ENSURING CORPORATE MISCONDUCT

How Liability Insurance Undermines Shareholder Litigation

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Ensuring Corporate Misconduct

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CHAPTER ONE

Introduction

Financial crises present opportunities for introspection. Beyond the initial concern over what happened and why, they present an opportunity to reflect on the regulatory framework as a whole and to consider the effectiveness of each element of the law affecting business, to ask what aspects of the regulatory structure work well and what aspects may benefit from some correction. In this book we take the opportunity afforded by the recent financial crisis to reflect on the effectiveness of shareholder litigation in regulating corporate conduct.

Shareholder litigation forms an important part of the structure of law and regulation affecting American business. Because public regulators cannot oversee every company at every moment and cannot anticipate or even respond to every report of a potential wrong, a variety of remedies are left in the hands of shareholders themselves. Shareholders who have suffered at the hands of a corporation in which they have invested can sue—either as a class or on behalf of the company itself—to right these wrongs. They thus assume, with their counsel, the role of "private attorneys general," with strong personal incentives to detect and prosecute corporate wrongdoing. The lawsuits they bring fill an important gap in the regulatory framework affecting American business.

Shareholder litigation exerts its regulatory effect through the mechanism of deterrence. That is, prospective wrongdoers realize, through the threat of litigation, that they will be made to account for whatever harms they cause and, thus internalizing the cost of their conduct, forswear bad

acts. This basic mechanism of deterrence explains much civil litigation. Corporate officers and directors, understanding that they may be held liable to their investors for the harms they cause, refrain from engaging in conduct that will harm investors and induce them to sue. In this way, shareholder litigation regulates corporate conduct.

The problem with this story in the corporate context is that officers and directors are typically covered under a form of insurance, known as "Directors' and Officers' Liability Insurance" or "D&O insurance," that insulates them from personal liability in the event of shareholder litigation. D&O insurance also protects the corporation itself from liabilities it may have in connection with shareholder litigation. This insurance disrupts the deterrence mechanism by transferring the obligations of the prospective bad actor (the officer, director, or the corporation itself) to a third-party payer (the insurer). An actor that is no longer forced to internalize the costs of its actions is no longer deterred from engaging in harmful conduct—managers who are no longer personally at risk for investor losses are less likely to take care in avoiding them, and corporations that are no longer at risk from shareholder litigation are less likely to monitor the conduct of their managers—and the regulatory effect of shareholder litigation is diminished, distorted, or destroyed.

Unless, that is, the insurer does something to prevent this outcome. The introduction of D&O insurance essentially establishes the D&O insurer as a third-party intermediary in the regulatory dynamic. If shareholder litigation is to deter bad corporate acts, it must be through the intermediary agency of D&O insurers who will have an opportunity to influence corporate conduct through the insurance relationship. Because they are the ones ultimately paying for the harms caused by their corporate insureds, insurers have ample incentive to exert this sort of constraining influence, and they have the means to do so. We identify three ways in which the insurance relationship may influence corporate conduct—through underwriting, monitoring, and the settlement of claims. The question thus becomes what influence D&O insurers do in fact exert through this relationship and whether this influence is sufficient to reintroduce the deterrence mechanism, thus preserving the effectiveness of shareholder litigation as a regulatory device.

There is a lot riding on this question. Indeed, if D&O insurers fail to preserve the deterrence mechanism, then shareholder litigation would seem to have little chance of regulating corporate conduct and thus would appear to be, as critics have long contended, mere waste, a tax on business

that supports an unnecessary plaintiffs' bar. In order to answer this question then, we must examine corporate and securities law through the lens of liability insurance.

That is precisely what this book seeks to do. In the pages that follow, we examine shareholder litigation through the lens of liability insurance in order to evaluate whether shareholder litigation accomplishes its regulatory objective. Through extensive interviews with professionals working in this area, we analyze each of these three ways in which insurers may preserve the deterrence function of shareholder litigation and we evaluate how well each works in achieving that end. The short answer, unfortunately, is not very well. As it is currently structured, D&O insurance significantly erodes the deterrent effect of shareholder litigation, thereby undermining its effectiveness as a form of regulation. The situation is not without hope, however, and we end by offering three narrowly tailored corrections that a rule maker such as the Securities and Exchange Commission (SEC) might enact to rehabilitate the deterrent effect of shareholder litigation, notwithstanding the presence of liability insurance.

But this brief preview of the analysis to come has taken much for granted. From this point onward we will be more careful. In the remainder of this chapter, we explain our assumptions and define some of the terms that we will use throughout the book. We also describe our empirical methodology and lay out, in some detail, the questions that we will confront in each chapter. Finally, we preview our policy prescriptions, recommending relatively simple reforms of SEC rules in order to prevent D&O insurance from subverting the deterrence function of securities litigation.

Shareholder Litigation

Throughout this book, we use the term "shareholder litigation" to encompass all civil actions brought by current or former shareholders of a corporation against the corporation or its managers for losses the shareholders have suffered as a result of actions taken by the corporation or its managers. This definition excludes criminal actions brought by prosecutors or other public authorities as well as enforcement actions brought by regulatory agencies, such as the SEC. It includes, principally, claims brought by shareholders under either federal securities law or state corporate law.

Among these claims, securities class actions represent, by far, the largest potential source of liability. Shareholders filed 210 federal securities class

actions in 2008, thirty-three more than they had filed in 2007 and eighteen more than the average number of class actions filed per year from 1997 through 2007.[1] Allegations in 94 percent of these claims were centered on misrepresentations in financial statements. In 2008, 2.23 percent of all companies listed on the NYSE, Nasdaq, and Amex at the beginning of the year became defendants in securities class actions filed later that year, down from 2.32 percent the year before and in line with the 2.24 percent average going back to 1997.[2] These numbers are somewhat higher for Standard and Poor's 500 companies, 9.2 percent of which were sued in a securities class action in 2008, up from 5.2 percent in 2007 and the highest since 12.0 percent were sued in 2002.[3]

In securities class actions, current or former shareholders are given the right to sue the corporation collectively for misrepresentations that allegedly induced the shareholders to trade. The allegations underlying such claims typically revolve around misrepresentations in financial documents or in the company's projections concerning future results. Shareholders who trade on the basis of this false information suffer losses when the market price of the security reverts to its "true" underlying value—that is, the price at which a trade might have occurred had it not been for the false information released by the defendants. Securities law thus gives investors the right to sue for this difference in price, which can grow to extremely large amounts once aggregated over the total number of shares transacted during the period of the misrepresentation.

In addition to federal securities class actions, shareholder claims can be brought against corporate defendants under state corporate law. These actions may be representative in form, as when a class of shareholders is deprived of a right, such as voting, that the shareholders possess in common, or they may take the form of shareholder derivative suits when the underlying harm is suffered primarily by the corporation itself and only derivatively by the shareholders, such as when a manager is vastly overcompensated or otherwise wastes corporate funds. Individual or representative claims brought under state corporate law often seek injunctive relief—for example, an order enjoining an unfair reorganization or requiring the board of directors to solicit additional bids in a merger transaction. Derivative suits, by contrast, are most often brought seeking damages. The damages in derivative suits, however, are limited to losses caused by the underlying misconduct—the amount of loss suffered by the corporation, for example, in overpaying its managers or in wasting assets in a particular transaction—not to losses measured by share price fluc-

tuations. Therefore, damages in derivative suits typically do not grow to the size of losses alleged in securities litigation. Additionally, a number of substantive rules and procedural requirements operate as barriers to recovery in derivative suits. As a result, state corporate law litigation is often viewed as secondary to securities law claims. Indeed the phenomenon of the "tagalong derivative suit," discussed in chapter 2, illustrates the way in which state corporate law claims often follow in the wake of more significant federal claims.

Regardless of how state corporate law and federal securities law claims compare in terms of relative importance, for purposes of this research we treat the two basic types of claims together under the rubric of shareholder litigation. Both types of claims feature shareholders seeking relief from the corporation or its managers for investment loss. Both types of claims principally involve monetary damages, not administrative sanctions or criminal penalties. And both types of claims focus on misconduct by the corporation or its managers leading to losses suffered by shareholders. Not all aspects of these claims are identical, and going forward we will be careful to make the distinction when an argument or line of analysis applies to one but not the other. Nevertheless, the claims seem to share the same basic functions, of both compensating shareholders for losses suffered at the hands of the corporation's managers and deterring conduct that might cause such losses in the first place.

This leads us to consider the regulatory function of shareholder litigation. What, in the larger picture, is shareholder litigation meant to accomplish? Two possibilities present themselves. The basic goal of shareholder litigation may be to compensate shareholders, to make them whole for losses suffered at the hands of the corporation and its managers. Alternately, the purpose of shareholder litigation may be to deter bad acts in the first place, to create incentives for corporations and managers to avoid claims. The perspective we choose on this question will have important implications for our policy analysis. So, which is it, compensation or deterrence?

Compensation or Deterrence?

Like other forms of civil litigation, shareholder litigation may be supported by either of two public policy justifications: compensation or deterrence.[4] According to the compensation rationale, shareholder litigation

is meant to make shareholders whole for losses they suffer at the hands of the corporation and its managers. Alternately, according to the deterrence rationale, shareholder litigation is meant to create incentives for the corporation and its managers to prevent conduct leading to certain kinds of loss. These two rationales are independent—the success or failure of one does not depend upon the other—so one or both or neither may in fact apply to justify shareholder litigation. Let us take a moment to examine each, starting with the compensation rationale.

Although the compensation rationale makes a great deal of intuitive sense, an emerging consensus among most corporate and securities law scholars rejects compensation as a justification for shareholder litigation.[5] Three forceful critiques of the compensation rationale compel this conclusion. First, shareholder litigation often involves mere "pocket shifting" since many plaintiffs are also shareholders of the corporate defendant and the corporate defendant, directly or indirectly, funds most settlements. Second and related, over time, diversified shareholders generally will not benefit from the most common form of shareholder litigation—the prototypical 10b-5 class action involving a nontrading corporation and alleging fraud on the market—because the plaintiffs' losses will be offset by gains to other groups of investors, which may, in the long run, include the plaintiffs themselves. Third, most shareholder litigation recovers only a small fraction of total shareholder loss and does so at very high transaction costs, suggesting that it is at best a very inefficient means of providing compensation for investors who have been harmed.

The first critique—that settlements and damages paid in shareholder litigation typically amount to pocket shifting and are therefore of no economic value—focuses on the fact that many plaintiffs are also shareholders. This is so in the context of many securities law claims, especially those for which the plaintiff class consists of those who purchased shares at a price allegedly inflated by fraud and who remain shareholders through the bringing of the suit. But it also applies to those 10b-5 claims for which the plaintiff class consists of those who sold shares at an allegedly deflated price as long as the plaintiffs do not sell all of their shares and thus remain invested in the corporate defendant, as will often be the case for fund holders and other long-term diversified shareholders. In these cases, the plaintiffs are essentially suing themselves and, if they "win," merely moving dollars from one pocket to another, minus very substantial litigation costs.

The pocket-shifting critique applies not only to many securities claims but also to many state corporate law claims, especially derivative suits for damages. In fact, as we shall describe in greater detail in chapter 2, state

law forbids indemnification of derivative suit settlements precisely because of pocket-shifting concerns (since the indemnification would essentially amount to a payment from the corporation to make whole a manager defendant who had just paid a settlement to the corporation). Nevertheless, as we shall see, state law permits such settlements to be insured, and, as a result, corporations now fund the settlements indirectly (through the insurance premium), even if they cannot fund them directly (through indemnification). This kind of circular wealth transfer is pocket shifting in the extreme. It is the type of transaction from which no one benefits, at least in compensation terms, except perhaps attorneys, who, on the plaintiff's side, receive a portion of the settlement and, on the defendant's side, receive hourly fees. From the actual plaintiff's perspective, however, this is not a good deal. Plaintiffs clearly do not benefit from compensation when they effectively pay it themselves minus whatever portion they pay out in attorneys' fees and other costs.

The second critique—that there is no real economic gain to diversified shareholders from being compensated for their losses in a typical 10b-5 claim—turns on the law of large numbers and the likelihood that, over time, a diversified shareholder will gain as often as he or she loses from mispricing in the market. All market transactions, obviously, involve buyers and sellers. Sometimes buyers will gain from mispricing due to faulty corporate disclosure—specifically, when the disclosure has the effect of unjustifiably deflating securities prices at the time of their purchase—and sometimes sellers will gain—that is, when the disclosure has the effect of unjustifiably inflating securities prices at the time of their sale. Over time, however, diversified investors are as likely to be on one side of the transaction as on the other, and their losses from some mispricing are likely to be offset by their gains in others. Systematically, therefore, they lose nothing at all under the facts of a typical 10b-5 claim. And, of course, if nothing at all is lost, then there is nothing at all to compensate. A diversified shareholder thus would not favor a rule that, in the words of two eminent commentators, "force[d] his winning half to compensate his losing half over and over."[6] Moreover, when the compensation system is as costly as the system of shareholder litigation in fact is—involving large payments to attorneys and other professionals on both sides, costs that from the perspective of a diversified shareholder are pure waste (unless there is a deterrent benefit, which we address separately)—rational investors would clearly prefer to forgo such compensation altogether.

Finally, the third critique—that the compensation offered by shareholder litigation is inefficient and wasteful because it returns a very small

portion of shareholder losses at very high transaction costs—focuses directly on the costs and benefits of the current system from a compensation perspective. Settlement values in 10b-5 claims are a tiny fraction of investor loss. In 2008, the median settlement was only 2.7 percent of total investor loss, a percentage that has been fairly consistent for a number of years—2.3 percent in 2007, 2.2 percent in 2006, and 3.2 percent in 2005.[7] The obvious implication of these statistics is that investors are not well compensated for their losses. If we imagine that shareholder litigation makes investors whole for market losses surrounding a corporate misrepresentation, then that is just what we are doing—imagining it. Shareholder litigation, in fact, compensates only pennies on the dollar of total investment loss (although, as we describe in chapter 8, investor loss is at best a crude proxy for losses from securities fraud). Moreover, the transaction costs associated with this compensation scheme—the plaintiffs' attorneys' commission and the defense lawyers' hourly rates—further reduce the benefit ultimately received by shareholders. Simply stated, the system is so costly and inefficient that it is difficult to believe that it provides meaningful compensation to investors.

As forceful as each of these critiques is on its own, taking all three of them together effectively destroys the compensation rationale as a justification for most shareholder litigation. We say "most" here because each of these critiques applies most clearly to the most common form of shareholder litigation—the prototypical 10b-5 claim. They do not apply as well to securities claims involving market manipulation or insider trading, but, as we describe in chapter 2, the vast majority of class actions under the federal securities laws do indeed center on what we are calling the prototypical 10b-5 claim—involving, essentially, a nontrading corporate defendant and allegations of fraud on the market. These critiques thus speak to the vast majority of securities claims. Moreover, they apply with equal force to much state corporate law litigation, especially the typical shareholder derivative suit. However, direct shareholder actions under state law, especially those challenging the fairness of corporate acquisitions and seeking additional compensation in the transaction, are not affected by these critiques and therefore may offer the best case for the applicability of the compensation rationale. We will therefore treat this type of claim as an exception to the rule that the compensation rationale does not supply a credible justification for shareholder claims. Nevertheless, having effectively dispensed with compensation as a possible justification for the bulk of shareholder litigation, we are left with the deterrence rationale,

for which there is considerably more support, both within the academic literature and in the courts.

Deterrence works when a prospective wrongdoer, recognizing that he or she will be forced to pay the full cost of any harm he or she causes (and more, perhaps, to account for a less than perfect likelihood of detection), therefore forswears the harmful conduct.[8] Widely recognized as a basic purpose of much civil litigation, deterrence essentially makes plaintiffs—or more accurately, plaintiffs' lawyers—into private attorneys general who serve a public purpose in bringing private claims. Each acts on the basis of his or her private incentives by bringing claims but in doing so creates a public good—namely, the *in terrorem* effect, basically inducing potential defendants to be good in order to avoid the liabilities associated with being bad. The deterrence justification for shareholder litigation thus focuses on the value it creates by preventing corporate managers from engaging in conduct leading to investor loss. The deterrence rationale is not without controversy, with much of the academic debate focusing on the incentives of the plaintiffs' attorneys and the related question of whether the deterrence effect of shareholder litigation is set at the optimal level or whether there is too much deterrence or not enough.[9] Deterrence is nevertheless widely accepted as the fundamental purpose of shareholder litigation by courts and commentators alike. The U.S. Supreme Court, for example, has long viewed the deterrence effect of private shareholder litigation as "a necessary supplement to [Securities and Exchange] Commission action."[10]

The deterrence function of shareholder litigation connects it to corporate governance. "Corporate governance" is a broad concept that much of the legal literature has given a narrow definition. Scholars discuss it most often in the context of specific regulatory reforms or in terms of charter provisions and other structural characteristics of firms. But corporate governance may refer more broadly to any system of incentives and constraints operating within a firm. Corporate governance is designed to constrain bad acts on the part of corporations and their managers. Insofar as these are the same acts that will lead to liability in shareholder litigation, corporate governance and shareholder litigation pursue similar ends—both seek to make managers better serve the interests of their shareholders. Good corporate governance ought to lead to less shareholder litigation, and the risk of shareholder litigation ought to lead prospective defendants to improve their corporate governance.

If we are thus to take deterrence as the basic rationale behind shareholder litigation, supplying it with its underlying purpose and justifying its

existence, we are left primarily with questions about how well shareholder litigation in fact accomplishes the end of deterrence. If shareholder litigation systematically fails to deter, it would fail to accomplish its underlying purpose and would have no reason to exist. Indeed, if shareholder litigation fails to deter, radical reform would seem to be appropriate, either to correct the defects of shareholder litigation or to abolish it altogether. These possibilities are presented most starkly when the underlying risks are covered by insurance.

Introducing Insurance

D&O insurance funds shareholder litigation. Almost every publicly traded corporation in the United States purchases D&O insurance to cover the risk of shareholder litigation.[11] And most shareholder litigation settles within the limits of these policies. D&O insurance transfers shareholder litigation risk away from individual directors and officers and the corporations they manage to third-party insurers.

This risk transfer is not complete. There have been approximately twenty so-called mega settlements over the past ten years that have significantly exceeded the value of existing D&O insurance policies, and there have been more cases in which corporate defendants paid a significant amount of corporate funds on top of the available insurance. It is difficult to know precisely how often or how much corporate defendants contribute to settlement because corporations are required to disclose neither D&O insurance limits nor how settlements are funded. Nevertheless, using the information on class action settlements available at the Stanford Class Action Clearinghouse Web site, we estimate that approximately 15 percent of class action settlements include a payment by the defendant in addition to the available insurance. In most of these cases, the amount of the corporation's contribution was substantially less than the amount paid by the corporation's D&O insurers, and, in some cases, the payment may have been part of satisfying an insurance deductible.[12] Michael Klausner and Jason Hegland, who run the Clearinghouse, recently looked carefully at a sample of cases in their database and concluded that corporations paid more frequently in their sample than we estimate, but they concluded, nevertheless, that "corporations' payments into settlements, on average, constitute relatively small portions of total settlements."[13] Thus, as far as we can tell on the basis of publicly available information, the risk

transfer from the insured to the insurer is not quite complete, but it is very nearly so.

This creates a problem for deterrence. With liability risk transferred to a third-party insurer, prospective defendants are no longer forced to internalize the full cost of their actions. With little or nothing at risk, in other words, they are unlikely to be deterred from the sorts of actions that may lead to shareholder litigation. Worse, once the reins of deterrence are loosened, prospective defendants may be more likely to engage in conduct leading to losses, thus creating a moral hazard problem in which the effect of insurance, paradoxically, is to increase loss. This is the insurance-deterrence trade-off analyzed so elegantly in economists' formal models, explored empirically in connection with personal injury litigation, and largely ignored in corporate and securities law scholarship.[14]

Even from the perspective of compensation, D&O insurance is problematic. D&O insurance serves to guarantee investors that they will be compensated for losses stemming from shareholder litigation. But if D&O insurance merely performs this compensatory function, then it is not a good investment from the shareholders' perspective, because the price of an insurance contract is always greater than the expected payout under the contract—insurance companies, after all, do not sell their products for free. And the same protection against loss could be obtained by shareholders for free (or very nearly so) simply by holding a diversified portfolio of investments, since the effect of diversification is essentially to cancel the risk of unexpected events (like shareholder litigation) that is associated with any one holding. Because diversification provides shareholders with essentially the same protection against loss as insurance and does so at a lower cost, rationalizing D&O insurance from the compensation perspective turns out to be as problematic as justifying shareholder litigation on the basis of the compensation rationale.

Insurance thus poses a challenge to the aims and ends of shareholder litigation. Indeed, to the extent that insurance weakens deterrence, it undermines the basic justification for shareholder litigation. Nevertheless, it would be leaping to conclusions to assume, without more, either that insurance necessarily destroys the basic rationale of shareholder litigation or that the purchase of D&O insurance cannot be justified. Insurers, after all, have both the incentive and the influence to design mechanisms to control the risk of loss, and in seeking to control their own losses under the policy, insurers may reintroduce the deterrence function of shareholder litigation. Our basic question then is, Do they? What do insurers do to