# CAPPING SECURITIES FRAUD DAMAGES: AN UNWISE PROPOSAL IN AN IMPERFECT WORLD

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Professor Donald C. Langevoort's paper[1] on capping securities fraud damages is comprehensive, analytically powerful, thought provoking, but ultimately unconvincing as a policy prescription. This comment explains why I am unwilling to artificially cap our somewhat sloppy—but functional in terms of its policy purposes—damage system for open-market securities frauds.

## COMPENSATION ISSUES

Let me begin with a basic principle of U.S. law. Individuals and corporations are normally liable for the damage their improper actions proximately cause.[2] Almost invariably the motivation behind the imposition of liability for damages involves a complex mix of compensation and deterrence values. In general, we should not move from these traditional compensation and deterrence values unless there is compelling cause. Under this standard, Don Langevoort's policy approach—to shift our focus away from compensation—falters.

Langevoort recommends that we move to a system that "makes deterrence the prime directive of private securities litigation in non-privity cases"[3] because the present system creates innocent winners and losers. He is correct in his "innocence" analysis, but the point does not support his policy prescription nearly as much as he suggests. To understand the point, assume a typical fraud-on-the-market class action in which Corporation A and its directors and officers have been charged with recklessly or intentionally making materially misleading optimistic statements and withholding material negative information. Also assume—less typically—that the material misrepresentation has in fact happened, and it occurred because some officers and directors wanted to sell their shares in an inflated market and others kept seeing "light at the end of the tunnel that would make everything turn out all right."

After a year, Corporation A's house of cards comes down and all of the bad news comes out. The shares of Corporation A fall from $20 to $10 per share. Those shareholders who sold their shares in Corporation A during the past year but knew nothing of the securities fraud are Langevoort's innocent

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1. Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639 (1996).

2. *See, e.g.*, 2 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 240–41 (1994).

3. Langevoort, *supra* note 1, at 643.

winners. The shareholders who bought Corporation A's shares during the past year are Langevoort's innocent losers. "[F]or obvious reasons," Langevoort concludes, "the law makes no effort to force the winners to disgorge their profits in order to fund the losers' recovery."[4]

But, admitting that the innocent winners received a fortuitous benefit because of the fraud (*i.e.*, were able to sell shares at $20 instead of $10), the real issues are: Why not compensate the innocent losers? Why depart from our traditional compensation rationale to protect venal directors and officers (*i.e.*, those who participated in the fraud in order to sell shares), reckless directors and officers (*i.e.*, those recklessly hoping for light at the end of the tunnel), and Corporation A itself? The shareholders of Corporation A who have held for a long period of time are, of course, more innocent than the directors and officers, but they elected Corporation A's directors and indirectly appointed its officers; they had the power to put people into office who would not participate in fraud. In publicly traded corporations, the option to exit (*i.e.*, sell their shares) was always available to shareholders.

Langevoort, in what he characterizes as the "most fundamental point," replies that since the "buyer or seller disadvantaged by the fraud...is balanced by another winner," over time the net harm to investors as a group—or even to individual investors—will be nonexistent or small.[5] But Langevoort is much too flippant in his "netting out" assertions. Despite the fact of investors realistically being on both sides of a fraud-on-the-market case, there will be no necessary "netting out" for given investors even in the long run. More important, how will we explain to victims of securities fraud that they have to live with their uncompensated losses? Will they accept the claim that they *may* be innocent winners in other situations and that everything will "net out" over time? My sense is that Langevoort's rejection of the compensation rationale would seriously undermine investor confidence in—and political support for—our present system of securities regulation. Perhaps most significantly, for a combination of compensation and deterrence reasons, we want to produce in Corporation A's long-term shareholders a concern about the quality and conduct of Corporation A's directors and officers. Fear of large damage awards creates concern in shareholders. Fear of personal liability—and of the wrath of shareholders and public embarrassment—creates concern in responsibility directors and officers. Don Langevoort would trade in all of this healthy concern for a $10 million cap on damages, which in the large public corporation might well be treated as an insignificant cost of doing business.

This brings us to the fundamental issue: would movement from the compensation rationale further the nation's economic and policy goals? My answer is "no." As Chairman Levitt of the Securities and Exchange Commission recently put it:

> Capital is the lifeblood of our economy. By guarding the integrity of our capital markets through full and fair disclosure, the federal securities laws protect investors while at the same time ease the ability for companies to raise funds from the public....
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4. *Id.* at 646.
5. *Id.*

> [We must] ensure that ours remains the strongest, most vibrant, transparent, and liquid capital market in the world for many years to come.[6]

A cap on damages—particularly in Langevoort's $10 million range—could have a seriously debilitating effect on director and officer conduct and, in general, on the adequacy of corporate disclosure. Why endanger our securities markets, among our most efficient and successful institutions?

To illustrate my concern, let me analyze *Basic Inc. v. Levinson*,[7] the seminal section 10(b) case with which Don Langevoort begins his paper. In *Basic*, company officials falsely denied involvement—three times—in ongoing merger discussions over a period of fourteen months. In the context of "no obvious claims of managerial corruption or self-dealing,"[8] Langevoort characterizes what happened as a "well-meaning white lie."[9] He concludes that out-of-pocket damages in such a case "creates the potential for recovery grossly disproportionate to the nature of the underlying violation."[10]

But why is Don Langevoort so concerned about damage exposure for what he concedes was the intentional deception of Basic Inc.'s shareholders? If we become more tolerant of reckless or intentional deception how much will we undermine efficient investment, capital formation, and basic corporate governance values?[11]

In *Basic*, the Supreme Court provided three doctrinal answers to Langevoort's concern about Draconian damage exposure. First, the Court told corporate directors and officers that deceit was not necessary to preserve the confidentiality of merger discussions; corporate silence or a simple "no comment" statement is permissible even if material discussions are nearing completion.[12] Second, the deception with respect to the early merger discussions between Basic Inc. and Combustion Engineering, Inc. may not have been about material matter; the "fact-specific" materiality issue was remanded by the Court.[13] Third, the Court went out of its way to state that its "decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind."[14] In my view, the Court has reserved ample room to be both more flexible and more realistic in the damage area than the Langevoort paper acknowledges. At the Supreme Court, the proper approach to damage calculation is one of the important open issues in the securities fraud area.

Thus, the *Basic* case, including its critical fraud-on-the-market discussion, represents sensible, pragmatic jurisprudence. It gives appropriate weight to the importance of full and fair disclosure.

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6. Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, accompanying issuance of the Report of the Task Force on Disclosure Simplification (March 5, 1996), *available in* SEC website at http://www.sec.gov/news/studies/smpl.htm.
7. 485 U.S. 224 (1988).
8. Langevoort, *supra* note 1, at 639.
9. *Id.* at 640.
10. *Id.* at 639.
11. As to the critical linkage between accurate disclosure and efficient corporate governance, see Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335 (1996). *See also* discussion *infra* at text accompanying notes 24–25.
12. *Basic*, 485 U.S. at 239 n.17.
13. *Id.* at 240–41.
14. *Id.* at 248 n.28.

The discussion so far is not intended to suggest that there is nothing to Don Langevoort's concern about damage exposure in open-market securities fraud cases. Rather, I believe that he has overplayed the problems of compensation and underplayed the advantages of our current system.

It should be carefully noted that many areas of the law have the same problems with respect to innocent winners and innocent losers that Langevoort perceives in the securities area. For example, if antitrust price fixing occurred three years ago, the companies involved would be sued for treble the damage to consumers that was caused. It is not unusual for hundreds of millions of dollars to change hands in such cases.[15] Yet the defendant corporations will often be populated, in part, by innocent shareholders (innocent losers) who recently purchased shares and suddenly find their corporation responsible for multi-million dollar damage payments. Similarly, shareholders who sold before the price fixing became public—the lucky winners—not only avoided paying treble damages but had the price of their shares inflated by the value of the illegal cartel profits. The same story, with analytical variations, could be told about toxic tort, duty of care, and dozens of other areas of the law. Should we give up on compensating those who have been injured across-the-board? To say the least, I am skeptical. The basic policy issue in the securities fraud area is not about whether we have a sloppy, imperfect damage system, but whether on balance it creates the right incentives and disincentives; in my view, the current damage scheme creates the sense of fairness to investors and the deterrence of wrongdoing that our legal system needs.

## DETERRENCE ISSUES

Although Don Langevoort underplays the importance of compensation, his emphasis on deterrence makes sense. In general, he handles admirably the various privity versus fraud-on-the-market scenarios, and his emphasis on the effectiveness of penalties on individuals is analytically very powerful. I wish, however, Langevoort had not given up so easily on limiting "liberal indemnification and insurance" rules.[16] He reasons that "if we toughen the standards" the "problem of overprecaution reemerges," and he concludes that although "the situation is unsatisfying, it may be best to leave matters where they are."[17]

Clearly, concerns about chilling proper conduct are legitimate, but there is enormous paydirt—in both scholarly and policy terms—to working out a sensible system of individual sanctions. Individuals will not be effectively deterred if penalties become a mere cost of doing business. It is entirely possible, however, to set up a fair, proportionate, and effective system of individual sanctions, and in such a system the impact of sanctions "should not be diffused by permitting indemnification, insurance repayment, tax abatement, or 'risk spreading or passing' by other means."[18]

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15. *See* MILTON HANDLER ET AL., CASES AND MATERIALS ON TRADE REGULATION 108–14, 127–41, 228–392 (3d ed. 1990).

16. Langevoort, *supra* note 1, at 657 n.76.

17. *Id.*

18. Harvey J. Goldschmid, *An Evaluation of the Present and Potential Use of Civil Money Penalties as a Sanction by Federal Administrative Agencies*, *in* 2 RECOMMENDATIONS

Don Langevoort's basic deterrence proposal—his capping scheme of tiered sanctions up to $10 million—is wholly inadequate.[19] Langevoort candidly admits that: "Here, of course, I have abandoned any pretense of rigor, and am simply working from intuition."[20] My intuition tells me that a maximum of $10 million for large public corporations will not create the incentive/disincentive balance that we need. The inadequacy is of particular concern because Langevoort is capping damage liability for extreme departures from standards of reasonable care; he is capping for reckless and intentional conduct.

Again, I come back to the stakes in the securities fraud area. If we underdeter, we jeopardize the efficiency, integrity, and fairness of our capital markets. We also put at risk the quality and effectiveness of our system of corporate governance. State laws put only limited pressure on directors to actively oversee senior corporate managers.[21] The federal securities laws, as interpreted since the late 1960's,[22] have created powerful legal incentives for boards of directors to monitor a corporation's business and to review major decisions. Directors, officers, and committees of the board all have to be in a position to demonstrate that any material disclosure failure did not occur because of reckless inattention. Directors who ignore red flags face claims for all of the losses of a class of injured shareholders. In the 1960's the average corporate director spent only thirty to forty hours a year on the job; by the late 1980's and early 1990's, outside directors were spending well over 100 hours at their corporations.[23] Much of this increased activity can be attributed to constructive pressures for increased diligence created by the federal securities laws. Don Langevoort's cap would put all this in jeopardy.

In addition, as my colleague Louis Lowenstein has effectively demonstrated, the disclosure requirements of the federal securities laws mandate that U.S. managers manage largely in the open, disclosing material operating and financial data in detailed and audited form. When properly complied with, the disclosure system forces managers to confront disagreeable realities early,[24] and permits outside directors to see and correct corporate problems in a timely and effective fashion.[25]

## CONCLUSION

Since the early 1970's, our corporate governance system has gotten considerably better in terms of the quality of board monitoring, the replacement of deadwood managements, and the overall quality of decisionmaking. The improvement has come about for a number of reasons; among those I would list most prominently are the impact of global

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AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES 896, 946–47 (1973).

19. Langevoort, *supra* note 1, at 660–61.

20. *Id.* at 661.

21. *See, e.g.*, 1 AMERICAN LAW INSTITUTE, *supra* note 2, at 134–98.

22. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224 (1988); Herskowitz v. Nutri/System, Inc., 857 F.2d 179 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989); Gould v. American–Hawaiian Steamship Co., 535 F.2d 761 (3d Cir. 1976); Gerstle v. Gamble–Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973).

23. *See, e.g.*, 1 AMERICAN LAW INSTITUTE, *supra* note 2, at 86–94; MYLES MACE, DIRECTORS: MYTH AND REALITY (1971).

24. Lowenstein, *supra* note 11, at 1361–62.

25. *Id.*

competition,[26] and the pressures created by federal securities laws and by more serious use of state duty of care doctrines.[27]

Today, however, vulnerable state legislatures have been persuaded to undo much of what state courts accomplished by putting some vigor into duty of care doctrines.[28] State shield statutes, and other state procedural devices, have already taken too much accountability and discipline out of our corporate governance system.

If all goes well, The Private Securities Litigation Reform Act of 1995 may help to reform aspects of private securities litigation. That Act, however, depending on how it is interpreted, also has the potential to significantly diminish accountability and discipline within our system. I am wary about the future.

In this context, I commend Don Langevoort for a very fine try. But I am unpersuaded by his recommendation that we move from our present sloppy, rough but relatively effective system of securities fraud damages based on a mix of compensation and deterrence rationales. If Don Langevoort and I were told to design a better system, we might be able to do so. But even a good capping scheme—with far more deterrence than Langevoort's creates—would have to go into the legislative hopper, and that process might well undermine too much of the discipline and accountability that the system has left. In any event, I am unwilling to take the risk when the stakes are so high.

I do not want to go back to the kind of disclosure and corporate governance we had in the 1960's. This is not the time to experiment with a capping scheme for securities fraud. I would, however, be open to experimentation with the "alternative remedies" that Langevoort discusses[29] and particularly to the use of more effective sanctions for individuals. This part of Langevoort's admirable paper makes considerable policy sense.

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26. Much recent scholarship has demonstrated that competitive pressure is a great stimulant of corporate efficiency and creativity. *See, e.g.*, MICHAEL PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS (1990); Harvey J. Goldschmid, *Is Antitrust Antagonistic to American Competitiveness?*, 93 COLUM. L. REV. 1572 (1993).

27. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. Sup. Ct. 1993), *on reargument*, 636 A.2d 956 (1994); Smith v. Van Gorkom, 488 A.2d 858 (Del. Sup. Ct. 1985).

28. For example, § 102(b)(7) of the Delaware General Corporation Law, enacted soon after the *Van Gorkom* decision in 1985, permits corporations to eliminate the exposure of directors to personal liability for monetary damages in most duty of care actions. DEL. CODE ANN. tit. 8, § 102(b)(7) (1995). Since 1985, more than 30 states have adopted similar protective legislation. *See* 1 AMERICAN LAW INSTITUTE, *supra* note 2, at 136–37.

29. Langevoort, *supra* note 1, at 661.