# WHO CARES?

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Jim Cox and Randall Thomas have identified an interesting phenomenon in their contribution to this symposium: institutional investors seem to be systematically "leaving money on the table" in securities fraud class actions.[1] For someone who approaches legal questions from an economic perspective, the initial response to this claim is disbelief. As the joke goes, economists do not bend over to pick up twenty-dollar bills on the street. The economist knows that the twenty dollars must be an illusion. In a world of rational actors, someone else already would have picked up that twenty-dollar bill, so the effort spent bending over would be a waste. But Cox and Thomas provide persuasive evidence that the overwhelming majority of institutional investors cannot be bothered to file claims that would allow them to recover their share of the settlement in securities class actions.

Should we care that institutional investors do not care? Cox and Thomas also make a persuasive case that institutional managers who fail to file claims in settled securities class actions are violating their fiduciary duties. Filing a claim is a purely ministerial task. Even if the settlement is modest, the return from filing the claim is likely to far exceed the costs. My wife spends more time filling out sweepstakes entries with much smaller expected values.

Less clear, however, is whether the investors in these institutions should care that their fiduciaries are not making claims. Money managers may be violating their fiduciary duties by leaving money on the table. How much money is another question. Cox and Thomas suggest that there is a "tremendous amount of money available in these settlements," (estimated at $8.39 billion over the past three years).[2] To you or me, $8.39 billion might seem like real money, but before we start filing derivative claims alleging waste, we should take a closer look at this number. Relative to the amount of money that these institutions manage, $8.39 billion may not be all that significant. In the year 2000, insurance companies, public and private pension funds, and mutual funds managed $16 trillion.[3] If we make the ballpark assumptions that institutions are entitled to half of the class action settlements, and three-quarters of the institutions are not filing claims, then those non-filing institutions are leaving $1.05 billion on the table per year—a

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1. James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fail to File Claims in Securities Class Actions?*, 80:3 WASH. U. L.Q. 855 (2002).

2. *Id.* at 871.

3. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, tbl.1163 (2001).

staggering *0.087%* of assets under management. Perhaps I am slightly understating the amounts available under class action settlements, but I think that most people—including the institutions ignoring class action settlements—would consider 0.087% to be in the range of a rounding error. It seems unlikely that such a small percentage would make a difference in the competition to attract investors. Perhaps money managers have more important things to worry about. For example, money managers may spend their time investigating companies so as to avoid investing in fraudulent firms.

Perhaps policymakers should have other concerns as well. The apparent sloppiness of institutional practices in preserving trust assets, for example, offends most people's sense of order and good stewardship. But from a societal perspective, the money that one institution leaves on the table simply goes to another institution. The second institution takes the trouble to file a claim, while the first cannot be bothered. Surely there is no unjust enrichment in this situation. The money is not returned to the defendants. It is difficult to see any important misallocation of resources—just sloppiness.

The mathematical exercise above does, however, suggest a point that is far from trivial: the compensation provided to defrauded investors by securities class actions has a negligible effect on investment returns. No reasonable investor considering where to allocate his savings (real estate, bank accounts, bonds, stocks, etc.) would take into account the availability of class action settlements. One of the principal arguments of defenders of securities fraud class actions—that they provide important compensation to defrauded investors[4]—is impossible to square with the available evidence. Cox and Thomas's empirical finding confirms the theoretical intuition that investors seeking to protect themselves from fraud do so through diversification, not lawsuits.[5] If they are correct, the sums paid out in securities class actions are so trivial that the most sophisticated investors can not be bothered to spend the time necessary to fill out and mail a claim form. Securities class actions cannot be justified as providing compensation.

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4. Arthur Levitt, Chairman U.S. Securities and Exchange Commission, Testimony Before the Subcommittee on Telecommunications and Finance Committee on Commerce United States House of Representatives Concerning Litigation Reform Proposals, February 10, 1995, at 1 (arguing that class actions "serv[e] as the primary vehicle for compensating defrauded investors") (available at www.sec.gov/news/testimony/testarchive/1995/spch025.txt).

5. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Monitors*, 85 VA. L. REV. 925 (1999).

If compensation is not important, deterrence should animate our securities fraud class action regime. Shifting our focus to deterrence might cause us to rethink the features of the current regime. Two aspects of the current regime come readily to mind: the measure of damages and vicarious liability. Both are driven by the goal of compensation and they work together to undermine deterrence.

In the typical securities fraud class action damages are measured by the difference between the price paid by the victim and the security's "true" value.[6] In the typical case, however, the losses to the victims of fraud on the market are entirely offset by the gains to individuals on the other side of the trade.[7] The damages measure provides no offset for those windfall gains. Consequently, the measure of damages in fraud-on-the-market cases can be enormous for a security in which there is active trading. Given this downside risk, settlement looks like an attractive option for the defendant company, even when it believes its prospects of prevailing are good.[8] Defendants' inclination to settle gives plaintiffs' lawyers an incentive to file even weak cases.[9] Thus, the enormous damages measures available in securities fraud class actions result in very imprecise sanctioning. If both strong and weak cases lead to settlements, the deterrent effect of class actions is likely to be muted at best.

Corporations' risk aversion is fueled by agency costs. Plaintiffs' lawyers generally sue the corporation's officers as well as the firm itself. This seems entirely reasonable, given that the most substantial motivations for securities fraud involve corporate managers' misstatements that benefit the managers rather than the corporation.[10] But the litigation process provides no check on continued self-dealing by the managers. Facing personal liability that could bankrupt even the wealthiest of individuals, corporate officers are

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6. *See* Sirota v. Solitron Devices, Inc., 673 F.2d 566 (2d Cir. 1982) (allowing recovery of the difference between price paid and security's "true value").

7. This ignores gains made by insiders selling on the basis of the fraud. These gains are likely to be small, however, relative to the overall damages claimed by the class. Moreover, as noted below, the current regime does nothing to induce insiders to disgorge these gains.

8. *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1511 (1996) ("The class-based compensatory damages regime in theory imposes remedies that are so catastrophically large that defendants are unwilling to go to trial even if they believe the chance of being found liable is small.").

9. On the subject of incentives to bring non-meritorious cases, see Lucian Ayre Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437 (1988); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3 (1990); David Rosenberg & Steven A. Shavell, *A Model in Which Suits Are Brought for their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985).

10. *See* Pritchard, *supra* note 5.

understandably reluctant to go to trial.[11] As a result, settlements are nearly universal. Of equal importance, settlements allow the officers to avoid a finding of intentional wrongdoing.[12] Without such a finding, the directors' and officers' insurer will be compelled to pay the claim.[13] By contrast, individual corporate officers found liable for a fraud judgment would have a hard time shifting that liability to the corporation.[14] As a result of the universal practice of settlement, officers and directors are usually able to walk away without paying anything.[15] Directors' and officers' insurance pays a portion of settlements, with the corporation paying the remainder.[16]

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11. *See* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1015 (1996) ("Individual defendants in class action suits were particularly risk averse and prone to settle. For them, going to trial, even with a strong defense, ran the risk, however slight, of a personally ruinous damage award.").

12. *See* Raychem Corp. v. Federal Ins. Co., 853 F. Supp. 1170, 1177 (N.D. Cal. 1994) (holding that indemnification for settlement costs of 10b-5 action was permissible).

13. *See* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55, 57 (1991) ("Policies routinely exempt losses from adjudication of dishonesty, but if a claim is settled, courts prohibit insurers from seeking an adjudication of guilt and thereby avoiding the claim's payment.").

Directors and Officers (D&O) insurance pays for settlements because a refusal to pay could expose the insurer to potential liability for bad faith refusal to settle. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Fraud Class Actions*, 43 STANFORD L. REV. 497, 533 (1991) ("The insurer cannot lightly refuse to fund a settlement because it could be subject to a claim for bad faith refusal to settle, which could make it liable for the entire amount of any eventual judgment, without regard to the policy limits."); *see also id.* at 560-66 (discussing insurers incentives to settle).

14. A fraud *judgment* is outside the coverage of most directors and officers (D&O) insurance policies. Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. L. & ECON. 115, 117 (1990) ("[L]iability insurance does not cover obvious conflicts of interest, willful misconduct, or acts the accused should have known were illegal."). *See also* Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 598-99 (1996) (excerpting typical provisions from D&O policies). Moreover, intentional wrongdoing is also likely to be beyond the corporation's indemnification authority in most states. *See, e.g.*, 8 DEL. CODE ANN. §145 (1993). The Securities and Exchange Commission also takes the position that indemnification for securities fraud violations is void as against public policy. *See, e.g.,* 17 C.F.R. § 229.512(h)(3). *See also* Eichenholtz v. Brennan, 52 F.3d 478, 483 (3d Cir. 1995) (stating that indemnification "runs counter to the policies underlying the 1933 and 1934 Acts").

15. James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997) ("[R]esponsible officers and directors only rarely contribute to the recovery."); *see also* Sherrie R. Savett, *The Merits Matter Most and Observations on a Changing Landscape Under the Private Securities Litigation Reform Act of 1995*, 39 ARIZ. L. REV. 525, 527 (1997) ("Plaintiffs' counsel will often settle with officer and director defendants who are usually the most culpable defendants within policy limits because there is little incentive to refuse a bird in hand and go outside policy limits.").

16. *See* Savett, *supra* note 15, at 527 ("Where the corporate defendant is solvent, in most instances it contributes to a settlement anywhere from 10-50% of the ultimate amount agreed to, usually at the insistence of the insurance carrier.").

The settlement process therefore leaves us with a scheme of exclusively vicarious corporate liability. The revelation of the fraud and subsequent lawsuit may lead to the firing of the offending manager in a small percentage of cases, but that sanction is simply the adverse outcome that the manager sought to avoid. If termination is the only sanction, and that sanction is applied in only a percentage of cases, fraud may still be a gamble worth taking for the corporate manager—she would likely find herself out of work, even if she did not commit the fraud. Likewise, if insider trading was the motivation for the misstatement, a settlement paid by the corporation would do nothing to disgorge the insider's ill-gotten gains. Failing to sanction the wrongdoers responsible for the fraud means that the threat of a class action lawsuit does little to deter those wrongdoers, thus substantially undermining the deterrent value of such suits.

We could do better with a class action regime that focused on deterrence rather than compensation. Instead of a compensation-based damages measure, we could use a damages measure premised on unjust enrichment.[17] Managers who distort stock prices in order to manipulate a stock price-based compensation scheme would be forced to disgorge the excess gains; insider traders would be forced to give up their profits.[18] Because the potential recovery would be modest, it could be made uninsurable and unindemnifiable without discouraging individuals from serving as corporate officers and directors.[19] In a scheme properly focused on deterrence, the corporation's "deep pocket" is no longer needed to assure a viable funding source for a judgment. If the company actually benefitted from the fraud, it could be forced to disgorge its benefits as well; if it did not, it should not be a party to the suit. If we eliminate the corporation altogether as a defendant, we greatly reduce the ability of managers to shift sanctions from themselves to the corporation.

So it turns out that we should care that institutional investors do not care enough to file claims in securities fraud class actions. The theoretical case for compensation in cases of open-market fraud has been under attack for a long time. If we add to that theoretical weakness the fact that a substantial

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17. The Supreme Court left open the question of damages when it recognized the fraud-on-the-market class action in *Basic, Inc. v. Levinson*. 485 U.S. 224, 248 n.28 (1988).

18. *See* Alexander, *supra* note 8, at 1515 (advocating "the disgorgement of any benefits defendants received from the violation, such as proceeds from any transactions they engaged in during the period of nondisclosure, increases in the value of stock options, or other compensation tied to the misleading statements or to the stock price during the period of nondisclosure").

19. Alexander, *supra* note 8, at 1512 ("A relatively small penalty to be paid personally (and by law made uninsurable and not indemnifiable) could have a larger deterrent effect on individuals than a much larger compensatory judgment to be paid by the corporation and its insurers.").

percentage of investors cannot be bothered to make claims, the case against compensation becomes overwhelming.

The question of compensation versus deterrence is not a purely academic one. Post-Enron, Congress is considering a variety of bills that would roll back the limitations imposed by the Private Securities Litigation Reform Act[20] and expand the ability of investors to recover their losses through securities class actions.[21] Legislators would do well to assess any such reform proposals against the standard of deterrence. Reforms geared toward enhancing compensation should be left on the table.

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20. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of volume fifteen of the United States Code).

21. *See* Abner J. Mikva, *Share and Shares Alike*, LEGAL TIMES, Apr. 8, 2002, at 50 (calling for repeal of the PSLRA).