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Citation: 105 Nw. U. L. Rev. 1679 2011

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This work was originally published in
105 Nw. U. L. Rev. 1679 2011

Essays

INTRAPORTFOLIO LITIGATION

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INTRODUCTION

In today's economy, public corporations are increasingly owned by diversified shareholders. Yet these corporations continue to sue each other all the time for breach of contract, patent infringement, theft of trade secrets, and myriad other legal wrongs. Such lawsuits—in which diversified shareholders essentially sue themselves—call into question the standard academic theories of corporate liability. Those theories posit that corporate liability serves to compensate victims and—by forcing shareholders to bear the costs of their agents' actions—to deter wrongdoing. But the compensation rationale fails when those being compensated are also paying the damages. And the deterrence rationale fails when the owners of the injurer also own the victim, because then the injurer's shareholders internalize the costs of their agents' actions regardless of whether a lawsuit is brought.

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** Associate Professor of Law, Fordham University School of Law. For helpful comments, we would like to thank Margaret Blair, Stephen Choi, Paul Edelman, Merritt Fox, Michael Klausner, Evan Lee, Susan Morse, Jason Rantanen, Jeffrey Schoenblum, Randall Thomas, William Wang, and participants in workshops at Vanderbilt University Law School, New York University School of Law, and Hastings College of the Law. We would like to dedicate this Essay to the memory of Richard Nagareda, who gave the project early encouragement. He is sorely missed.

The puzzle of self-suing shareholders was first noticed in the context of “fraud-on-the-market” class actions, in which shareholders try to collect damages from their corporation for allegedly false statements by managers. Critics argue that these lawsuits merely shift wealth from one shareholder pocket to another, minus a hefty attorneys’ fee. Randall Thomas and James Cox have countered this circularity critique with a *reductio ad absurdum*, arguing that the same point could be made about any lawsuit between companies owned by diversified shareholders.¹ And yet, Thomas and Cox assert, such firm-on-firm lawsuits must be socially valuable, albeit for reasons they do not specify.²

In this Essay, we introduce a new theory of corporate liability—called the “informational” theory—that seeks to explain why litigation between publicly traded firms can in fact be socially valuable even when those firms are owned by the same shareholders. We posit that such litigation makes sense not in conventional terms of compensation and deterrence, but rather in terms of the principal–agent conflict between diversified shareholders and undiversified managers. In short, we show how “intraportfolio litigation”—in which one firm in a diversified shareholder’s portfolio sues another—can serve as a corporate governance tool. Intraportfolio litigation can improve the quality of firm-specific financial data, making earnings reports and stock prices better measures of the contribution of each firm’s managers to overall portfolio value.

Our argument that intraportfolio lawsuits can make managers better agents is related to the standard deterrence rationale for corporate liability, except that we invert the normal way of thinking about means and incentives. Existing theories of corporate liability assume that shareholders have the means to discipline corporate agents but lack the incentive to do so when the agents injure third parties. Under this account, corporate liability supplies the missing incentive by forcing the shareholders, within the confines of limited corporate liability, to bear the costs of their agents’ actions.

With respect to intraportfolio litigation, we make the reverse claim. Diversified shareholders already have the incentive to prevent their agents from imposing excessive costs on other corporations that the shareholders own. What diversified shareholders lack are cost-effective means to act on this incentive. Information deficits and collective action problems make it uneconomical for shareholders to police managers’ behavior directly. All the shareholders can do is encourage a manager to maximize her firm’s

¹ James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164, 177 (2009).

² *Id.* Thomas and Cox argue that lawsuits among diversified shareholders vindicate an “important principle,” though it is unclear whether this principle is something other than the simple right to sue. *Id.* In Part V we revisit their *reductio* in the light of the theory of corporate liability that we develop.

profits by, for example, tying her pay to the firm's stock price. But this motivational technique introduces a conflict of interest, as the manager could inflate her firm's reported profits through conduct that, by imposing costs on other public firms, diminishes the overall value of the shareholders' portfolio. Allowing the injured firm to collect damages from the injuring firm corrects the distortion that would otherwise appear in each firm's reported profits. Put another way, intraportfolio litigation makes it easier for shareholders to evaluate and motivate their agents, because it attributes costs that the shareholders already bear to the responsible corporate managers.

We believe that this informational theory places a conceptual foundation beneath a wide variety of civil lawsuits between public firms with potentially overlapping owners—including contract actions, and tort actions based on negligence or strict liability. There are limits, however, to how much self-suing activity the theory can salvage. In particular, we doubt it can justify the very category of lawsuits that started the circularity debate in the first place: the securities fraud class action. For one thing, the informational value of private securities lawsuits against public corporations is low, both because the calculation of damages in such cases overstates the actual injury to portfolio value, and because most corporate fraud is already revealed through other sources. In addition, securities fraud is likely to be well deterred by direct lawsuits against the responsible managers, making corporate liability unnecessary. In these ways securities fraud is different from other legal causes of action, which if directed solely against corporate agents would either underdeter them (because, for example, the responsible agents are judgment proof) or overdeter them (because the actionable conduct also confers benefits on shareholders that the agents do not internalize). We thus believe that the informational theory rebuts the Thomas and Cox *reductio ad absurdum*, as it provides a principled distinction between securities fraud class actions and other potentially circular intercorporate lawsuits.

This Essay has five Parts. Part I surveys the traditional scholarly justifications for corporate liability. Part II lays out the circularity critique of corporate liability in fraud-on-the-market class actions. Part III extends that critique to intercorporate litigation generally. Part IV explains how the informational theory might justify corporate liability even in lawsuits between firms owned by the same shareholders. Part V returns to the topic of fraud-on-the-market class actions, and examines whether these actions can be defended on informational grounds. In the Essay's conclusion, we extend its argument by briefly considering how a manager's decision to initiate an intraportfolio lawsuit can itself be a source of principal-agent conflict.

I. TRADITIONAL JUSTIFICATIONS OF CORPORATE LIABILITY

When a corporation is held liable for the acts of its agents, it is its shareholders—within the constraints of limited shareholder liability—who foot the bill. Corporate liability can arise through a variety of legal sources. Like other employers, corporations face respondeat superior liability, meaning that they are strictly liable for torts committed by their employees acting within the scope of their employment.³ Corporations can also be held liable for employee violations of statutes and regulations.⁴ And when a corporate agent causes the corporation to breach a contract, it is the corporation rather than the agent that the law holds accountable.⁵ Finally, corporations can voluntarily assume their employees' liability by promising to indemnify them or by purchasing liability insurance coverage on their behalf.⁶

Scholars have developed several theories to justify these forms of liability, which we will refer to collectively as instances of "corporate liability." The theories fall into two general categories, which we describe below.

A. Compensation

The most straightforward compensation rationales sound in notions of fairness.⁷ It is unfair, the argument goes, for a person to bear a loss that is someone else's fault. When that someone else is a corporate employee who was acting within the scope of his employment, it is fair that the corporation should be required to make the victim whole, at least to the extent that the relatively more culpable employee cannot. The employer defines the scope of employment and hence is responsible for placing the employee in a position to harm third parties.

Another compensation rationale identifies a risk-spreading or insurance benefit in shifting losses from third-party victims to corporations.⁸ The

³ RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006).

⁴ See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 696 & n.22 (observing that "most courts of appeal now hold that the common law doctrine of respondeat superior applies to securities fraud actions" brought pursuant to federal law, and collecting cases).

⁵ See Robert B. Thompson, *Unpacking Limited Liability: Direct and Vicarious Liability of Corporate Participants for Torts of the Enterprise*, 47 VAND. L. REV. 1, 7 (1994) ("An individual who signs a contract on behalf of the corporation is cloaked in the mantle of the enterprise and is not personally liable for action taken in the corporate name.")

⁶ See DEL. CODE ANN. tit. 8, § 145 (2010).

⁷ For a description and critical review of fairness justifications for enterprise liability, see Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1749–54 (1996).

⁸ For the classic treatment of this argument, see GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* 50–54 (1970). For a more recent discussion of the insurance

presumption is that corporations are more efficient risk bearers than the typical victim because they tend to have many shareholders⁹ and can more easily buy insurance. Forcing the corporation to compensate the victim spreads the loss from one person to many, which from a social perspective makes the loss less onerous.

B. Deterrence

By far the best developed justifications for corporate liability focus on its potential to increase social welfare by promoting the goal of optimal deterrence. A legal system promotes this goal when it forces actors to bear the full social costs of their conduct, thereby encouraging them to engage in the conduct only if the total costs of doing so are outweighed by the benefits.¹⁰ Deterrence arguments for corporate liability come in two varieties. The first contends that corporate liability is necessary to prevent underdeterrence in situations when employees are inadequately deterred by personal liability. The second maintains that corporate liability is necessary when employees might react too strongly to personal liability, refraining from activity that imposes costs on third parties but that is nonetheless socially worthwhile.

1. *Underdeterrence: The Lawsuit-Resistant Employee.*—It is natural to assume that people without money will not heed the threat of monetary sanctions. These so-called “judgment-proof” defendants are the most widely cited justification for corporate liability.¹¹ The argument is straightforward: since many employees are judgment proof, holding employers liable for employee conduct enhances deterrence by encouraging

justification for litigation generally, see Brian T. Fitzpatrick, *Do Class Action Lawyers Make Too Little?*, 158 U. PA. L. REV. 2043, 2060–61 (2010).

⁹ See Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705, 1707 (1996).

¹⁰ This result may be achieved if the law attaches a monetary sanction to behavior equal to its social costs multiplied by the inverse of the probability that the sanction will be imposed, assuming well-informed, risk-neutral, rational actors. See STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 483 (2004) (“Thus, if the harm is 100 and the probability of sanctions is 50 percent, the sanction should be multiplied by $1/.5 = 2$, so the sanction should equal 200 (and thus the expected sanction would equal 100) . . .”). On the other hand, society may deem the utility derived from certain categories of activities to be illegitimate; the goal of sanctions targeted at such activities would be to deter them altogether rather than to encourage would-be perpetrators to weigh social costs against personal benefits.

¹¹ See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 188–90 (7th ed. 2007); Arlen & Carney, *supra* note 4, at 707; Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168, 168 (1981). Even a sanction that a person cannot fully pay should deter him so long as the expected amount of liability he can pay is greater than the benefit he would derive from the proscribed behavior. Thus, the problem of judgment-proof defendants is particularly likely to undermine deterrence with respect to people who are poor *or* who have a great deal to gain from the sanctionable conduct. See, e.g., Arlen & Carney, *supra* note 4, at 703 (hypothesizing that corporate officers are most likely to commit securities fraud when they perceive it as necessary to preserve their jobs and their personal wealth that is tied to the value of their firm’s stock).

the employers to take measures that limit the costs their employees impose on third parties.¹² An employer might screen applicants for their propensity to take care, monitor employee conduct on the job, modify production processes to reduce the likelihood of harm, or use pay and promotions to reward prudence and punish recklessness.¹³ The employer also might reduce activity levels to decrease the risk that its operations or products will cause harm.¹⁴ In the absence of liability, the argument goes, employers would lack incentive to invest in socially desirable deterrence efforts or to scale back production to efficient levels. Indeed, employers might *encourage* employee conduct that generates social costs in excess of social benefits, so long as those costs are externalized to third parties.¹⁵

There are reasons beyond a lack of personal wealth why personal liability for employees might be an inadequate deterrent. In some situations it may be impossible for victims to discover or prove which particular employees within a firm caused their injuries.¹⁶ To the extent they know of this possibility, employees will discount the risk of personal liability

¹² Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345, 1362–63 (1982).

¹³ For discussions of these methods, see Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 702–03, 706 (1997); Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 569–70 (1988) [hereinafter Sykes I]; Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231, 1255–56 (1984) [hereinafter Sykes II]. On the other hand, there may be situations where the employer can do nothing to affect employee behavior, such as when the behavior is difficult to observe and the employee has no interest in maintaining a long-term employment relationship. See Sykes II, *supra*, at 1247–52. In these situations, respondeat superior liability might lead to *worse* behavior by employees. See Sykes I, *supra*, at 570. Respondeat superior liability also may undermine deterrence if employer efforts to deter employee misconduct increase the probability that the employee's misconduct will be detected and hence expose the employer to a greater risk of sanction. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 842–43 (1994).

¹⁴ The possibility that employers will adjust activity levels is a commonly cited reason why vicarious liability is strict. See Sykes II, *supra* note 13, at 569. If such liability instead were duty-based, employers might escape liability on grounds that they had invested in all cost-justified precautions, even though the employer was producing at levels at which the marginal social value of output was less than its marginal social costs. This argument for strict liability assumes that courts would not take production levels into account when evaluating the employer's standard of care. See SHAVELL, *supra* note 10, at 198.

¹⁵ See, e.g., Sykes II, *supra* note 13, at 1241–42. This hazard is most likely to arise when the victims do not have a contractual relationship with the employer. If they do—for example, if they are customers or other employees of the firm—and if they have accurate information about the risks posed by the firm's operations, then demand for the firm's output will fall or its labor costs will rise, causing the firm to internalize the expected social costs of its employees' conduct. SHAVELL, *supra* note 10, at 213.

¹⁶ See Kornhauser, *supra* note 12, at 1350 (explaining that placing liability on the employee alone may result in too many accidents because injuries may “result from a complicated combination of acts by various agents” that courts cannot untangle, thus allowing “many agents [to] escape liability because the plaintiff cannot prove a particular agent was at fault”).

accordingly. Placing liability on the employer might then be efficient because the employer might take steps to prevent the injury from occurring in the first place.¹⁷ Alternatively, employees might systematically underestimate liability risk in a way that employers do not. This might occur because the employees have less information than employers or are more susceptible to behavioral biases.¹⁸ In such situations, holding employers liable will increase deterrence toward efficient levels.¹⁹

2. *Overdeterrence: The Lawsuit-Overreactive Employee.*—While some employees will underreact to personal liability, others will overreact. And this too can be a justification for corporate liability. Overreaction to liability can be a problem because some business activities impose costs on third parties but nonetheless create social wealth. Factories that make valuable products may pollute neighboring farmland. Contract breaches are sometimes efficient even though the counterparty suffers a reliance cost. When an employee decides, on his employer's behalf, to build a factory or breach a contract, most of the benefit goes to the employer in the form of higher profits. This means that if the employee is held personally liable for the costs of such decisions, he will face an asymmetric payoff function: the expected cost of the decision *to him* might be greater than his expected personal gain even though the decision creates wealth for society as a whole. The employee will therefore be overdeterred.²⁰ In the case of the factory, he might spend more employer resources on pollution scrubbers than is justified, or he might refuse to build the factory at all. In the case of

¹⁷ See *id.* at 1370. For liability against the employer to be justified on this basis, the plaintiff must, as a legal matter, be able to hold the employer liable despite the plaintiff's inability to hold anyone within the firm individually responsible. This will not always be the case. For example, in securities fraud litigation, courts have rejected the notion of "collective scienter," instead requiring plaintiffs to plead and prove that specific individuals acted with the requisite intent. See, e.g., *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008) (internal quotation marks omitted) (citing Brief of Appellant at 17); *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008); see also Schwartz, *supra* note 7, at 1756 (identifying other weaknesses with this rationale).

¹⁸ See Croley, *supra* note 9, at 1733–37; Kornhauser, *supra* note 12, at 1373.

¹⁹ In addition to the deterrence measures available to employers that we have already discussed, employers also might try to avoid liability by educating employees about true risk levels. See, e.g., Croley, *supra* note 9, at 1731. Importantly, the notion that vicarious liability will promote deterrence in this context assumes that employers would be unable to shift the expected liability back onto employees through indemnity actions, compensation practices, or otherwise. See Arlen & Kraakman, *supra* note 13, at 852 (explaining that if corporations can shift liability back to employees without cost, "they will not treat this liability as a cost, and thus vicarious liability will not induce firms to incur enforcement expenditures"). Shifting liability back to employees may be infeasible due to transaction costs or because the employees are judgment proof.

²⁰ See Bruce Chapman, *Corporate Tort Liability and the Problem of Overcompliance*, 69 S. CAL. L. REV. 1679, 1693 (1996) (observing that employees whom employers cannot cheaply monitor may "overcomply" with legal standards when they face personal liability but can pass compliance costs on to their employer).

the contract, he might refuse to order a breach even though complying with the contract is, from a social perspective, no longer worthwhile.

A second reason that personal liability might overdeter applies with particular force to corporate agents. Legal liability is fraught with chance. The whims of judges and juries, the happenstance of accidents, and the natural limits of human self-control mean that even conscientious employees cannot fully predetermine their future liability. This uncertainty increases the deterrent effect of personal liability for employees who are risk averse, as most are.²¹ Shareholders are naturally risk averse too, but they can reduce much of their firm-specific risk by holding a diversified investment portfolio.²² This means that, as a structural matter, diversified shareholders will be less risk averse than their agents with respect to liability for harms those agents cause. From their perspective, corporate agents who face personal liability may therefore give too much weight to liability risk when making decisions on the corporation's behalf.

To overcome this overdeterrence problem, shareholders may want to shield their agents from personal liability. We see here a justification for the common law rule whereby an agent who causes his principal to breach a contract is not held liable to the principal's counterparty. And for those areas of law in which employees are held liable, such as tort law, employers often agree to shield them contractually.²³ For example, Delaware corporations are allowed to indemnify their managers and other employees against personal liability so long as the agent was honestly seeking to advance the corporation's interests.²⁴

Once, however, the employee is shielded from liability, he will be lawsuit-resistant, much like someone who lacks personal wealth and thus has nothing to lose in a civil suit. The employee might then cause his firm to underinvest in pollution-reducing technologies or to breach contracts whenever there is some personal advantage in doing so. For such an employee, the underdeterrence justification for employer liability reemerges. If the employer is held liable, then she (or, if a firm, its owners) will have the incentive to utilize the various means at an employer's

²¹ See, e.g., SHAVELL, *supra* note 10, at 225 (observing that uncertainty in the negligence determination can cause risk-averse parties to be excessively careful).

²² See Sykes II, *supra* note 13, at 1235-36 (offering reasons why employers are likely to be less risk averse than employees).

²³ As an alternative to indemnification, an employer could purchase liability insurance on the employee's behalf. See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 865 (1984). Insurers are better risk-bearers than employers when the employer is not owned by numerous diversified shareholders or is small enough that its liability risk could render it insolvent and thereby generate the costs of financial distress.

²⁴ DEL. CODE ANN. tit. 8, § 145(a)-(b) (2010).

disposal to prevent employees from engaging in socially wasteful conduct.²⁵ When the employer indemnifies the employee, this transfer of liability happens automatically. But even when no indemnification agreement is in place, the employer may be held liable as a formal legal matter, either directly (as in breach of contract cases) or vicariously (as in tort and criminal cases). In either situation, the employer internalizes the costs of the employee's conduct. And because the employer also typically receives the benefits of that conduct, she will be more likely to strike the wealth-maximizing balance between encouraging employees to engage in productive activity and preventing them from injuring third parties.

It is interesting to note that the two categories of employee we have described—the lawsuit overreactive and the lawsuit underreactive—are not mutually exclusive. Imagine a corporate manager who is deciding whether to engage in activity that will generate \$200 in profits for her corporation but will impose a \$100 cost on a third party. Imagine further that the manager has \$50 in personal wealth. As traditionally defined, this manager is judgment proof: the liability the activity would generate (\$100) exceeds her personal wealth (\$50). Yet from a social perspective the manager may be overdeterred if she is held personally liable. The activity is socially worthwhile, with benefits (\$200) in excess of costs (\$100). But the manager might refrain from engaging in it because she stands to lose her \$50 while the \$200 upside will go to her firm's shareholders.

II. THE CIRCULARITY CRITIQUE OF SECURITIES FRAUD CLASS ACTIONS

Many scholars agree that the compensation rationales for corporate liability fail in the context of fraud-on-the-market lawsuits.²⁶ In a typical fraud-on-the-market case, a corporation's managers have allegedly made misleading statements that inflated the corporation's stock price, and investors who bought the overpriced stock on a public exchange sue the corporation to recover their losses.²⁷ Although the investors often sue the responsible managers as well, the managers rarely pay anything. Instead, the corporation or its insurer foots the bill.²⁸

²⁵ Employers can avoid harms caused by employees by screening them for carefulness, monitoring them on the job and adjusting their pay and promotions accordingly, investing in safety measures, and adjusting production levels. See *supra* Part I.B.1.

²⁶ James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323, 328 (2009) (“[M]ost scholars have concluded that securities-fraud actions are inherently unable to compensate investors because of a circularity problem.”).

²⁷ Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1312 (2008).

²⁸ See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1550 (2006) (observing that the corporate defendant and its insurer typically advance the entire settlement amount).

The critique of corporate liability in these actions begins with the observation that diversified investors both buy *and* sell shares on the stock market. They therefore are just as likely to benefit from fraud that inflates stock prices as they are to be injured by it, and these gains and losses are likely to net out over time.²⁹ Thus, to the extent that most investors are diversified, fraud-on-the-market class actions do not promote compensatory goals, for the simple reason that diversified shareholders suffer no net loss that requires compensation.

Shareholder diversification also undermines the deterrence rationale for corporate liability in fraud-on-the-market lawsuits.³⁰ As noted previously, the deterrence rationale posits that activity which imposes costs on third parties will be curbed if those costs are shifted to parties in a better position to prevent them. In a fraud-on-the-market suit, any possible deterrence benefit would derive from the shifting of losses from the plaintiff class of shareholders to the owners of the corporation whose agents committed the fraud. This benefit will not arise, however, with respect to diversified shareholders who over time are just as likely to be owners of the defendant corporations as members of the plaintiff classes. Indeed, many members of a plaintiff class may continue to be shareholders of the very corporation they are suing.³¹ Corporate liability in such cases is, from the perspective of diversified shareholders, mere pocket shifting. Since the damages awards do not threaten diversified shareholders with the prospect of a net loss, they do not have the deterrent effect normally attributed to civil liability.³²

²⁹ This argument is traceable to Judge Frank H. Easterbrook & Daniel R. Fischel's seminal article, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611 (1985). See, e.g., Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 225 (2007) ("[S]cholars . . . have used Easterbrook and Fischel's insight to decry the provision of securities fraud compensation as inefficient . . ."). While this is the prevailing view, and we adopt it here for purposes of analysis, we note that it has not gone unchallenged. See, e.g., *id.* at 229–34 (arguing that even diversified investors may suffer net losses as a result of securities fraud if, for example, they are net purchasers of stock, or if stock prices drop upon the revelation of fraud below where they would have traded without fraud); Park, *supra* note 26 at 340–41 (arguing that diversification may not completely protect unsophisticated investors from fraud losses if such losses are not randomly distributed but rather are concentrated on corporate outsiders).

³⁰ Because they are the most controversial, we focus on fraud-on-the-market class actions—that is, fraud that affects the price at which stock trades amongst investors on the secondary market. But class actions challenging primary market fraud—fraud that affects the price at which the issuer itself sells shares—may also be attacked on circularity grounds if the issuer is owned by diversified shareholders and the offering is likewise marketed to diversified shareholders. This would exclude IPOs but include many primary offerings by seasoned issuers.

³¹ Cf. Coffee, *supra* note 28, at 1562 ("[E]nterprise liability in this context is a strategy akin to punishing the victims of burglary for their failure to take greater precautions.").

³² Although the out-of-pocket losses investors suffer from fraud on the market are perfectly offset by other investors' gains, such fraud nevertheless imposes well-recognized societal costs: it increases the cost of capital for all firms and hence decreases economic efficiency. See Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173,

To be sure, the compensation and deterrence rationales for corporate liability in fraud-on-the-market cases still have teeth with respect to shareholders who are undiversified.³³ But the mere presence of some undiversified shareholders may not be sufficient to justify the lawsuit. This is because the standard deterrence and compensation benefits seem to apply *only* to undiversified shareholders. Therefore, these social benefits of the litigation decrease as the degree of diversification increases. Meanwhile, the social costs of litigation—lawyers’ fees, management distraction, and so on—do not depend on the degree of shareholder diversification. As diversification increases, the benefits of the lawsuit decline, but its costs hold constant. At some point the value proposition must turn negative—that is, unless there is some other benefit of the lawsuit that applies even to the shareholders who over time tend to be on both sides of the “v.”

Thus, if you accept the basic premises of the circularity critique—i.e., that most shareholders are diversified and that diversified shareholders do not suffer net out-of-pocket losses from fraud on the market—then *all* of the classic justifications for corporate liability are called into question in fraud-on-the-market cases.³⁴ In Part IV we develop an alternative justification: that corporate liability serves a portfolio governance function by aligning the interests of managers with those of diversified shareholders. We call this the “informational theory” of corporate liability. But before we explore that theory and apply it to fraud-on-the-market suits in particular, we consider the implications of shareholder diversification for corporate liability more broadly.

2179–80 (2010). It therefore ought to be deterred. But the damages paid in fraud-on-the-market class actions will not cause diversified shareholders to internalize these more-amorphous societal costs either if the shareholders are just as likely to be members of the class receiving the damages payment as to be owners of the defendant corporation making the payment.

³³ Some scholars have argued that the compensation justifications for corporate liability fail even with respect to undiversified shareholders because those investors *could* diversify if they so chose. Diversification is a cheaper form of insurance against securities fraud than litigation. See Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 309. If investors choose not to avail themselves of diversification’s advantages, the argument is that it hardly seems right for the law to compensate them for their avoidable losses. *See id.*

³⁴ Jill Fisch has argued that corporate liability is justified on behalf of informed traders, who tend to be undiversified by necessity and who produce a positive externality by promoting capital market efficiency. “If fraud increases the cost of providing this externality, [diversified shareholders] should compensate traders for the resulting losses.” Jill E. Fisch, *Confronting the Circularity Problem in Private Securities Litigation*, 2009 WIS. L. REV. 333, 347–48. We wonder whether this rationale remains persuasive once the possibility of a direct lawsuit against the responsible agent is recognized. *See infra* text accompanying note 55.

III. EXTENDING THE CRITIQUE: THE SEEMING POINTLESSNESS OF
INTERCORPORATE LITIGATION IN A WORLD OF DIVERSIFIED
SHAREHOLDERS

Although there is an extensive academic literature exploring the implications of shareholder diversification for securities fraud litigation,³⁵ few scholars have considered its significance for corporate liability more broadly. Yet there is nothing special about securities fraud litigation that should limit the arguments against corporate liability to that context. To the extent that shareholders are diversified, the same concerns call into question the compensation and deterrence justifications for just about any lawsuit in which one public firm sues another, regardless of whether the cause of action is breach of contract, patent infringement, theft of trade secrets, or some other legal wrong.³⁶

To illustrate, imagine that Firm *A* and Firm *B* are both members of the S&P 500,³⁷ and that *A* sues *B* to collect damages for an injury that *B* inflicted on *A*. Imagine further that 50% of the outstanding shares of each company are owned by investors who also own proportionate equity stakes in all other S&P 500 companies. This means that the shareholders of the two companies overlap by 50%. For these overlapping shareholders the lawsuit between *A* and *B* serves no compensatory function, as those shareholders would effectively be paying damages to the same extent they received them.³⁸ Nor with respect to these overlapping shareholders does the lawsuit serve the deterrence function traditionally attributed to corporate liability. The shareholders of *B* who also own *A* have already internalized the costs that *B* imposed on *A* before the lawsuit was brought. With respect to these shareholders, the lawsuit creates no incentive to prevent the injury that the shareholders did not possess already. To be sure, the lawsuit would have the traditional compensation and deterrence benefits with respect to

³⁵ See, e.g., *supra* notes 27–29, 33–34.

³⁶ Robert Hansen and John Lott have observed that “[t]here are numerous economic settings where one firm’s actions affect other firms’ values,” including a “supplier . . . withholding shipments after customers have made sunk investments dependent on those shipments.” Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholders/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 47 (1996).

³⁷ The S&P 500 is an index of the 500 largest companies traded on the New York Stock Exchange and the NASDAQ. Many investors own S&P 500 index funds, which give the investor equity stakes in all companies in the index. The index is capitalization weighted, meaning that it allocates value across its 500 member companies based on the companies’ relative size as measured by their market capitalization. See *S&P 500*, STANDARD & POOR’S, <http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usdof--p-us-l--> (last visited Oct. 26, 2011).

³⁸ We also note that the loss-spreading version of the compensation rationale for corporate liability seems not to apply to firm-on-firm lawsuits as a general matter. There is no reason to think that the plaintiff companies will usually have fewer shareholders than the defendant companies, or will be in a worse position to purchase insurance. Therefore, the loss-spreading rationale seems to be limited to suits in which the plaintiff is an individual or a small class rather than a public corporation.

the shareholders who only own shares of one of the companies. But these benefits may not be sufficient to justify the lawsuit from a social perspective given that, as the amount of shareholder overlap increases, the lawsuit's traditional social benefits decrease but its costs stay constant.

The point at which the value proposition in firm-on-firm lawsuits turns negative may be reached more often than one would expect. Hansen and Lott have shown that many institutional investors—who own about 50% of all corporate equity in the United States and over 75% of the shares of the largest 1000 corporations³⁹—approach full diversification within industries, where firm-on-firm misconduct is most likely to occur.⁴⁰ Moreover, a growing number of shareholders hold broad-based index funds, thereby approaching the ideal of the fully diversified investor.⁴¹

Parallel logic applies if we look at the matter in terms not of shareholder overlap but rather of shareholder diversification across the economy. Imagine a hypothetical economy with 101 firms. Assume that each of the shareholders of one firm, XYZ Corp., own a proportionate equity stake in twenty-five randomly selected other firms in the economy.⁴²

³⁹ Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1963 (2010).

⁴⁰ See Hansen & Lott, *supra* note 36, at 49–50, 49 tbl.1, 51 tbl.2 (reporting evidence of substantial cross-ownership in the computer and automotive industries, and concluding that “[t]hese levels of cross-ownership clearly indicate that large numbers of important shareholders would benefit from having the firms they own internalize externalities imposed on other firms”).

⁴¹ See INV. CO. INST., INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 32–33 (50th ed. 2010), available at http://www.ici.org/pdf/2010_factbook.pdf (detailing the net inflow of capital into index funds since 1995).

⁴² The assumption that the shareholders own an equal, proportionate stake of all firms in their portfolios is consistent with the widespread use of index funds, which typically own equal, capitalization-weighted proportions of the equity of each of the firms in which they invest. The effects of disproportionate equity holdings across portfolio firms can be modeled as follows:

Let P be the cost of Firm XYZ's investment in a precaution to avoid an accident that, if it occurs, will inflict costs on other firms in the economy (but not on XYZ). Let R be the percentage by which the investment reduces the likelihood of the accident. Assume that all other firms in the economy have an equal probability of suffering the costs of the accident. Let T be the total costs of the accident to all firms if it occurs. On these assumptions, the socially efficient result is for Firm A to invest P whenever $P < RT$.

Diversified share ownership complicates the analysis as follows. Let A be the percentage of Firm XYZ's equity owned by diversified shareholders. Let B be the percentage of the equity of all other firms in the economy owned by these same diversified shareholders. These shareholders would want Firm XYZ to invest P whenever $AP < BRT$. In this inequality, the left side represents the cost of the investment to the diversified shareholders, and the right side represents the benefits. The inequality can be rewritten $(A/B)P < RT$. It follows that when $A = B$, the diversified shareholders will have the socially efficient incentive: they will want Firm XYZ to invest P when it is efficient to do so. In that case, firm-on-firm litigation to redress the costs of the accident will have no deterrent effect with respect to these diversified shareholders. If, however, $A > B$, then the shareholders' interest will be for Firm XYZ to underinvest in precautions because the shareholders internalize the costs of the investment more than they reap the benefits. This would occur if the shareholders own a larger proportion of Firm XYZ's equity than they do the equity of the other firms in their portfolios, or if their portfolios do not include

Imagine further that XYZ's shareholders are deciding whether to cause XYZ to invest in safety measures that would reduce the chances of an industrial accident which, if it occurred, would injure some randomly selected group of the other firms in the economy. On these assumptions, the shareholders of XYZ would bear 100% of the costs of the safety measures but internalize only 25% of the expected benefits. It follows that, to correct the shareholders' insufficient incentive to invest in precautions, we would only need to empower a randomly selected group of seventy-five other firms to sue XYZ for injury. If instead all 100 other firms in the economy enjoyed the right to sue XYZ for any injuries they incurred (as would be true under current law), then 25% of the suits brought against XYZ would serve no deterrence or compensation function, as those suits would be brought to redress harms whose costs and benefits the shareholders of XYZ had, in expected value terms, already internalized. The litigation expenses for those suits would be, from a social perspective, a deadweight loss. In practice it would be difficult for lawmakers to determine *ex ante* which potential intercorporate suits should be allowed and which should not. But it remains true that as shareholder diversification increased (meaning here that XYZ's shareholders progressively added more firms to their portfolios), the expected social benefits of intercorporate lawsuits in this economy would decline, and eventually would fall below their costs. The general right for firms to bring intercorporate lawsuits would then, in the absence of other benefits from such litigation, do more harm than good.

We are not the first to recognize that the circularity critique of securities fraud class actions can be directed against intercorporate litigation generally. Randall Thomas and James Cox have observed that "well diversified investors may own both Cisco and Northern Telecom," and "[i]f there was a patent infringement judgment won by Cisco against Northern Telecom, this might be seen as yielding no net benefit to such a diversified shareholder."⁴³ But Thomas and Cox go on to argue that such a lawsuit would still be worthwhile because the circularity critique "fails to take into account the value society gains by enforcing its laws, including the federal securities laws."⁴⁴ Just what that value is, however, Thomas and Cox do not specify. As explained above, intercorporate litigation fails to serve the traditional compensation and deterrence functions of corporate liability to the extent that the owners of the plaintiff and defendant overlap. In the next

all other firms in the economy. In that case, firm-on-firm litigation to redress the harm will serve a (partial) deterrent effect for these diversified shareholders. Finally, if $A < B$, the diversified shareholders will want Firm XYZ to overinvest in precautions. This will occur if the shareholders own a smaller proportionate interest in Firm XYZ than they do in the other firms in their portfolios. In that case, firm-on-firm litigation to redress the harm will exacerbate these shareholders' incentive to encourage XYZ to overinvest in precautions.

⁴³ See Cox & Thomas, *supra* note 1.

⁴⁴ *Id.* at 181.

Part we identify a new justification for intercorporate litigation that, unlike the traditional rationales, is valid even if we assume extensive shareholder diversification. We thereby give Thomas and Cox's essential intuition—that firm-on-firm lawsuits must serve *some* purpose even for diversified shareholders—a more solid theoretical footing. Whether our justification can also support corporate liability in fraud-on-the-market class actions is a separate question, to which we will return in Part V.

IV. A NEW JUSTIFICATION FOR CORPORATE LIABILITY: THE INFORMATIONAL THEORY

In this Part we seek to explain something that previous theories of corporate liability cannot: why shareholders would be willing to pay for litigation directed against themselves. Our argument has two parts. First, we assume that diversified shareholders can use financial information about their portfolio firms to evaluate and motivate the firms' managers. Second, we posit that litigation between portfolio firms can make firm-specific financial information a better indicator of managers' contributions to total portfolio value. Unlike traditional justifications for corporate liability, our theory takes into account that diversified shareholders already have the incentive, even without corporate liability, to limit intraportfolio harms. As a practical matter, however, diversified shareholders lack the means to act on this incentive. Our argument is that litigation between portfolio firms—litigation in which shareholders essentially sue themselves—can provide those means.⁴⁵

Our claim that firm-specific financial reports permit diversified shareholders to evaluate and motivate managers has an analogue in the academic literature on corporate groups. A corporate group is a set of legal entities owned by a holding company that in turn has its own (typically public) shareholders. From those shareholders' perspective, all that matters is the profits of the group as a whole. Yet the holding company's senior executives might treat the group's various subsidiaries as profit centers that each prepare their own financial statements.⁴⁶ This profit-center system permits the senior executives to delegate decisionmaking authority to midlevel managers while retaining a means for holding those managers accountable. And it creates a kind of managerial tournament in which midlevel managers compete for pay and promotion by trying to maximize the profits of their respective subsidiaries.

⁴⁵ If the conduct giving rise to the injury also imposes costs on parties outside the portfolio, such as consumers or (in the case of environmental harms) property owners, diversified shareholders will not automatically internalize those costs. Our theory does not undermine the traditional rationales for allowing third parties to recover against the employer in such situations.

⁴⁶ Richard A. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 513 (1976).

For a shareholder who owns a diversified portfolio, firm-specific financial information can serve similar functions. Such a shareholder will find it impractical to pay attention to day-to-day operations at all the firms he owns. And even if he did pay attention, he rarely would own enough shares in any particular firm to be able to influence its affairs. For these reasons, the diversified shareholder will rationally delegate almost all decisionmaking power to his firms' managers. When such delegation occurs, the publication of firm-specific financial data can help ensure that, despite the high degree of delegation, managerial interests do not deviate too far from those of shareholders. For example, many public firms link the pay of their CEO and other top managers to the firm's reported profits.⁴⁷ Pay can be connected to profits through a contractual formula, or it can be tied to the firm's public share price, which will respond to earnings reports. Managers will also be motivated by the fact that poor financial results may induce shareholders to vote them from office or cause their firm to become the target of a hostile takeover.

By motivating managers to maximize the profits of their respective firms, diversified shareholders hope to maximize the value of their portfolios as a whole. This hope would be frustrated, however, if the portfolio firms could impose costs on each other with impunity.⁴⁸ For example, Firm *A* might renege on a promise to deliver supplies to Firm *B* for use in *B*'s manufacturing process. In that case the cost of finding another supplier would reduce *B*'s reported profits for a reason that may have nothing to do with the competence of *B*'s managers. Because those managers' pay is tied to *B*'s financial results, the managers will want some kind of adjustment, such as a compensatory payment from *A* to *B* to cover the costs of the missed delivery. And shareholders who own both *A* and *B* may also want *A* to make the compensatory payment, for otherwise *A*'s reported profits would overstate, and *B*'s would understate, their management teams' respective contributions to overall shareholder wealth. This is true even though the direct effect of the payment is merely to shift wealth from one shareholder pocket to another. In other words, compensatory payments of this type would align management and shareholder interests by forcing managers to consider the impact of their actions on all firms in their shareholders' portfolios.

⁴⁷ See Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 272 (1999) (noting the “substantial increase in the use of stock options, performance-based bonuses and other forms of pay for performance” since the early 1990s).

⁴⁸ As Robert Hansen and John Lott have observed, “If shareholders own diversified portfolios, and if companies impose externalities on one another, shareholders do not want [share] value maximization to be corporate policy” but rather “want companies to maximize portfolio values.” See Hansen & Lott, *supra* note 36, at 43.

The problem with such a voluntary system of compensatory payments is that the managers responsible for an intraportfolio harm will resist making the payment, as their own pay and job prospects are tied to their firm's profits, which the payment would reduce. To continue with the earlier hypothetical, Firm *A*'s managers would likely refuse Firm *B*'s demand for compensation, and if compelled to explain why might argue that the promise to deliver was subject to a contingency that in fact arose. In short, the two management teams would have an incentive to dispute who is at fault and for how much. For this reason, a system of firm-to-firm payments to compensate for intraportfolio harms is not one that the managers themselves could be trusted to administer.

Similar problems could arise in a corporate group managed under the profit-center system: one subsidiary could impose costs on another that distort each profit center's financial data, and the conflict of interests among the respective management teams would make it difficult for them to agree on a resolution. In that context, however, the management teams have a common superior: the senior executive at the holding company. The executive could be called upon to resolve disputes among subsidiary managers, for example by setting transfer prices within the group that reflect the actual cost to shareholders of the resources that the various subsidiaries consume. In such ways, senior executives can fine-tune the system to ensure that the interests of the subsidiaries' managers do not deviate too far from those of the group's ultimate shareholders.

In the context of a diversified investment portfolio, by contrast, there are no such overseers. While diversified shareholders have interests in both parties to an intraportfolio dispute, their rational ignorance of firm-specific affairs leaves them in a poor position to determine whether a compensatory adjustment is warranted in any particular case. Thus, from a practical perspective, the managers of public firms have no common superiors, even if the firms themselves have common owners. The shareholders must rely on someone else to sort out intraportfolio externalities and thereby protect the informational value of firm-specific financial information.

An interesting question arises at this point: why is it that portfolio firms lack common overseers? In other words, why do all public companies not merge into one sprawling corporate group whose super-senior executive team could evaluate the performance of the constituent entities' managers on behalf of public investors? There are a variety of potential answers to this question, including the obvious antitrust problems that forming this conglomerate would entail. But perhaps the most persuasive answer is that the super-senior executives, facing essentially no competition themselves, would be tempted to place their own interests—including their desire to perpetuate themselves in office—ahead of the interests of investors. The wave of conglomerate bust-ups in the 1980s

suggests that there is a point beyond which the principal–agent costs of bringing multiple enterprises under common control exceed the benefits.⁴⁹

In the absence, then, of economy-wide overlords, diversified shareholders need some other mechanism for resolving intraportfolio conflicts. One possibility would be for the shareholders to allow their portfolio firms to bring lawsuits against the managers and employees of other portfolio firms responsible for intraportfolio injuries. This would be the most direct way to deter undesirable behavior by corporate agents, and in some situations would be sufficient. However, the drawbacks we mentioned earlier of direct actions against corporate agents do not go away merely because the two firms involved have common shareholders. Direct lawsuits against employees will still be an inadequate deterrent if the employees are judgment proof.⁵⁰ The employees also will be underdeterred if they systematically underestimate risk or they think their role in misconduct will be impossible for a plaintiff to prove.⁵¹ While diversified investors would want their management teams to take cost-justified steps to deter destructive behavior by these lawsuit-resistant employees, they cannot trust the managers to do so on their own initiative given that the payoff from investments in deterrence may not appear in the reported profits of the managers' own firms.

With corporate managers, who are likely to be wealthy, the primary problem with personal liability is more likely to be overdeterrence than underdeterrence. Personal liability might cause managers to refrain from conduct that imposes costs on other portfolio firms but that nonetheless is cost-justified from a shareholder perspective. An example would be a decision by an oil executive to build an offshore rig that, if a spill occurs, could damage a shrimp farm owned by another public firm. Despite this risk, the oil rig might have a positive expected value to shareholders who own both the oil firm and the shrimp-farming firm. Yet the executive might decline to build the rig if the personal liability he expects to incur from oil spills exceeds his share of the profits the rig would generate. Diversified shareholders may not want to impose personal liability on the executive in this situation. But in the absence of liability, his incentives will swing to the other extreme: he will be like a judgment-proof employee who is unimpressed by the prospect of a lawsuit against him. He might then build a rig that has a negative expected value for diversified shareholders if by doing so he could boost his own firm's bottom line.

⁴⁹ See, e.g., WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 444 n.4 (3d ed. 2009) (discussing how the conglomerate mergers of the 1960s proved to be inefficient and led to the well-publicized bust-up takeovers of the 1980s).

⁵⁰ See *supra* Part I.B.1.

⁵¹ See *supra* Part I.B.1.

These drawbacks to personal liability mean that diversified shareholders need some other device to prevent excessive intraportfolio injuries. We propose that corporate liability can serve as this device. Under our informational theory, diversified shareholders effectively delegate to the court system the responsibility for authorizing compensatory payments among portfolio firms, thereby correcting the distortions in those firms' financial data caused by intraportfolio injuries. The shareholders themselves ultimately bear the costs of this system, as the attorneys' fees and other litigation expenses incurred by both parties to an intraportfolio lawsuit reduce those parties' net earnings. Unlike the damages award, which is a mere shift of value from one shareholder pocket to another, these legal expenses deplete the total value of the shareholders' portfolio. Yet the expenses may be outweighed by the informational benefits of the lawsuit, which could cause financial data about each portfolio firm to better reflect the contribution of that firm's managers to overall portfolio wealth. As a result, managers will be more likely to make decisions that maximize portfolio value, including by investing in measures to prevent subordinates from engaging in conduct that is not cost-justified from the perspective of diversified shareholders.

There are multiple mechanisms by which a lawsuit could generate information that influences manager behavior. The mere filing of the suit may have an immediate impact on the firms' respective stock prices if the lawsuit is publicized and traders take into account the suit's expected impact on each firm's bottom line. In addition, firms may be required under standard accounting rules to take reserves against expected material litigation losses, in which case the lawsuit may have a direct effect on reported profits before the final judgment is entered and any damages are paid. Conversely, firms could settle a matter privately if their managers agree on how a court would likely rule and they do not wish to reduce their respective profits by incurring attorney fees. In that case, the settlement payment will have the effect of adjusting each firm's reported earnings.

Unlike traditional justifications for intercorporate liability, which grow weaker as the degree of shareholder diversification increases, the justification we develop here grows stronger. Indeed, it is strongest if one assumes a market dominated by fully diversified shareholders, from whose perspective any litigation between publicly traded firms constitutes a dispute between firms the investors own.⁵² But what about a market in which shareholders are only partially diversified? In such a market, firm-on-firm litigation is best understood as serving a hybrid deterrence function. In line with traditional theory, intercorporate liability gives partially

⁵² If most investors were fully diversified, and hence there were fewer active traders, the informational value of stock prices would fall. But intraportfolio litigation would still affect firms' reported profits, which could serve the informational function we describe here to the extent that profits were used in setting managers' compensation.

diversified shareholders the right *incentives* to prevent their agents from imposing costs on firms not in their portfolio. At the same time, in line with our informational theory, it provides the shareholders with the *means* for ensuring that their agents act in ways that maximize portfolio value. The relative importance of each function will depend on how broadly investors are exposed to the market as a whole (or to a particular industry, if firm-on-firm misconduct tends to be concentrated within industries).

We believe that the informational theory we have outlined here has the potential to justify a wide range of lawsuits between firms with overlapping owners. To summarize our analysis, the justification could apply to suits to redress two types of intraportfolio harm. The first is harm caused by corporate agents who are lawsuit-resistant. And the second is harm caused by agents who are not lawsuit-resistant and who were engaged in conduct that had the potential to increase the total value of the shareholders' portfolio. Harms of this second type would include many contract breaches, unintentional torts, and patent infringements (so long as the infringement was inadvertent). As the oil executive example illustrated, these harms are the inevitable byproduct of socially productive activity. In other words, the optimal amount of these harms is, from a diversified shareholder perspective, greater than zero. In order not to discourage the activities altogether while at the same time ensuring that agents do not ignore the activities' intraportfolio costs, shareholders would rationally pay for litigation that is ultimately directed against themselves.

In the next Part we consider whether the type of litigation that started the circularity debate—securities fraud class actions against corporate defendants—also can be justified by the information it generates.

V. SECURITIES FRAUD CLASS ACTIONS REVISITED

We are now back at the point where we began this Essay: the debate over whether the so-called circularity critique invalidates fraud-on-the-market lawsuits against corporate defendants. To review the bidding, the debate started with commentators who noted that the diversified shareholders that constitute the typical class members in such actions are also the primary beneficiaries of securities fraud. The lawsuits thus seem to serve no compensation or deterrence function; they just generate hefty fees for lawyers. Rising to defend the status quo, Randall Thomas and James Cox argued that the circularity critique proves too much, as it could apply to any lawsuit between corporations owned by diversified shareholders.⁵³ The shareholders who own the plaintiffs and defendants in such cases typically overlap, and to that extent are merely suing themselves. Yet such

⁵³ Cox & Thomas, *supra* note 1.

lawsuits are justified, Thomas and Cox argue, because they “affirm[] an important principle that underlies the right vindicated.”⁵⁴

As the discussion to this point makes clear, we agree with Thomas and Cox that the circularity critique casts a shadow on the legitimacy of any lawsuit between firms owned by diversified shareholders. But we are not convinced by the alternative justification for such lawsuits they offer: the vindication of an (unspecified) principle that underlies the right to sue. We think the relevant question is not whether there should be a right to sue *per se*, but rather whether that right should apply not only against the responsible individuals but also against their corporate employer. On that question, Thomas and Cox’s argument provides no guidance.

In this Essay we have made our own attempt to identify a benefit of corporate liability that applies even with respect to overlapping shareholders. As we explained in Part IV, our informational theory explains why shareholders would be willing to pay for a wide variety of lawsuits that ultimately are directed at themselves. In particular, the theory can justify intraportfolio suits seeking redress for harms caused by agents who are either (1) lawsuit-resistant or (2) lawsuit-responsive and engaged in activities that from a diversified shareholder’s perspective could be overdeterred. Many lawsuits based on traditional common law causes of action—including breach of contract, strict liability, and simple negligence—often fall into these categories. In this way, the informational theory puts a stop to the circularity bulldozer before it clears away the entire field of firm-on-firm lawsuits.

The question we now reach is whether our informational theory also can reanimate the securities fraud lawsuits that started the circularity debate in the first place. We think the answer is likely to be no, for two reasons. First, we think that personal liability is an effective deterrent for most types of securities fraud. If the law is effective at disciplining agents directly, there is no need for the indirect means we describe here, whereby corporate liability disciplines agents through its impact on stock prices and reported financial results. Second, even if this were untrue—meaning that personal liability were *not* an effective deterrent—we still think that corporate liability in fraud-on-the-market cases would not be justified by our informational theory, because the marginal value of the information generated by such cases is likely to be low. We discuss these reasons in turn.

With respect to the effectiveness of personal liability, the first relevant question is whether the corporate agents who commit fraud on the market tend to be lawsuit-resistant. The answer is yes if the agents lack wealth and thus are not deterred by the threat of a judgment for damages. This description, while perhaps apt for some lower-level corporate employees,

⁵⁴ *Id.*

does not fit the corporate agents who stand in a position to defraud the market. Most of these agents are high-ranking corporate officers and hence are persons of means. They therefore should be adequately deterred by the threat of personal monetary sanctions.⁵⁵

To be sure, even wealthy corporate officers might be lawsuit-resistant, at least some of the time. For example, Jennifer Arlen and William Carney have explained that officers may be underdeterred by personal liability in a “last period” situation, when telling the truth will cost them their job and most of their wealth.⁵⁶ But while this possibility argues against the effectiveness of personal liability in last-period situations, it does not argue for corporate liability as an alternative.⁵⁷ Corporate liability would mitigate the last-period problem if it encouraged boards to invest in measures to prevent fraud on the market by lawsuit-resistant managers. But corporate liability for last-period fraud is unlikely to have this effect because the directors would typically stand to gain more from the fraud than they stand to lose via corporate liability.⁵⁸ A better solution to the last-period problem would be to impose criminal sanctions severe enough that even officers who are *in extremis* will heed them.⁵⁹

A second theory of lawsuit-resistant corporate officers has been offered by Donald Langevoort.⁶⁰ Under his account, cognitive distortions such as overoptimism and confirmation bias may lead lower-ranking employees to skew the information they convey to officers, and they also may cause the officers to publish falsely positive information notwithstanding the seeming irrationality of doing so.⁶¹ We note that this theory of lawsuit resistance, if correct, also does not support corporate liability: why should we expect officers and board members to react rationally to the threat of monetary sanctions for the corporation if we do not expect them to react rationally to the much more salient threat of personal liability?

In analyzing the effectiveness of personal liability, the next question we must consider is whether it will cause potential defendants to overreact. Recall that there are situations in which personal liability for corporate

⁵⁵ One might ask, if this is the case, why should we worry about the assignment of corporate liability given the ability of firms to seek indemnity for corporate liability from responsible agents? Besides the additional transaction costs associated with an indemnity action, there is reason to worry that boards captured by managerial interests might not seek reimbursement from managers even when it is in the interests of shareholders.

⁵⁶ Arlen & Carney, *supra* note 4.

⁵⁷ *Id.* at 716 (concluding that “the presence of judgment proof agents does not justify enterprise liability for Fraud on the Market”).

⁵⁸ *See id.* at 715.

⁵⁹ *Id.* at 718.

⁶⁰ Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

⁶¹ *Id.*

agents might discourage conduct that enhances portfolio value.⁶² For example, diversified shareholders sometimes are better off when one portfolio firm breaches a contract with another, but the breach might not occur if the responsible managers were responsible for paying the resultant damages. Shareholders would prefer to immunize managers from personal liability in such cases. Once the managers are immunized, however, their incentives are “overcorrected”: they will commit even those breaches that reduce portfolio value so long as doing so inflates their own firm’s profits. In that situation, the imposition of corporate liability could help align the managers’ interests with those of shareholders.

While this rationale for corporate liability may work with breach of contract, it does not apply well to securities fraud, for the simple reason that securities fraud is not the type of behavior that shareholders would want corporate agents to undertake in measured amounts. To the contrary, securities fraud debases the very financial data that the shareholders use to evaluate and motivate those agents. In other words, diversified shareholders would not want management to run a cost–benefit analysis when deciding whether to engage in securities fraud, because to the shareholders there is no benefit. Securities fraud therefore is not the type of conduct that can be overdeterred, at least in a way that justifies corporate liability as an alternative to personal liability.

An objection at this point might be that our analysis ignores the very real prospect of legal error—that is, the risk that securities fraud lawsuits might be based on stock-price drops that managers did not foresee but that a jury, with the benefit of hindsight, would nonetheless blame on malice. This too could create an overdeterrence problem, as it could discourage managers not only from making dishonest statements but also from making statements they honestly believe to be true but that they cannot support with exhaustive documentation.⁶³ As a result, firms may overspend on accountants, and they may withhold useful information they would otherwise disclose. Put another way, while securities fraud per se has no upside for shareholders, financial disclosures do, and a securities fraud enforcement regime plagued by legal error will decrease both the quantity and quality of published information.

While we agree that the possibility of legal error could motivate diversified shareholders to shield their agents from personal liability for fraud on the market, it does not follow that those same shareholders would want to shift that liability to the corporation rather than abolish it entirely.

⁶² See *supra* Part I.B.2.

⁶³ To be sure, the problem of legal error today is not as severe as it may have been in the past. See Rose, *supra* note 32, at 2220 (“[C]ongressional and judicial reforms of Rule 10b-5 class actions—including stricter pleading requirements, a statutory safe-harbor for forward-looking statements, a discovery stay pending decision on a motion to dismiss, and the elimination of aiding-and-abetting liability—now strongly discourage private plaintiffs from bringing marginal suits.”).

Legal error, after all, also undermines the informational value of corporate liability. Thus, a better response would be to reform the enforcement mechanism to increase the accuracy of securities fraud litigation targeted at corporate officers.⁶⁴

Although we suspect that personal liability is an adequate deterrent of fraud on the market, our skepticism of corporate liability for such conduct does not rest on that perception alone. There are also several reasons to believe that the informational value of corporate liability in fraud-on-the-market lawsuits is likely to be low. As a result, corporate liability is unlikely to be cost-justified in such cases even if, contrary to our arguments above, securities fraud cannot be adequately deterred through personal liability for responsible managers.

We have already identified one reason that fraud-on-the-market lawsuits against corporations might have low informational value: a high rate of legal error. But there are other important reasons as well, starting with the method that courts use to calculate damages in such cases. In our model of an intraportfolio lawsuit with high informational value, a necessary assumption is that the suit causes the defendant firm's reported financial results to reflect the net impact of the agents' conduct on portfolio value—that is, the portfolio benefits minus the portfolio costs. But this description does not fit fraud-on-the-market class actions, which seek to punish misstatements that allegedly distorted the price of a stock trading on a public exchange.⁶⁵ When managers make false statements that inflate their firm's stock price, buyers of the stock suffer a loss but sellers receive a windfall. And this upside, unlike the profits from (say) building a factory that also pollutes, does not automatically show up in the financial data of the managers' firm. Nor, importantly, is the corporate defendant entitled as a legal matter to claim credit for these "positive externalities" in the calculation of damages, which are set to equal buyers' out-of-pocket losses without an offset for sellers' gains. As a result, a securities fraud suit can cause the defendant corporation's financial results to understate the contribution of the firm's managers to overall portfolio wealth. The consequence, as with other types of legal error that produce false positives or excessive penalties, will be overdeterrence.

On the other hand, this distortion in a firm's financial data will be avoided if the judgment or settlement is covered by the firm's litigation insurance policy. But in that case the lawsuit may lack informational value altogether because the full amount of the damages—not just those in excess of the amount of net harm—is transferred from the books of the defendant to those of the insurer. Indeed, corporate liability insurance undercuts the informational value of *any* intraportfolio lawsuit that the insurance covers.

⁶⁴ See generally *id.* (arguing that securities litigation reform should focus on improving the incentives of the enforcer so as to reduce the likelihood of legal error and overdeterrence).

⁶⁵ See *supra* note 27 and accompanying text.

This problem would be mitigated if insurers charged higher premiums to firms with greater liability risk, as higher premiums would reduce those firms' reported profits. However, Tom Baker and Sean Griffith have found that "there is not a large marginal difference between the . . . premiums paid by a well-governed firm relative to a poorly-governed firm."⁶⁶ In a world of diversified shareholders, money spent by corporations on liability insurance may simply be another agency cost: a way for managers to shield their equity-based pay from the impact of harms they visit upon other firms in their shareholders' portfolios.⁶⁷

A third reason that the information generated by corporate liability in fraud-on-the-market lawsuits seems to have little marginal value is that, in most cases, the same information has already been brought to light through other sources. Our informational theory applies to agent behavior that will not be disciplined except through the information generated by a private lawsuit against the agent's employer. But most instances of securities fraud are ferreted out not by someone who will bring a private lawsuit, but rather by the media or another source.⁶⁸ And the revelation of the fraud through these alternative sources creates a reputational hit that typically reduces the firm's stock price by an amount several times larger than the firm's expected legal penalty.⁶⁹ It follows that the marginal amount of new information generated by a private lawsuit against the corporation is likely to be extremely small, especially as compared to the lawsuit's costs. In combination, these features of fraud-on-the-market lawsuits appear to make it highly unlikely that the marginal value of the information generated by corporate liability—which we have defined to include both vicarious liability and corporate indemnification of agents—is greater than the considerable legal expenses and other costs that the lawsuits impose.

CONCLUSION

Scholars of corporate law are preoccupied (some might say they are obsessed) with principal-agent conflict. How, the scholars perennially ask, can lawmakers stop corporate managers from putting their own interests ahead of the interests of shareholders? A long list of answers has been

⁶⁶ Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1821 (2007).

⁶⁷ *Accord id.* at 1825–34 (noting the likely connection between equity-based pay and demand for corporate liability insurance).

⁶⁸ One study concludes that private litigation uncovered only 3% of the incidents of fraud exposed between 1996 and 2004 in companies with more than \$750 million in assets. See Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* 2 (Univ. Chi. Booth Sch. of Bus., Working Paper No. 08-22, 2009), available at <http://ssrn.com/abstract=891482>.

⁶⁹ See Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582 (2008) (finding that a firm's reputation losses as a result of financial fraud "exceed[ed] the legal penalty by over 7.5 times, and . . . the amount by which firm value was artificially inflated by more than 2.5 times").

proposed, including imposing liability on corporate managers for breaching fiduciary duties. To our knowledge, however, no one has given the answer we offer here: make the corporation—and hence, within the constraints of limited liability, its shareholders—legally answerable for the costs its agents impose on other public corporations. Until now, corporate liability has been seen as a device for compensating victims and, through cost internalization, aligning shareholder interests with those of society. But both of these justifications weaken as shareholders diversify their investment portfolios and hence are more likely, at least in lawsuits between public firms, to be paying the very damages they at the same time are recovering. In other words, as shareholders become more diversified, their incentive to limit the costs their agents impose on other public corporations naturally grows. What diversified shareholders lack are cost-effective *means* for reining in those agents. They need information, boiled down to dollars and cents, about each management team's contribution to overall portfolio value. Corporate liability can help provide this information. Hence, corporate liability is valuable to shareholders in situations where personal liability for managers and employees will not solve principal-agent conflict, either because the agents will be deterred too little by the threat of a direct lawsuit, or because they will be deterred too much.

But what about the Goldilocks cases—the ones in which the deterrence supplied by personal liability is neither too strong nor too weak, but “just right”? In those cases, corporate liability appears to be unnecessary. And, as we argue here, there is good reason to think that securities fraud lawsuits are Goldilocks cases. Personal liability for securities fraud should serve as an effective deterrent. And even if this is untrue, the information generated by corporate liability in fraud-on-the-market lawsuits is probably of minimal value. For these reasons, corporate liability for fraud on the market appears to be justified neither by traditional compensation and deterrence rationales nor by the informational rationale we advance here. Meanwhile, a wide variety of other potential firm-on-firm lawsuits—breach of contract cases, tort cases based on negligence or strict liability, and so on—are not cases in which personal liability for agents would generate the right amount of deterrence. These are cases in which diversified shareholders may be perfectly willing to allow their managers to bring lawsuits that are, in essence, directed against the shareholders themselves. Liability in those suits may be circular but it is nonetheless worthwhile. In this way, our informational theory provides the first justification for corporate liability that can distinguish between securities fraud class actions and other types of intraportfolio lawsuits even when, in both contexts, the same shareholders are standing behind the plaintiff and the defendant.

Yet, as corporate scholars will always remind us, principal-agent conflict never entirely goes away; often it just changes form. Thus, it may very well be true that corporate liability in intraportfolio lawsuits makes

managers better agents. But we must not forget that it is the agents who decide whether to bring the suits. And this decision too can be skewed by conflicts of interest. For one thing, when managers decide to bring an intraportfolio suit, they will not consider the litigation expenses that the other corporation will incur even though diversified shareholders would want them to. Additionally, if there is systematic bias in favor of plaintiffs in a particular area of law, managers will exploit it by bringing suits in that area in order to inflate their firms' reported earnings, which again will be contrary to diversified-shareholder interests. An unexplored area of principal-agent conflict—and one that our informational theory brings into focus—is the degree to which litigation between public firms is itself a source of, and not just a solution to, agency costs.

It follows that a practical extension of our analysis would be to consider how diversified shareholders might want to curb the discretion of managers to bring suits against other public companies. In the extreme case, shareholders might want to opt their firm out of a particular category of intercorporate lawsuit altogether, reasoning that the information generated by actions in that category does not justify the litigation costs. Or, more modestly, shareholders might want to require that certain types of intercorporate lawsuit be sent to arbitration rather than to court as a means of reducing litigation expenses and avoiding perceived biases among judges and juries. And shareholders might also want to impose a “loser pays” rule for attorneys' fees in order to force managers to take both parties' litigation expenses into consideration.

Although the litigation opt-out system we imagine here could be implemented through charter amendments, this approach may be impracticable since amendments require board consent.⁷⁰ A better approach might be to have opt-outs organized and enforced through public stock exchanges. The exchanges could identify those firms that are majority-owned by diversified shareholders, and then those firms' shareholders could vote on proposals to curb or modify management's power to bring various types of intercorporate suits. The proposals might be structured to be binding only with respect to litigation against other qualified firms on the exchange whose own shareholders have adopted a matching litigation restriction. Management resistance to the system would then be reduced because no firm's managers would be forced to disarm unilaterally.

Although the immediate beneficiaries of such an opt-out system would be the diversified shareholders of the participating firms, we see a broader public benefit as well. When shareholders are on both sides of a lawsuit, their interests are largely aligned with those of society as a whole: they want the litigation to proceed only if it is meritorious and can be prosecuted

⁷⁰ See, e.g., DEL. CODE ANN. tit. 8, § 242(b) (2010) (providing that amendments to the certificate of incorporation must be proposed by the board of directors).

and adjudicated in a cost-effective manner. Therefore, if shareholders decided to opt out of a particular category of lawsuit, send it to arbitration rather than court, or change the rules for attorneys' fees, their choice would provide a powerful market signal about the efficiency of the legal regime that the shareholders are modifying. In this way, an opt-out system would serve as a discovery mechanism, providing information that lawmakers could use to reform legal rules that apply to all litigants.

Obviously such an opt-out system would raise a multitude of issues that we do not attempt to address here, and perhaps there are mechanisms other than firm-on-firm litigation that diversified shareholders could use to encourage managers to maximize portfolio wealth as opposed to the reported profits of the managers' own firms. What we can say with confidence is, as shareholder diversification continues to increase, these issues will be among the leading variations on the unremitting scholarly theme of principal-agent conflict.