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A COMMENTARY ON LIABILITY RULES AND THE DERIVATIVE SUIT IN CORPORATE LAW

Harold Demsetz †

Fischel and Bradley (F&B) argue, and seek to demonstrate, that derivative suits are a relatively unimportant source of protection for investors.¹ They conclude that numerous alternative methods of protection are effective enough to reduce the significance of derivative suits.² They also bring systematic evidence to bear on their claims by statistically assessing the impact of derivative suits, or their dismissal, on stock prices.³ Their findings show only a slight relationship between derivative suits and stock prices, but the authors view the direction of those effects as consistent with their conclusion.⁴ In this comment, I discuss both F&B's statistical study and their discussion of the availability of substitute protections.

The authors are to be commended for using statistical evidence, a method too often neglected in legal debate. I have no quarrel with their chosen statistical technique;⁵ they rely on a regression analysis of the impact of the resolution of derivative suits. Nor does this reply quarrel with the authors' conclusion that their evidence shows that derivative suits have only a small impact on stock prices. F&B, however, fail to explain how we should interpret this conclusion because they fail to discuss the theory that lies behind their interpretation of the statistical findings.

Because stock prices play a key role in F&B's work, finance theory might guide their inquiry. According to finance theory, stock prices are influenced by investors' changes in expectations about (1) earnings, (2) systematic risk, and, potentially, (3) firm-specific risk.⁶ This comment ignores systematic risk because investors are unlikely

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¹ Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986) [hereinafter cited as F&B].

² *Id.* at 274-76.

³ *Id.* at 277-83, 293-97.

⁴ *Id.* at 282.

⁵ F&B apply a "standard event-study" analysis to their data to determine the effect of derivative suits' resolutions on stock prices. *Id.* at 279.

⁶ See W. PETERSON, *PRINCIPLES OF ECONOMICS: MICRO* 363 (4th ed. 1980).

to change their views of marketwide peril on the basis of the filing or disposition of a single derivative suit.

A derivative suit and the alleged managerial malfeasance that gave rise to it, however, are very firm-specific. Hence, expected earnings and expected firm-specific risk are possible routes of impact on stock prices unless investors can cheaply alter the consequences of the derivative suit.

Portfolio diversification offers shareholders an inexpensive method of avoiding the impact that a derivative suit might have on firm-specific risk. Owning shares in enough firms produces a statistical attenuation in the firm-specific risk associated with a diversified portfolio of stocks. Therefore, only the impact of the derivative suit on expected earnings links the suit and share prices.

This conclusion is not correct, however, if investors incur costs to maintain diversified portfolios. To the extent that costs limit diversification, derivative suits would change investors' expectations about firm-specific risk and thus have at least some effect on stock prices. As a result, the market would need to compensate investors to entice them to own shares exhibiting high firm-specific risk. Consequently, if a derivative suit or its dismissal unexpectedly increases firm-specific risk, the price of the firm's stock should fall; if firm-specific risk is unexpectedly decreased, the price of the firm's stock should rise. F&B give us no theoretical reason for believing that one of these cases is more likely than the other, and they fail to demonstrate that firm-specific risk is not significantly affected by the derivative suit.

Broadly based statistical studies of stock price behavior do not reveal a very significant relationship between the magnitude of the firm-specific risk exhibited by a stock and the rate of return received by its owners. This finding suggests that investors can diversify their portfolios at a cost that eliminates the market's need to compensate them for bearing this risk. If this finding is valid, the route to stock price change offered by the impact of the derivative suit on firm-specific risk must be discounted. Thus, derivative suits can only affect stock prices by changing shareholders' earnings expectations. Before we can confidently interpret the statistical results of F&B's study, we must assess the likely impact of a derivative suit, and its dismissal, on these expectations.

Stock prices should fall when a court dismisses a derivative suit if such dismissals cause investors to revise their earnings expectations downward. However, the dismissal should not necessarily be linked to a downward revision in expected earnings. The suit may be ill-founded, or it may be a nuisance suit, in which case its dismissal may lead investors to revise their earnings expectations upward.

If the court or the corporation's special litigation committee correctly assessed management's reasonableness in representing investor interests, then all legal review actions should positively affect the stock's price.⁷ If we believe there is a large margin for error, judging the consequences of these legal review choices is more difficult. A court's dismissal of an unfounded suit could raise earnings expectations, while dismissal of a well-founded suit could lower earnings expectations. But even if legal action is frequently in error with respect to investor interests, dismissal may generate a positive impact on stock price simply because the corporate energy absorbed by the legal action can now be spent on the business of making a profit. An assessment of the impact of the dismissal of a derivative suit on earnings expectations is difficult to make absent some basis for judging the validity of the suit.

Perhaps more important in assessing the statistical significance of a dismissal is the small impact a derivative suit may have on investors' expectations concerning future managerial malfeasance, and, therefore, on expectations about future earnings. Some firms, by their very nature, subject investors to a greater risk of fraud and malfeasance than do other firms. Stock prices should reflect this risk because shareholders must expect lower earnings from any given revenue stream. Investments in insurance and financial firms, for example, are more vulnerable to management misbehavior than are investments in firms whose assets are less mobile. Managements come and go, some to Brazil, and cash is easier to carry than steel mills. Because the characteristics of the firm change only slowly, the dismissal of a derivative suit should have little impact on stock price. These attributes may determine the earnings impact of managerial malfeasance more than do the existence of a particular management, a pending derivative suit, or the suit's dismissal.

Perhaps an analogy would be useful. Fire insurance premiums are determined by the kind of business and the nature of the neighborhood and, generally, not by the identity of management. These factors give rise to the insurers' expectations about the probable frequency and severity of fires, which in turn determine the price of insurance. Fires happen, and so does arson, but if their frequency and severity do not lead the insurance company to revise the firm's classification, the premium should not change. Insurance, and the right of the insurance company or the insured to sue, are not unimportant. Rather, their importance may not be ascertainable by examining the relationship between insurance premiums and the dismissal of accident suits. Similarly, if the characteristics of the

⁷ This effect should be positive at least in comparison to the stock's price immediately after the plaintiffs commenced the derivative suit.

firm, rather than those of the incumbent management, determine the probability of malfeasance, then the outcome of a typical derivative suit will not affect the price of a particular stock.

Changes in legal attitudes toward derivative suits may also require investors to revise their earnings expectations. If plaintiffs find it easier to bring and win derivative suits, and courts dispose of such suits correctly from the investor's viewpoint, then the expected earnings of firms that are more susceptible to management malfeasance should increase relative to the expected earnings of other firms. Furthermore, these firms' share prices should rise in proportion to the degree to which the firm's attributes expose it to management malfeasance. By focusing on specific stocks, F&B may therefore underestimate the benefits or costs of a legal system that allows derivative suits. In view of these complications, F&B should provide us with a greater explanation of the theory implicit in their statistical analysis of the consequences of derivative suits. Absent either a convincing theory or richer data to measure the consequences of dismissal, we must rely on the authors' discussion of the availability of substitute methods for bringing management behavior into accord with shareholder interests. I find myself in broad agreement with F&B's evaluation of these.

F&B correctly point out that investors have adequate substitutes for the derivative suit.⁸ The takeover market, the market for managerial services, and the market in which a firm's shares are priced, for example, judge managers and bind them to the shareholders' interests. These markets however are more likely to be effective for duty of care problems than for duty of loyalty problems because their efficacy depends on management's desire to continue to serve as professional officers of business firms. Duty of loyalty problems are more likely to be associated with a willingness to disengage from professional management. The risks taken in the commission of fraud, theft, or self-dealing would seem to require a psychological disposition to be willing to "chuck it all" for a single shot at a large take. Thus, investors need the derivative suit to supplement market protections against breaches of loyalty.

F&B deny that any substantive difference exists between the duty of care and the duty of loyalty. They state that "there is no difference between working less hard than promised at a given level of compensation (a breach of the duty of care) and being compensated more than promised at a given level of work (a breach of the duty of loyalty)."⁹ The authors correctly assess this situation if their conclusion is judged by the impact a breach of either duty has on

⁸ See F&B, *supra* note 1, at 274-76.

⁹ *Id.* at 291.

shareholders. Reasons other than shareholders' immediate concerns may, however, support the distinction between the duty of care and the duty of loyalty. For example, courts may often be able to judge the evidence in a loyalty case more effectively than in a duty of care case. Because breach of loyalty cases can involve acts such as embezzlement, where courts need not second-guess a complex business decision, the terms breach of loyalty and breach of duty may reflect a difference in the court's competence to judge. Thus, evidentiary concerns support distinguishing the duty of care from the duty of loyalty and permitting suits involving a breach of the latter.

In matters involving the duty of care, F&B probably underestimate the availability of workable substitutes for the derivative suit. The structure of ownership in the modern corporation is itself a source of pressure for keeping management tied to shareholder interests. The literature generally ignores this source of discipline for management, but a paper soon to be published¹⁰ demonstrates that the ownership of shares is more concentrated in the hands of a few investors in precisely those situations that seem to call for tighter monitoring of management. The fact that ownership is more concentrated if private monitoring of management is likely to yield greater returns to investors indicates that shareholders have and use alternatives to the derivative suit.

¹⁰ Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences* (to be published in J. POL. ECON., Dec. 1985).