average tenure of directors on the board} + \beta_9 \times \% \text{ of independent directors on the board} + \epsilon, \quad (2)$$

The results continue to show that both SLC report to dismiss and legal standard 1 are significantly and negatively associated with case settlements, and with high value settlements, but significantly and positively associated with case dismissals. But the interaction term between SLC report to dismiss and legal standard 1 is not significant. Options backdating cases, being the stronger ones, are significantly associated with high value settlements. Among the governance variables, the only one weakly significant is the longer the average tenure of the extant directors, the less likely the case will be dismissed and the more likely the case will be settled, perhaps because of accumulated evidence over time.

4.3. Concurrence tests: SLC recommendations and actual outcomes

We are interested in further exploring the importance of SLC recommendations to courts in making their decisions about SLC cases. In particular, we want to examine whether courts concur with SLC recommendations about dismissal and settlement. Therefore in Table 10, we examine the concurrence between SLC recommendations and court action. We examine the associations of defendant type on SLC recommendations and actual outcomes after controlling for important variables, using the following regression equation:

$$Y = \beta_Y + \beta_1 \times \text{Delaware Standard} + \beta_2 \times \text{Legal Standard 1} + \beta_3 \times \text{Multiple Suits} + \beta_4 \times \text{Multiple Jurisdictions} \\ + \beta_5 \times \text{Breach DOL} + \beta_6 \times \text{General breach of fiduciary duties} + \beta_7 \times \text{Options Backdating} \\ + \beta_8 \times \text{All Defendants current or former directors} + \beta_9 \times \text{Defendant entity other than Defendant firm} + \epsilon, \quad (3)$$

where Y is (a) Case Dismissed when SLC recommended Dismissal, (b) Case Settled when SLC recommended Dismissal, or (c) Case Settled when SLC recommended Settlement, pursuit or pursuit and settlement. Table 10 reports the regression coefficients and, in parenthesis, heteroscedasticity-consistent firm-clustered standard errors. As before we are most interested in the effect of legal standards.

We find the Delaware standard of review is significantly negatively associated with case dismissals when the SLC recommended dismissal, and significantly positively associated with the case being settled when the SLC recommended settlement. This is consistent

Table 10

Concurrence rates between SLC recommendations and case outcomes.

| | Case dismissed when SLC recommended dismissal | Case settled when SLC recommended dismissal | Case settled when SLC recommended settlement, pursuit or pursuit and settlement |
|--|---|---|---|
| N | 105 | 45 | 27 |
| Delaware Standard | -1.32** (-2.00) | 0.20 (0.60) | 1.04** (2.10) |
| Legal Standard 1 | 1.05*** (3.35) | -1.44** (-2.38) | -1.32* (-1.89) |
| Multiple Suits | -0.64** (-1.97) | 0.57** (1.97) | 0.63 (1.06) |
| Multiple Jurisdictions | -0.44 (-1.17) | -0.07 (-0.17) | -0.07 (-0.11) |
| Breach DOL | 0.22 (1.02) | 0.68 (1.56) | 0.30 (0.58) |
| General breach of fiduciary duties | 0.86*** (2.67) | -0.52 (-1.18) | -0.32 (-0.67) |
| Options Backdating | -0.86 (-1.50) | 0.63 (1.44) | 0.80 (1.01) |
| All Defendants current or former directors | 0.25 (0.69) | 0.05 (0.10) | 0.51 (0.76) |
| Defendant entity other than Defendant firm | 0.22 (0.68) | -0.75 (-1.17) | -2.23** (-2.11) |
| Period Dummies | Yes | Yes | Yes |
| Pseudo R ² | 12.69 | 15.78 | 12.43 |

This table reports the regression coefficients, and in parenthesis, heteroskedasticity-consistent firm-clustered standard errors, of regressions explaining SLC recommendations and lawsuit outcomes, run over cases in our final sample where we know SLC report recommendations. Included in the regressions as controls are β_Y , a vector of time-period fixed effects. The number of observations over which each regression is run is shown. All variables are defined in Table A of Appendix.

*, **, and *** denote significantly different from zero at the 10%, 5% and 1% levels respectively.

with the Delaware standard being skeptical about SLC dismissal recommendations, but agreeing with the SLC about settlement/pursuit of the litigation.

Legal Standard 1 is significantly and positively associated with case dismissal when the SLC recommended dismissal. Recall that legal standard 1 applies the defendant friendly business judgment standard of review to an SLC recommendation. Furthermore, SLC recommendations are more likely to be associated with lower chances of a settlement in courts applying legal standard 1.

These findings are significant because they address selection effects. More specifically, as we have discussed Legal Standard 1 is a lower threshold of review by courts of SLC decisions in certain states. Priest and Priest and Klein's (1984) model capitalizes on the parties' incentive to settle in the shadow of a liability standard – such that: if the standard is tougher for defendants, more defendants will be willing to settle; if the standard is tougher for plaintiffs, more plaintiffs will be willing to settle, and eventually among the cases that are adjudicated, the plaintiffs' win rate will be about 50% (regardless of how stringent or lenient the court's liability standard is). Thus under the Priest-Klein framework, legal standards should be immaterial to the outcome of a litigation. Our findings are evidence that not only do legal standards matter, but that SLCs, when removed from judicial oversight, seem to favor management.

Multiple suits, perhaps the stronger cases, are significantly and negatively associated with case dismissals with SLC recommends dismissals, while general breach allegations, perhaps the weaker cases, are significantly and positively associated with case dismissals with SLC recommends dismissals. If one of the defendants is an entity other than the defendant firm, then it is significantly negatively associated with the case being settled even when the SLC recommended settlement. Overall, this result is consistent with SLC reports to dismiss being filed with significantly higher frequency when only directors are involved, but actual case dismissals are significantly more likely when entities other than directors are involved.

In order to further examine these findings, in untabulated results we analyze whether SLC report recommendations are biased in favor of case dismissals and against settlements/pursuits, using a simple logit regression model,

$$Y = \beta_0 + \beta_1 \times X + \varepsilon,$$

where Y = SLC recommended Dismissal (1) or SLC recommended Settlement, pursuit or settlement (0), and X = Case Dismissed (1), or Case Settled (0).

In this specification, we can think of Y as the SLC's assessment of the outcome of the case plus a measure of (x) potential systematic bias in that assessment and (y) random error. The intercept term is the estimate of the SLC's systematic bias in its recommendation. In a logit regression, the odds of the bias is $\exp(\beta_0)$. We run the regression over the 229 cases in our final sample where SLC reports have been filed. The β_1 coefficient is significantly positive at the 1% level, and β_0 is 0.46, significant at the 5% level, implying odds of a bias of 1.58 in SLC recommendation towards dismissals in cases where there is an SLC recommendation.

4.4. Stock market reaction

In order to further examine the economic effects of SLCs, we examine stock market reactions for a number of relevant dates related to the litigation in our sample. We examine three different dates– the litigation announcement date, the SLC formation date, and the SLC report date. For the SLC sample, we have 288 observations involving public firms for which we can get the stock returns. We also examine the abnormal stock-return around the litigation announcement date for the non-SLC matched-sample for comparison purposes. We then analyze the announcement-period abnormal-stock-returns, defined as the seven day stock return around the announcement date minus the equally-weighted CRSP index return around the same days, to examine stock market reaction. Table 11 reports the results.

We find that the market reacts significantly negative at -3.3% even at the time litigation was announced for the SLC sample. This reflects the market's negative perception of shareholder litigation. The market reacts significantly at -2.2% (at the 5% significance level) around the SLC formation date. However, the market reaction is insignificant at -1.5% around the SLC report date. Thus, it appears that although the reaction is negative upon SLC report announcement, it is not significantly so, perhaps because the market anticipates the SLC's recommendations.

4.5. Non-SLC matched sample analysis

As a robustness check and a further control for selection effects, we construct a non-SLC matched sample for a subsample of SLC cases. SLCs are generally employed in derivative lawsuits, a fact we document in Table 2, Panel A. This suggests that an appropriate

Table 11
Announcement period abnormal stock returns.

| | Litigation announcement (–3, +3) | SLC formation (–3, +3) | SLC report (–3, +3) |
|------------|----------------------------------|------------------------|---------------------|
| SLC sample | –3.32%* | –2.16%** | –1.51% |

This table compares the seven-day announcement period abnormal returns, computed as stock return minus the equally weighted CRSP index returns, around litigation announcement, SLC formation, and SLC report dates, for 288 observations that entail SLCs for public firms. All variables are defined in Table A of Appendix.

*, and ** denote significantly different from zero at the 10%, 5% and 1% levels respectively.

matched sample would consist of derivative lawsuits without SLCs. To construct a matched sample, data concerning Delaware court outcomes is easiest to obtain because they are available from the beginning of 2004 and all of the necessary information is electronically accessible on Bloomberg Law.¹⁵ Consequently, to construct our matched sample we compile a database of all Delaware court derivative suits from 2004 through 2015 (the end of our sample period) where no SLC is appointed. We then code for the period 2005–2015 a sample of 100 derivative suits drawn randomly from the population of such cases. In constructing our sample, we discard all cases involving SLCs, and code all cases with a single complaint as well as cases with a consolidated complaint (discarding the other complaints filed in such cases).

We have 35 derivative cases in Delaware courts from 2004 through 2015 where an SLC is appointed in our sample. We match each of the 35 SLC cases with a non-SLC case from our group of 100 coded cases, matching by year (to control for time effects), by the claims in the lawsuit (a measure of the seriousness of the allegation), and whether multiple suits are filed in the same jurisdiction (another indicator of the importance of the case). We are also careful to consider only those cases that are not connected (via multijurisdictional filing) to the SLC cases. Thus, we have 35 SLC cases and 35 non-SLC cases for our matched-sample analysis.

The results (reported in Table 12) have to be interpreted in the context of Delaware courts being more plaintiff-friendly than the other legal standards. Nevertheless, the proportion of cases dismissed is significantly higher at around 41% when an SLC is involved as compared to around 29% when no SLC is involved. Conversely, the proportion of cases settled (44%) and cases settled with high settlement value (29%) are significantly lower in SLC cases, as compared to 71% settled and 50% with high settlement value for non-SLC cases. The seven-day announcement period return is also significantly lower (and negative) upon lawsuit announcement where an SLC is expected to be involved, compared to lawsuit announcement where no SLC is expected to be involved.

Thus, a subsample analysis using carefully matched non-SLC cases confirms our prior evidence of pro-defendant bias in SLCs even accounting for the potentially differing treatment of SLC decisions in Delaware court.

4.6. Effect of change in legal standard: Oracle and Delaware SLCs

In Table 6, we saw that SLC reports are less likely to recommend dismissal in Delaware court cases. We further analyze the effect of the Delaware courts on SLC decisions by exploiting a change to the judicial review standard in Delaware after the Delaware Chancery Court decision in the *Oracle* case.¹⁶ *Oracle* was decided on June 17, 2003. By raising the judicial standard for independence of SLC directors, it arguably made it harder for SLCs to dismiss cases (Holland, 2009). The underlying facts were that lawsuits were filed in Delaware and California in March 2001 against Oracle Corp., a Delaware corporation. In April 2002, Oracle formed an SLC to investigate the underlying allegations in a derivative action, which claimed that four of its directors had engaged in insider trading in its shares. The SLC engaged in an extensive investigation, then filed its report with the court and moved to dismiss the derivative suit. Then Vice Chancellor Strine applied a strict definition of independence, finding that the SLC did not meet its burden to prove its directors were independent, and denying the defendants' motion to dismiss. Subsequent commentary posited that Oracle marked a heightened standard of review of SLC decisions in Delaware (Holland, 2009).

To see what effect Oracle, and its underlying change to the legal standard applied by Delaware courts to SLC recommendations, would have, we conduct a diff-in-diff test by using all cases (with a DE dummy, a Post-Oracle dummy, and an interaction of the two dummies with the SLC recommendation to dismiss). We use the following regression specification:

$$\begin{aligned}
 Y = & \beta_1 \times \text{SLC report to dismiss} + \beta_2 \times \text{Post Oracle Period} + \beta_3 \times \text{Delaware Court Case} + \beta_4 \\
 & \times \text{Delaware Court Case} \times \text{SLC report to dismiss} \times \text{Post Oracle Period} + \beta_5 \times \text{Breach DOL} \\
 & + \beta_6 \times \text{General breach of fiduciary duties} + \beta_7 \times \text{Options Backdating} + \epsilon,
 \end{aligned} \tag{4}$$

where Y takes the value of 1 for case dismissals, and 0 otherwise. We exclude variables that were found uninformative in the previous tables and time fixed effects, and a post-Oracle period dummy variable is included. We find in Table 13 that the SLC report recommending case dismissal is significantly and positively associated with case dismissals. The post-Oracle period is also significantly associated with case dismissals. However, the interactive term between a SLC report to dismiss in Delaware for a Delaware case in the post Oracle period is significantly and *negatively* associated with the probability of case dismissals supporting the claim that the change in the legal standard in the post Oracle period made the Delaware courts more skeptical of SLC recommendations calling for dismissals.

5. Policy implications and conclusions

Using a hand collected final sample of 384 SLC events spanning the 26-year period Jan 1, 1990 through Dec 31, 2015, we examine the role and usage of SLCs. We find that SLCs are not commonly employed in shareholder litigation. When they are used, a vast majority (87%) of SLC associated cases are derivative suits, and only 18% contain class action allegations. Within derivative lawsuits, they are most frequently utilized where the complaint contains allegations of breach of the directors' duty of loyalty or the

¹⁵ Delaware court cases are particularly appropriate because the Delaware Chancery Court exclusively decides corporate law cases and has established expertise in this area. We do not include federal derivative cases since these cases are typically associated with federal securities law suits also.

¹⁶ *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003).

Table 12
Matched sub-sample analysis.

| | Delaware derivative court cases 2004–2015 SLC sample | Delaware derivative Court cases 2004–2015 No-SLC matched sample |
|----------------------------------|--|---|
| N | 35 | 35 |
| Case Dismissed | 0.41 | 0.29* |
| Case Settled | 0.44 | 0.71** |
| Settlement Value High | 0.29 | 0.50* |
| High Plaintiff Lawyer fee | 0.58 | 0.47 |
| Shareholder Appeal | 0.12 | 0.12 |
| Appeal outcome Affirmed | 0.06 | 0.12 |
| Litigation Announcement (–3, +3) | –0.41% | 1.05%* |

This table compares lawsuit outcomes as well as announcement period abnormal returns upon lawsuit announcement, for derivative suits in Delaware court, from 2004 through 2015, for which an SLC is appointed. Taken from our final sample. There are 35 such suits. Each of these lawsuits is matched to a derivative suit in Delaware court matched by year, reason for lawsuit and whether the suit is part of multiple suits filed in the same jurisdiction, but without any SLC involvement. There are 35 of these. All variables are defined in Table A of Appendix.

*, and ** denote significantly different from outcomes of the other cohort, at the 10%, 5% and 1% levels respectively.

Table 13
Determinants of case outcomes: The effect in Delaware of the Oracle case.

| | Case dismissed |
|--|-------------------|
| SLC report to dismiss | 1.23*** (3.22) |
| Delaware Court case | –0.40 (–1.29) |
| Post-Oracle Period | 0.97** (2.30) |
| SLC report to dismiss x Delaware Court case x Post-Oracle Period | –0.90* (–1.88) |
| Breach DOL | 0.53* (1.84) |
| General breach of fiduciary duties | 0.36* (1.65) |
| Options Backdating | –0.41 (–1.09) |
| Pseudo R ² | 18.07 |

This table reports the regression coefficients, and in parenthesis, heteroskedasticity-consistent firm-clustered standard errors, of regressions explaining whether case is dismissed (taking the value = 1). The regressions are run over 384 observations in our final sample. Of these, the number of cases in the Post-Oracle Period = 244, and the Cases Dismissed = 176. All variables are defined in Table A of Appendix.

*, **, and *** denote significantly different from zero at the 10%, 5% and 1% levels respectively.

commission of corporate waste by the board.

SLCs often file reports with the court that is hearing the case they are investigating. These reports frequently recommend dismissal of the underlying litigation, and much less commonly file reports recommending settlement of the case. Judicial dismissals of SLC cases occur with roughly the same frequency as the SLC recommends dismissal, however, settlements in SLC cases occur much more frequently than the SLC recommends in its report. This discrepancy provides some evidence that SLC report recommendations are biased in favor of case dismissal and against settlement.

State law standards of review for SLC reports vary widely. In this regard, we make two important findings about how the application of different legal standards for SLC reports impacts case outcomes. First, we note that Delaware is generally viewed as having the most plaintiff friendly standard which is corroborated by our findings. This is consistent with the evidence we find: Delaware incorporation, and thus review of the SLC report under Delaware law, is significantly and negatively associated with case dismissal. Conversely, Delaware incorporation is significantly and positively associated with a settlement of the underlying case. Second, in states with the lowest level of judicial review for SLC reports, we find that SLCs are most likely to recommend case dismissal, more likely to have a case dismissed, and least likely to result in a high value settlement. In other words, stronger judicial review of SLC reports seems more likely to help the plaintiff, while weaker judicial review of these reports makes it more likely that defendants will win.

We also use a matched sample approach to examine how SLC usage affects case outcomes. We compare a matched sample of Delaware derivative lawsuits with our sample of Delaware court cases where the defendants have chosen to employ an SLC. Controlling for year of filing, type of claims made and number of complaints filed in the case, we find evidence that is consistent with

the claim that the use of an SLC in a Delaware court case makes it more likely that a derivative suit will be dismissed and less likely that it will result in a high value settlement.

Finally, we further examine the effects of legal standards by looking at the impact of a Delaware court's decision in the *Oracle* case, which arguably changed the standards for director independence and resulted in stricter judicial review of SLC reports recommending dismissal. Using a difference-in-difference analysis, we find that an SLC report recommending case dismissal is significantly associated with an increased probability of case dismissals in Delaware. When we examine the effect of the post-*Oracle* legal standard using an interactive term, we find an SLC report recommending case dismissal in Delaware court in the post-*Oracle* period is significantly and negatively associated with the probability of a case dismissal. Thus, the change in the legal standard appears to have made the Delaware courts more skeptical of SLC recommendations calling for case dismissals.

Overall, our results support the claim that legal standards matter: stronger judicial scrutiny of SLC reports recommending case dismissal is associated with fewer case dismissals, while weaker standards of judicial review for those reports leads to more case dismissals. The use of SLCs themselves also appears to increase the likelihood that a derivative case will be dismissed. Defense lawyers appear to exploit these differences to obtain dismissals at a higher rate, potentially impacting shareholder value. We are therefore skeptical about the use of SLCs and argue that when they are used, the courts should apply enhanced judicial scrutiny to their reports.

Appendix A

| Firm variable | Description |
|--|--|
| DE Incorporation | Indicator variable that takes the value of 1 if Defendant firm's state of incorporation is Delaware, and 0 otherwise. |
| Public | Indicator variable that takes the value of 1 if Defendant firm is a publicly traded firm, and 0 otherwise. |
| E-Index | The Bebchuk et al. (2009) entrenchment index, using 6 corporate governance provisions: staggered boards, limits on shareholder bylaw amendments, supermajority requirements for mergers, supermajority requirements for charter amendments, poison pills and golden parachutes, taken from the IRRIC database. |
| Average tenure of directors on the board | The average tenure of directors on the board, in years, for each firm, for each year, taken from the IRRIC database |
| % of independent directors on the board | Percentage of independent directors on the board for a firm each year taken from the IRRIC database. |
| Announcement Period Abnormal Return | Stock return over the seven day period around the announcement date minus the equally weighted CRSP return over the same period, taken from the CRSP database. |
| Type of litigation | Description |
| Derivative Suit | An indicator variable that takes the value of 1 if the suit includes derivative claims, and 0 otherwise. |
| Class Action | An indicator variable that takes the value of 1 if the suit includes class action claims, and 0 otherwise. |
| Breach DOC | An indicator variable that takes the value of 1 if the case alleges a breach of the duty of care (DOC), and 0 otherwise. |
| Breach DOL | An indicator variable that takes the value of 1 if the case alleges a breach of the duty of loyalty (DOL), and 0 otherwise. |
| Breach Contract | An indicator variable that takes the value of 1 if the case alleges a breach of contract, and 0 otherwise. |
| Fraud | An indicator variable that takes the value of 1 if the case alleges fraud, and 0 otherwise. |
| Waste | An indicator variable that takes the value of 1 if the case alleges a claim of waste, and 0 otherwise. |
| General breach of fiduciary duties | An indicator variable that takes the value of 1 if the case alleges general, unspecific claims of breach of fiduciary duties, and 0 otherwise. |
| Options Backdating | An indicator variable that takes the value of 1 if the litigation relates to options backdating, and 0 otherwise. |
| Federal Suit | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed in a federal court, and 0 otherwise. |
| Multiple Suits | Indicator variable that takes the value of 1, if multiple suits are filed in the same jurisdiction where the SLC is being used, and 0 otherwise. |
| Delaware Court case | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed in the Delaware Chancery Court, and 0 otherwise. |
| Delaware Standard | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed in the Delaware Chancery Court, or in another court involving Delaware incorporated defendants, and 0 otherwise. |
| Legal Standard 1 | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed, where the defendant corporation is incorporated in New York, Alabama, Alaska, California, Colorado, Indiana, Kentucky, Louisiana, Minnesota, Ohio, and Pennsylvania. |
| Legal Standard 2 | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed, where the defendant corporation is incorporated in Arizona, Connecticut, Florida, Georgia, Hawaii, Idaho, Maine, Michigan, Mississippi, Montana, Nebraska, New Hampshire, Rhode Island, South Dakota, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia. |
| Legal Standard 3 | Indicator variable that takes the value of 1, if the suit where the SLC is being used is filed, where the defendant corporation is incorporated in all other states. |
| Multiple Jurisdiction | Indicator variable that takes the value of 1, if suits are filed in the multiple jurisdictions and the SLC is being used in them, and 0 otherwise, |

| Activity variables | Description |
|----------------------------------|---|
| Motion to Stay | Indicator variable that takes the value of 1, if the SLC filed a motion to stay the case. If the SLC did not file a motion to stay, then 0 |
| SLC Report filed | Indicator variable that takes the value of 1, if the SLC filed a report with the Court. If the SLC did not file a report with the Court, then 0 |
| SLC Report to Dismiss | If the SLC complied a report, what did the SLC recommend the corporation do with respect to the litigation. Indicator variable that takes the value of 1, if the report recommended that the corporation dismiss the litigation, and 0 otherwise. |
| SLC Report to Settle | If the SLC complied a report, indicator variable that takes the value of 1, if the report recommended that the corporation settle the litigation, and 0 otherwise. |
| SLC Report to Pursue | If the SLC complied a report, indicator variable that takes the value of 1, if the report recommended that the corporation pursue the litigation, and 0 otherwise. |
| SLC Report to Pursue and Settle | If the SLC complied a report, indicator variable that takes the value of 1, if the report recommended that the corporation pursue with some defendants and settle with some defendants, and 0 otherwise. |
| Preliminary Injunction Motion | Indicator variable that takes the value of 1, if any of the plaintiffs or the SLC committee in the litigation filed a motion with the court seeking a preliminary injunction, and 0 otherwise. |
| Motion to dismiss by SLC | Indicator variable that takes the value of 1, if a motion to dismiss is filed by the SLC in the litigation, and 0 otherwise. |
| Motion to dismiss by Defendant | Indicator variable that takes the value of 1, if the corporation or any of the individual defendants file a motion to dismiss in the litigation, and 0 otherwise. |
| Outcome variables | Description |
| Motion to Stay outcome | Indicator variable that takes the value of 1, if the SLC filed a motion to stay, and the Court granted the motion. If the SLC filed a motion to stay, and the Court denied the SLC's motion, and permitted the case to continue, then 0. |
| Judge accepted report to dismiss | Indicator variable that takes the value of 1, if the judge in the matter accepted the SLC report recommendation and dismissed the case, and 0 otherwise. |
| Case Dismissed | Indicator variable that takes the value of 1, if the case was dismissed by the court, and 0 otherwise. |
| Judgment for Plaintiff | Indicator variable that takes the value of 1, if the case went to a judgment for the plaintiffs, and 0 otherwise. |
| Judgment for Defendant | Indicator variable that takes the value of 1, if the case went to a judgment for the defendants, and 0 otherwise. |
| Case Settled | Indicator variable that takes the value of 1, if the case was settled in court, and 0 otherwise. |
| Post Oracle | Cases decided after the Oracle case was decided on June 17, 2003 By Delaware court. |
| Settlement Value | If the case was settled, the full dollar value of the settlement awarded |
| High Settlement Value | Indicator variable that takes the value of 1 if the settlement value is more than \$1 million, and 0 otherwise. |
| High Plaintiff Lawyer Fee | Indicator variable that takes the value of 1 if the plaintiff lawyer fee is more than \$1 million, and 0 otherwise. |
| Shareholder Appeal | Indicator variable that takes the value of 1, if the shareholder appealed a lower court decision, and 0 otherwise. |
| Appeal Outcome affirmed | Indicator variable that takes the value of 1, if the appellate court affirmed the judgment of the lower court, and 0 otherwise. |

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