Which Corporate Victims Get Justice?

Anat Admati, Stanford GSB
Greg Buchak, Stanford GSB

GCGC Oxford University
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"What if Apple sold phones that it knew would explode after one year, and they all exploded and killed millions of people? And the Justice Department looked into it, examined the facts and the law, and said: "You know, this looks like securities fraud. The real victims here are Apple's shareholders, who had no warning that the phones would explode and kill their users, and who have lost money when the stock dropped.""

"If you were an alien trying to understand the U.S. legal system from cases like this one (also opioid cases, climate-change lawsuits, gun control, etc.), you might conclude that its purpose is to protect shareholders from losing money when the companies they own harm consumers"

Matt Levine, "Money Stuff" Bloomberg Blog, January 31, 2018

Real life example: **Theranos**

- Holmes found guilty for <u>defrauding investors</u>

- NOT for endangering consumers

Make a safe iPhone or an exploding iPhone?

Safe iPhone:

- Costs $100k manager effort

- Causes $0 damage to consumers

Exploding iPhone:

- Costs $0 manager effort

- Causes $100m damage to consumers

- Consumers will sue & get $100m from shareholders

Managers: make exploding iPhone

Corporate Governance to the rescue?

Corporate governance problem:

- Managers have wrong incentives vis. <u>shareholders</u>

Corporate governance solution:

- Tie manager outcomes to shareholder outcomes

- Carrots and sticks:
  incentive pay, market for control, reputation, legal consequences, etc.

  … very developed governance literature …

What happens with governance:

- Managers make safe iPhone

- Shareholders (<u>and society</u>) better off

Is key assumption valid?

Do customers get $100m when iPhone explodes?

- Shareholder-focused governance assumes others' rights are protected

- Solution breaks down if, e.g., customers can't sue for exploding iPhone

A fundamental governance problem:

- Shareholders' incentives may be misaligned with other stakeholders

- Ecosystem of solutions: indirect via market, <u>torts</u>, <u>regulations</u>, etc. Do they work?

Our paper: **Does legal system act to protect other stakeholders?**

Not an ESG point! ESG is based on hope shareholders want to be charitable to others. **We ask—who gets basic "justice" in the law?**

What do we do?

Assemble data (insofar as possible) tracking:

- Corporate "harms" (e.g., B.P. oil spill)

- Corporate "victims" (e.g., shareholders, employees, customers)

- Resultant outcomes in the legal system (e.g., civil, criminal, prison, etc.)

Examine:

- Does legal action happen less frequently for non-shareholder victims?

- Is legal action less severe for non-shareholder victims?

Main finding: Shareholders better protected than other stakeholders → "shareholder primacy" is insufficient

Related Recent Literature (Partial List)

- **Corporate legal rights and external governance forces**
  - Metzer (2017), Pollman (2019, 2021), Winkler (2018)

- **Corporate crimes and punishment**
  - Alexander and Arlen (2018), Coffee (2020, 2022), Garett (2016, 2020), Buell and Garrett (editors, 2020), Rakoff (2021), Taub (2020)

- **Securities law enforcement in context**
  - Choi, Erickson and Pritchard (2020), Spamann (2022), Strauss (2021)

- **Arbitration and class waivers**
  - Egan, Matvos and Seru (2021), Pfeffer-Gillett (2022), Szalai (2019)

- **Political economy and corporate purpose**
  - Admati (2017, 2021), Bebchuk and Tallarita (2020), Lund and Pollman (2021), Strine (2019), Zingales (2017)

Roadmap

1. Data

2. When does the legal system act?

3. How does the legal system act?

Data—we do what we can!

The ideal dataset…

- All times when corporation causes loss to a stakeholder

- Whether law compels corporation to internalizes loss

    Settlements, torts, class actions, civil/criminal regulatory action

…doesn't exist:

- No standardized dataset encompassing many victim types

- Typically organized by law (e.g., Stanford FCPA; SSLA)

So we build it ourselves. Difficulties:

- Most corporate harms hidden or unreported

- Much resulting litigation sealed (e.g., arbitration)

- We'll get: selected sample. Key is to think about how this biases results

Part 1: Media-based universe

Media-report based universe

- Based on NYT news searches, 2007-2014

- Programmatic search based on victim/harm type

Victim	Search terms
Shareholders	Shareholder; investor
Customers/ Employees	Employee; worker; contractor
Government	Government; agency; treasury; public

Harm	Search terms
Death	Death; died; killed
Injury	Injury; Hurt
Financial	Money; dollars; financial

- Manual checks for relevancy, other harmed parties, violation types
  (e.g., accounting fraud; off-label marketing)

- 286 observations, working to expand (e.g., local media)

Part 1: Media-based universe

Linking corporate harms to legal outcomes

- Manually link corporate harms to resulting legal outcomes

Sources:

- GoodJobsFirst (~500k torts / private / government actions, incl. settlements)

- Corporate Prosecution Registry (DOJ actions)

- Stanford Securities Litigation Analytics (Securities litigation)

- ClassAction.org/ConsumerAction (class actions; ongoing, appears not many)

- Lexis (everything, including derivatives lawsuits)

- Unstructured internet searches (N is small enough to do manually)

Attempt to be as comprehensive as possible subject to caveats

Part 2: Civil litigation-based universe

Condition on civil cases & look at intensive margin

- Take civil cases in GoodJobsFirst as starting point

- Ask how intensive margin (e.g., criminal; prison) varies with victim

Process

1. Start with civil case

2. Assemble data on underlying harm (complaint, media searches, etc.)

3. Link with other legal outcomes following earlier procedure

Pros/cons

- Pro: easier to assemble large sample; less concern on unobserved cases

- Con: conditions on *some* legal involvement

# Major concerns: selection & observability

Selection:

- Harms that are notable enough for NYT media mentions

- Will be larger/more severe than average

- May be in the news *because* or legal action; news may *cause* legal action

    → more legal involvement than unconditional universe

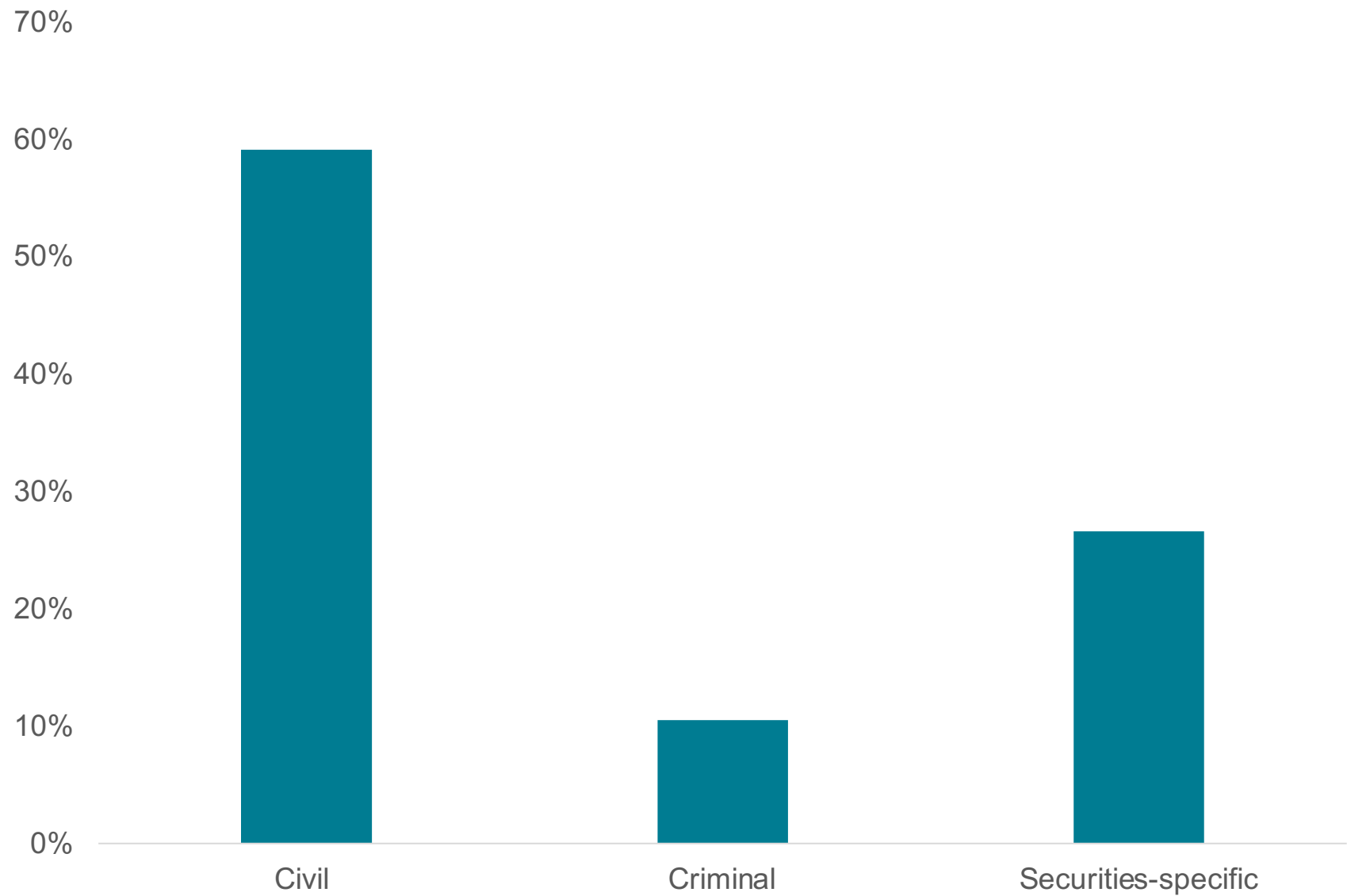   → likely more severe for non-shareholder harms

Observability:

- Easier to observe legal actions on behalf of shareholders

- Many non-shareholder harms go through arbitration/settlement

- We do some robustness checks around arbitration, no effect on estimates

Harms by victim/type
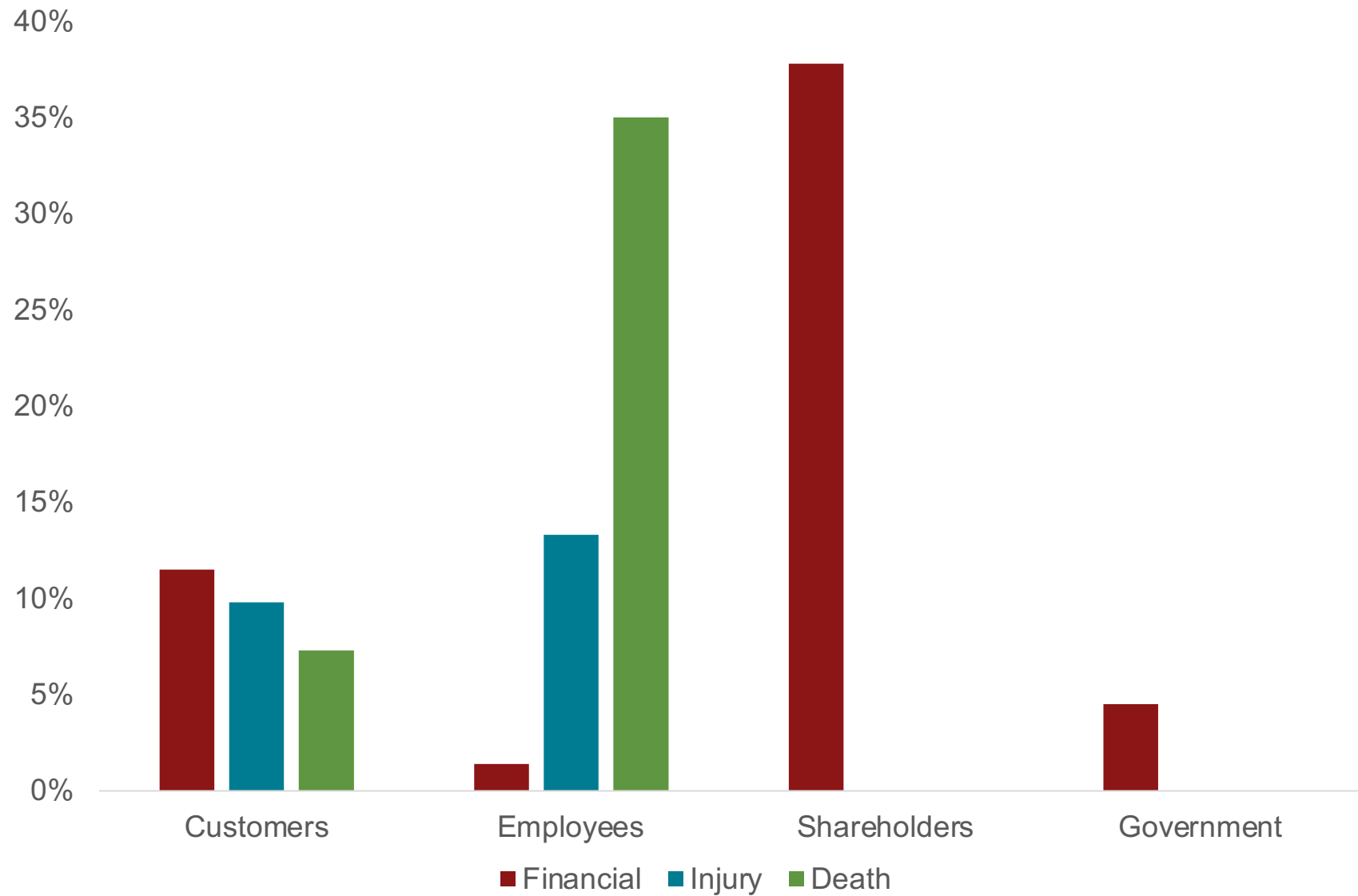
Legal outcomes

Roadmap

1. Data

2. When does the legal system act?

3. How does the legal system act?

Victim status and legal action

$$Litigation_i = \beta_0 + \beta_1 Share_i + \beta_2 Gov't_i + \gamma_i + \epsilon_i$$

Specification:

- Media-based universe

- Litigation: is there (any/civil/criminal/securities) litigation?

- Share/gov't: is a shareholder/government harmed?

- γ_i: harm-type FE (e.g. fraud)

Interpretation:

- Litigation more likely when shareholder or gov't is harmed?

- Without harm-type FE: are laws/enforcement different by victim?

- With harm-type FE: conditional on law, does enforcement differ?

Harms by victim/type
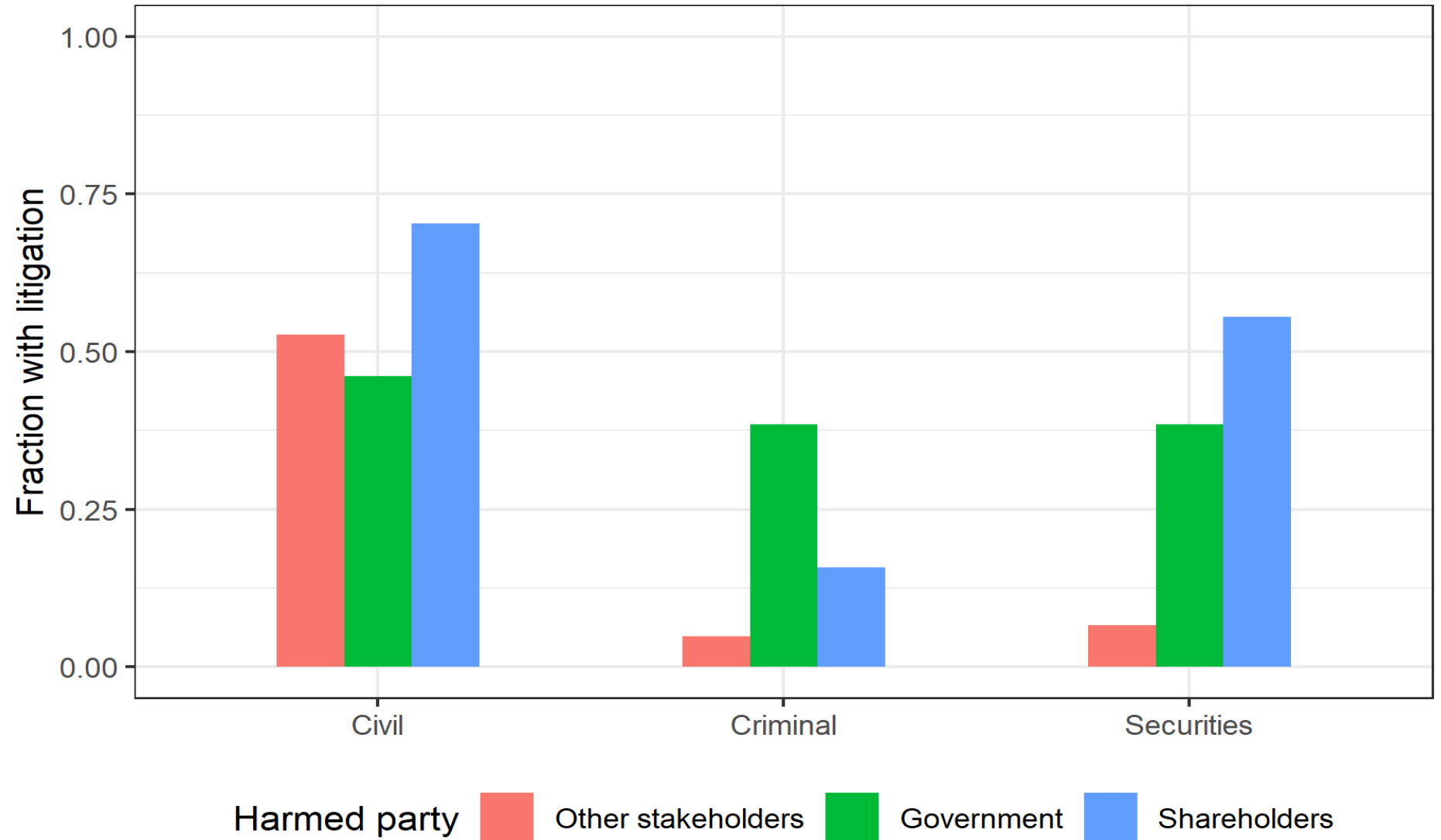
Harms by victim/type

	Dependent variable: Litigation			
	Any	Civil	Criminal	Securities
	(1)	(2)	(3)	(4)
Shareholders harmed	0.347***	0.176***	0.109***	0.489***
	(0.054)	(0.060)	(0.037)	(0.047)
Government harmed	0.064	-0.066	0.336***	0.318***
	(0.126)	(0.140)	(0.086)	(0.108)
Constant	0.552***	0.527***	0.048**	0.067**
	(0.034)	(0.038)	(0.023)	(0.029)
Harm type FE	N	N	N	N
Observations	286	286	286	286
R^2	0.128	0.033	0.069	0.283
Note:			*p<0.1; **p<0.05; ***p<0.01	

Harms by victim/type: with harm type FE

	Dependent variable: Litigation			
	Any	Civil	Criminal	Securities
	(1)	(2)	(3)	(4)
Shareholders harmed	0.025	-0.141	0.079	0.192***
	(0.083)	(0.093)	(0.060)	(0.072)
Government harmed	-0.332*	-0.472**	0.275**	0.017
	(0.193)	(0.217)	(0.140)	(0.168)
Harm type FE	Y	Y	Y	Y
Observations	286	286	286	286
R^2	0.228	0.134	0.074	0.353
Note:			*p<0.1; **p<0.05; ***p<0.01	

Robustness: driven by arbitration? No

	Dependent variable: Litigation			
	Any	Civil	Criminal	Securities
	(1)	(2)	(3)	(4)
Post *Concepcion*	0.035	0.057	-0.069	0.091
	(0.068)	(0.076)	(0.046)	(0.058)
Shareholders harmed	0.352***	0.177**	0.112**	0.493***
	(0.073)	(0.081)	(0.049)	(0.063)
Government harmed	-0.035	-0.167	0.252**	0.310*
	(0.185)	(0.206)	(0.125)	(0.158)
Post x Shareholders	-0.009	0.005	-0.016	0.002
	(0.109)	(0.121)	(0.074)	(0.094)
Post x Government	0.180	0.181	0.164	0.005
	(0.253)	(0.281)	(0.171)	(0.217)
Constant	0.535***	0.500***	0.081**	0.023
	(0.047)	(0.053)	(0.032)	(0.040)
Harm type FE	N	N	N	N
Observations	286	286	286	286
R^2	0.130	0.037	0.080	0.294

Note: $^*p<0.1$; $^{**}p<0.05$; $^{***}p<0.01$

Victim status and legal action

- Litigation <u>more likely</u> when shareholders are harmed

- Mainly driven by differences in laws (not enforcement)

  Exception: Harms vs. government

- Robust to shocks to arbitration (*Concepcion*)

- Robust to other specs (e.g., incl' interactions, not shown)

Roadmap

1. Data

2. <u>When</u> does the legal system act?

3. <u>How</u> does the legal system act?

Victim status and legal severity

$$Outcome_i = \beta_0 + \beta_1 Share_i + \beta_2 Gov't_i + \gamma_i + \epsilon_i$$

Specification:

- Civil litigation-based universe

- Outcome: is there (criminal/individual/prison) as an outcome?

- Share/gov't: is a shareholder/government harmed?

- γ_i: harm-type FE (e.g. fraud)

Interpretation:

- Litigation more severe when shareholder or gov't is harmed?

- Without harm-type FE: are laws/enforcement different by victim?

- With harm-type FE: conditional on law, does enforcement differ?

Victim status and legal severity
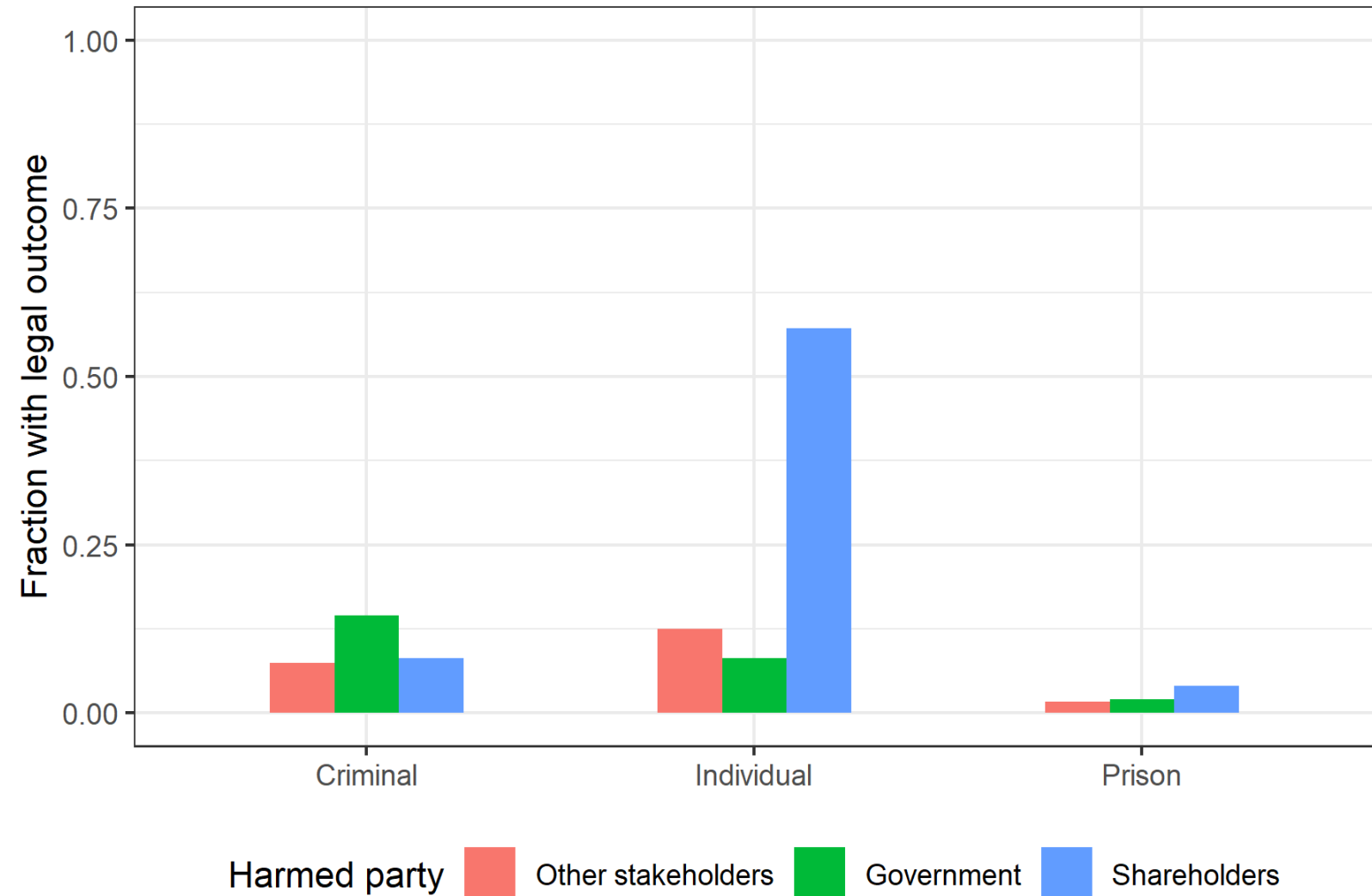
Is there a criminal case?

		Dependent variable:		
		Criminal case		
	(1)	(2)	(3)	(4)
Shareholders harmed	-0.006	0.001	0.011	0.011
	(0.026)	(0.026)	(0.033)	(0.033)
Government harmed	0.072***	0.078***	0.063***	0.062***
	(0.016)	(0.016)	(0.017)	(0.017)
Injury or death		0.056**		-0.016
		(0.025)		(0.027)
Constant	0.074***	0.066***		
	(0.010)	(0.010)		
Harm Type FE	N	N	Y	Y
Observations	1,522	1,522	1,522	1,522
R^2	0.013	0.016	0.221	0.221
Note:			*p<0.1; **p<0.05; ***p<0.01	

Is there a case against an individual officer?

	Dependent variable:			
	Individual defendant			
	(1)	(2)	(3)	(4)
Shareholders harmed	0.456***	0.451***	0.065*	0.065*
	(0.029)	(0.029)	(0.038)	(0.038)
Government harmed	-0.034*	-0.039**	0.018	0.018
	(0.019)	(0.019)	(0.020)	(0.020)
Injury or death		-0.042		-0.052*
		(0.029)		(0.031)
Constant	0.122***	0.128***		
	(0.011)	(0.012)		
Harm Type FE	N	N	Y	Y
Observations	1,522	1,522	1,522	1,522
R^2	0.143	0.145	0.291	0.292
Note:	*p<0.1; **p<0.05; ***p<0.01			

Does an individual go to prison?

	Dependent variable:			
	Individual to prison			
	(1)	(2)	(3)	(4)
Shareholders harmed	0.024**	0.025**	0.027	0.027
	(0.012)	(0.012)	(0.017)	(0.017)
Government harmed	0.006	0.006	0.016*	0.016*
	(0.008)	(0.008)	(0.009)	(0.009)
Injury or death		0.004		-0.009
		(0.012)		(0.014)
Constant	0.016***	0.015***		
	(0.005)	(0.005)		
Harm Type FE	N	N	Y	Y
Observations	1,522	1,522	1,522	1,522
R^2	0.003	0.003	0.031	0.031
Note:			*p<0.1; **p<0.05; ***p<0.01	

Victim status and legal severity

- Government is harsher when it is harmed!

  More likely to pursue criminal charges for similar wrongs

  More likely to send individuals to prison

- Harsher outcomes for individuals when shareholders are harmed

  Law (and enforcement) empowered to act against individuals

  Individuals more likely to go to prison

Conclusion

- Focus on manager-shareholder conflicts in corporate governance implicitly assumes other rights are well-protected

- **Our paper** : The US legal system responds more aggressively when corporations harm shareholders than when corporations harm other stakeholders.
  - **Challenges core assumptions** of corporate law/governance
  - **Antecedent to ESG:** if contracts and laws properly protected all but shareholders, would we need shareholders or managers to care about ESG?
  - **Consistent with "strong managers, weak owners, weaker others"**

- Suggests rich agenda for further research!