

Team Production and Securities Laws

*Urška Velikonja**

I. INTRODUCTION

In the seminal paper that this symposium celebrates, *A Team Production Theory of Corporate Law*, Margaret Blair and Lynn Stout made two related points.¹ The first one is a straightforward and fairly modest claim: Delaware law does not require shareholder primacy in public corporations.² Rather, the broad deference afforded to the decisions of predominantly independent corporate boards of directors is consistent with a contrary theory, that of team production, or, as they call it, “the mediating hierarch” theory.³ The fundamental role of the board of directors is to mediate between the interests of various stakeholders that contribute to the corporation’s output. As a result, Delaware courts have repeatedly authorized board decisions that further the interests of stakeholders at the expense of shareholders’ short-term interests, so long as directors are pursuing the long-term interests of the corporation.

Blair and Stout’s second claim is normative: that such an arrangement is more efficient than narrow shareholder primacy.⁴ Board decisions are protected by the business judgment rule, which allows and enables the board, without risk of liability, to further the interests of stakeholders because that increases overall social welfare. In their subsequent writing, Blair and Stout have focused on the normative question and stressed that whether their mediating hierarch model is more efficient than shareholder primacy can only be answered empirically.⁵ They have

* Assistant Professor of Law, Emory University School of Law.

1. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 289 (1999) [hereinafter Blair & Stout, *Team Production*].

2. *See id.* at 290–91.

3. *See id.* at 291–92.

4. *See id.* at 292.

5. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403 (2001); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1201 (2002) (concluding that the question of whether director primacy or shareholder primacy is more efficient “cannot be answered

since assembled a solid amount of empirical evidence in support of their theory.

Blair and Stout's positive and normative assessments that team production is a better fit with Delaware corporate law, and likely more efficient, are convincing. In my brief contribution, I will draw on a closely related area of law—securities regulation—to make two related points. First, unlike corporate law, and as a positive matter, securities regulation can be described as requiring shareholder primacy, or at least investor primacy. This is important because securities compliance takes up more of directors' and officers' time than compliance with corporate law, and thus likely influences and informs their day-to-day decisionmaking to a greater degree than does corporate law. If so, perhaps the persistent dominance of shareholder primacy in corporate governance should not be surprising. Second, as a normative matter, investor primacy in securities regulation and enforcement may produce efficient results for most securities activities, but produces suboptimal compliance and enforcement for the most heavily litigated and debated category of securities misconduct: accounting fraud. Empirical evidence on the economic consequences of fraudulent financial reporting suggests that the exclusive focus on shareholders is misplaced. I discuss these observations in turn in Parts II and III of this Essay, and suggest some implications.

II. INVESTOR PRIMACY IN SECURITIES LAWS: A POSITIVE ACCOUNT

Despite Blair and Stout's, and others', efforts to dethrone shareholder primacy from dominating academic and policy debates about corporate governance and regulation, it continues to reign supreme. Professor Stout has advanced three reasons for the persistent dominance of shareholder primacy: misleading metaphors describing shareholders as "owners," activist shareholder opportunism, and accounting scandals.⁶ I would like to add a fourth reason: the rising importance of securities regulation—a closely related area of law and economic activity—where the law does appear to require investor primacy.

except on the basis of empirical evidence" (emphasis added)); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 798–803 (2007) [hereinafter Stout, *Mythical Benefits*] (concluding that evidence favoring shareholder governance is "weak" and evidence favoring board control is "strong"); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 692 (2003) ("[T]he longstanding debate between proponents of the monitoring model of the board and proponents of the mediating model is an empirical argument that can only be resolved satisfactorily by empirical inquiry." (emphasis added)).

6. See Stout, *Mythical Benefits*, *supra* note 5, at 803–07.

The twin goals of securities regulation are to protect investors and further the public interest, which have been understood relatively narrowly as relating to capital market efficiency and competition.⁷ When the Securities and Exchange Commission (SEC) regulates, section 106 of the National Securities Markets Improvement Act of 1996 requires the SEC to consider investor protection and the impact of proposed regulations on efficiency, competition, and capital formation.⁸ Although its governing statutes afford the SEC some flexibility to consider both overall social welfare and the impact of proposed rules on overall efficiency, the SEC has limited its cost-benefit assessments by comparing the out-of-pocket cost of compliance for firms with benefits accruing to investors.⁹ Indeed, the D.C. Circuit, reviewing the SEC's proxy-access rule, has suggested that the SEC should limit its analysis to "maximizing shareholder value" and ignore the economic consequences on employees, retirees, and local governments, even in their capacity as investors.¹⁰

Moreover, when the SEC and the Department of Justice (DOJ) enforce securities laws, they do so with investor protection in mind.¹¹ Investors, (which, to be fair, includes bondholders) are the only group entitled to remedies under the securities laws.¹² Only purchasers and sellers of securities have standing to bring a lawsuit for damages caused by securities violations, and only they are entitled to compensation from the SEC's and DOJ's compensation funds.¹³

7. See, e.g., U.S. SEC. & EXCH. COMM'N, STRATEGIC PLAN: FISCAL YEARS 2014–2018, at 1 (2014), available at <http://www.sec.gov/about/sec-strategic-plan-2014-2018-draft.pdf>.

8. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996), codified in 15 U.S.C. §§ 78c(f) (2010), 78w(a)(2) (2011), 80a-2(c) (2010).

9. See Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus*, 56 ARIZ. L. REV. (forthcoming 2015) (manuscript at 12) (describing Circular A-4 which provides guidance for economic analysis of SEC rulemaking).

10. See *Bus. Roundtable v. Sec. & Exch. Comm'n*, 647 F.3d 1144, 1152 (D.C. Cir. 2011).

11. See, e.g., *Statement of the Securities and Exchange Commission Concerning Financial Penalties*, U.S. SEC. & EXCH. COMM'N (Jan. 4, 2006), <http://www.sec.gov/news/press/2006-4.htm> (focusing almost exclusively on injured shareholders when discussing the appropriateness of corporate penalties).

12. One exception may be Section 16(b) liability for short-term swing profits by corporate insiders, where disgorgement is paid to the corporation, not to individual investors. See 15 U.S.C. § 78p(b) (2014).

13. See generally Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STAN. L. REV. (forthcoming 2015). For example, it is well understood that bribery and corruption do not harm shareholders of the bribing firm. To the contrary, shareholders are the indirect beneficiaries of corrupt payments. Those harmed in the first order include rival businesses that are excluded from competition and consumers who have no choice but to buy inferior or pricier products, and in the second order various stakeholders who are indirectly harmed by distorted competition. The SEC and DOJ have extracted very large settlements in FCPA

To a large extent, the exclusive focus on investors in securities laws makes perfect economic sense. Although section 2 of the Securities Exchange Act lists, as one of four reasons justifying the need for securities regulation, the impact of capital market dislocations on “general welfare”—specifically on employment, trade, transportation, and industry¹⁴—many securities violations affect investors primarily, if not exclusively.¹⁵ When investment banks fix interest rates paid to municipalities for reinvesting their bond proceeds, municipalities are hurt in their capacity as investors, not as local governments.¹⁶ When brokers embezzle funds from their customers’ accounts,¹⁷ charge undisclosed commissions,¹⁸ or cherry-pick by allocating cheaply bought securities to the firm’s own account and more expensive ones to customers’ accounts,¹⁹ their investor-customers bear the cost of the misconduct. Meanwhile, individual brokers and their firms benefit. Competition among broker-dealers may be distorted as a result of such misconduct, but the economic costs of such distortions—beyond the losses to brokers’ customers—are generally relatively small.²⁰

More to the point, most investment vehicles fit the underlying assumptions of shareholder primacy—that the firm is a nexus of contracts and that shareholders are the residual claimants—more closely than public corporations. Blair and Stout start their article with a statement of the shareholder primacy view: “[P]ublic corporations are little more than bundles of assets collectively owned by shareholders (principals) who hire directors and officers (agents) to manage those assets on their be-

enforcement actions, but because investors in those companies were not obviously harmed, the collected funds were paid to the U.S. Treasury, not to the victims. *See id.* at 27.

14. 15 U.S.C. § 78b (2010).

15. *See Velikonja, supra* note 13, at 45–51.

16. *See, e.g.,* Complaint at 5–6, Sec. & Exch. Comm’n v. Wachovia Bank, N.A., No. 11-cv-7135 (D.N.J. Dec. 8, 2011).

17. *See, e.g.,* Raymond James Fin. Servs., Inc., Initial Dec. Rel. No. 296, Admin. Proc. File 3–11692, at 52 (Sept. 15, 2005) (finding that Raymond James Financial Services, Inc., a broker–dealer and investment advisory firm, allowed its broker to embezzle \$16.4 million from clients by failing to take adequate steps despite multiple red flags).

18. *See, e.g.,* Franklin Advisers, Inc. & Franklin/Templeton Distrib., Inc., Exchange Act Release No. 50841 (Dec. 13, 2004) (finding that Franklin Templeton Investments, a mutual fund investment complex, used \$52 million of fund assets to compensate broker–dealers for marketing those funds).

19. *See, e.g.,* Complaint, Sec. & Exch. Comm’n v. K.W. Brown & Co., 555 F. Supp. 2d 1275 (S.D. Fla. Apr. 21, 2005) (No. 05-cv-80367-CIV).

20. For example, Lehman Brothers allegedly pressured its research analysts to issue falsely optimistic reports about firms, on the hopes that Lehman Brothers would secure their investment banking business. The federal district court granted defendant’s motion to dismiss the class action because Lehman’s conduct caused no harm. *See* Memorandum & Order at 8–9, *Swack v. Lehman Bros.*, 1:03-cv-10907-NMG (D. Mass. Aug. 17, 2005) (No. 39).

half.”²¹ While the shareholder primacy model does not describe public corporations, it is a fairly accurate abstraction for another type of entity: an investment fund.

An investment fund is little more than a contract between two parties: fund investors and a management company (often called an investment adviser) that agrees to manage assets of fund investors in exchange for a fee.²² The fund is a legal entity distinct from the management company. The fund has no employees, no office space, no leases, and no operational assets. Under the terms of the contract, the management company agrees to supply all of the operational and administrative services the fund requires.²³ In exchange for management services, fund customers pay the manager set fees, which are usually part fixed and part based on the manager’s performance, measured by increase in the value of assets. The contract between the customers (principals) and the manager (agent) is comprehensive and complete in the sense that the agent cannot collect fees in excess of those specified in the contract.

The fund structure thus fits fairly closely with the nexus-of-contracts and residual claimant theories of the firm. The contract between the management firm and fund investors separates the two and ensures that fund investors are the only residual owners of the fund. This is so because any stakeholders necessary to manage the fund have contacts only with the management company.²⁴ When managers steal from the fund, it is the fund’s customers who are directly harmed and have a right to sue the manager who benefited from the misconduct—not the fund—for compensation. Since the fund has no other stakeholders, only fund investors are harmed.

But securities laws do not govern just investment funds. They apply to operating companies where many different stakeholder groups contribute to the output of the company in ways that are not easily observable or measurable and make firm-specific investments. Where Delaware corporate law defers to the board of directors to mediate among the different groups and limit rent-seeking, securities laws do not.

The disparity between Delaware corporate law and securities law can be illustrated by drawing on one of the examples that Blair and Stout

21. Blair & Stout, *Team Production*, *supra* note 1, at 248.

22. See generally John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1238–39 (2014).

23. *Id.* at 1238–39.

24. The number of stakeholders is small relative to public corporations. Recently, the Wall Street Journal ran a story about David Abrams, a hedge fund manager, who with a very limited staff manages \$8 billion for his customers. See Rob Copeland, *Hedge Fund World’s One-Man Wealth Machine*, WALL ST. J., June 2, 2014, at C1.

use: private litigation. Blair and Stout describe the shareholder derivative suit and its various procedural aspects in support of the model of the board as a mediating hierarch.²⁵ At first blush, a derivative suit appears to be a shareholder remedy: shareholder plaintiffs sue the board of directors for violating their fiduciary duties of loyalty, by self-dealing,²⁶ or of care, by failing to further the interests of the company in bad faith or not on an informed basis.²⁷ But, on closer inspection, the remedy is consistent with team production. First, shareholders seeking to sue derivatively must first demand that the firm's board take legal action.²⁸ The board can decline to do so, and its decision is subject to the deferential business judgment rule. Demand may be excused when the board has obvious and substantial conflicts of interest, but an independent committee without such disabilities can terminate or take control of derivative litigation that shareholders already initiated.²⁹ Second, if the suit is successful, damages are paid to the corporation, not to the plaintiff shareholders.³⁰ As Blair and Stout explain, if "shareholders could be the direct recipients of damages payments in derivative cases, . . . [s]hareholders as a group would become wealthier at the expense of the corporate entity. This sort of wealth transfer usually harms creditors, employees, and other stakeholders in the corporation."³¹ And third, in some limited circumstances, unsecured creditors have a right to bring a derivative action when shareholders have been wiped out.³²

Securities litigation is often compared to derivative litigation and described as its substitute.³³ But unlike a derivative suit, a typical securities class action under rule 10b-5³⁴ (or, for that matter, under sections 11 and 12 of the Securities Act) can be filed without the intermediation of the board of directors, regardless of the board's independence and over the board's direct objection.³⁵ While the plaintiff must plead scienter and

25. See Blair & Stout, *Team Production*, *supra* note 1, at 288.

26. See *id.* at 298.

27. See *id.* at 299–301.

28. See *id.* at 294.

29. *Id.*

30. *Id.* at 295.

31. *Id.*

32. See *id.*

33. See, e.g., Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 904 (2003) (noting that securities litigation, instead of derivative litigation, is commonly used to litigate fiduciary duty claims).

34. 17 C.F.R. § 240.10b-5 (2014).

35. One exception under securities laws is Section 16(b) litigation for short-term swing profits by corporate insiders. Damages are paid to the corporation and not to the shareholder plaintiffs. See 15 U.S.C. § 78p(b) (2014).

a host of other things in order to avoid dismissal of the suit,³⁶ a class action under securities law is a direct class action suit by defrauded shareholders for compensation, thereby removing the decision to dismiss the action from the corporate board's hands.

Another distinction is that damages in class actions are paid to the plaintiffs, not the corporation. Securities class action damage payments are frequently described as circular wealth transfers by shareholders to themselves, "shifting money from one pocket to another, minus the high transaction costs of securities litigation."³⁷ While circularity may be a legitimate concern, that payment of damages³⁸ also drains cash from the corporation, often at a time that it needs it most, and transfers wealth to shareholders at the expense of corporate stakeholders. Finally, except for a handful of bankruptcy cases, in reality, only equity investors can bring a class action for fraud.³⁹

These differences between derivative and securities litigation are important because securities litigation by far surpasses derivative litigation, both by the number of lawsuits filed and certainly by settlement dollars.⁴⁰ And not just in the world of private litigation; with the rise of capital markets over the last three decades, securities laws have gained influence over the regulation of public corporations, and with it, over the theory of public corporate governance.⁴¹ This is an unfortunate and inefficient result, in particular when it comes to the most heavily litigated and debated category of securities violation: accounting fraud.⁴²

36. See Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4 (2010).

37. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1558 (2006).

38. Most public firms purchase Directors' and Officers' (D&O) insurance. A large majority of cases settle within the insurance policy's limits, and so the D&O insurance covers the entire class action settlement. But the corporation pays D&O premia with corporate funds. Either way, shareholders fund the cost of class action settlements. See Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 497-98 & n.3 (2007).

39. See James J. Park, *Bondholders and Securities Class Actions*, 99 MINN. L. REV. (2014) (forthcoming) (describing class actions by bondholders and noting that they are limited to large bankruptcy cases where the firm issued a lot of public debt shortly before bankruptcy).

40. See Baker & Griffith, *supra* note 38, at 497 n.39 (quoting interviews with D&O insurance in support).

41. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C.); Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections of the U.S. Code); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

42. More than 60% of class action settlements and more than 90% of all damages paid in class actions are for accounting fraud. See CORNERSTONE RESEARCH, ACCOUNTING CLASS ACTION

III. THE CASE OF FINANCIAL REPORTING FRAUD

As a positive matter, shareholder primacy accurately captures the underlying premise of securities regulation. As a normative matter, however, our securities enforcement and compensation schemes would be more efficient if they took into account the team production model where it is applicable and most relevant: in accounting fraud cases.

A. A Normative Critique

Accounting fraud is commonly described as a transfer of wealth to managers from the firm's shareholders. Under the nexus-of-contracts theory, the firm is described as a team of inputs organized under a net of related contractual arrangements. The contracts require the firm to pay claimants fixed amounts, except for shareholders, whose claims are variable and depend on the residual value of the enterprise: the firm's profits.⁴³ The value of an investment in stock depends entirely on the estimates of profits the firm might generate in the future. Insiders, usually managers, can manipulate these estimates by releasing false but credible information. Fraudulent disclosures inflate the stock price, while eventual exposure of fraud returns the price to the correct level reflecting fundamentals, which is what the price would have been absent fraud. Sellers win, buyers lose, and those who hold on are unaffected by fraud.⁴⁴

Under the nexus-of-contracts theory, fixed claimants are unaffected by false disclosures and securities fraud because their claims are, by definition, fixed by contract.⁴⁵ But this is only true if their claims are well defined, if fixed claimants are compensated fully for firm-specific investments, if switching between jobs or clients is frictionless and costless, and if association with fraud has no reputational effects on payoffs from future contracts.⁴⁶

These assumptions do not describe labor markets or most supplier markets. Compensation for firm-specific investments is usually deferred, at least in part. Labor and supplier markets are far less homogenous than

FILINGS AND SETTLEMENTS: 2011 REVIEW AND ANALYSIS 1, 11–12 (2012), available at <http://securities.stanford.edu/research-reports/1996-2011/accounting-class-action-filings-and-settlements-2011.pdf>.

43. See Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 180.

44. See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 635 (1985).

45. Less doctrinaire theorists have relaxed the no-loss assumption by fixed claimants, but assert that contractual solutions are preferable to regulation. See Macey, *supra* note 43, at 174.

46. Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1915–16 (2013) [hereinafter Velikonja, *Cost of Fraud*].

markets for capital, and finding substitute employment or customers takes time. Without accurate information about the firm's prospects, employees and suppliers will underestimate the likelihood of firm failure and over-rely. To add salt to the wound, if fraud is unmasked, the fraud firm often unravels quickly. The revelation of accounting fraud thus both increases the likelihood of termination and extends the period of unemployment (assuming all else is equal).⁴⁷ Finally, unlike shareholders, employees (and to a lesser extent suppliers) cannot self-insure against the risk of fraud, like shareholders can, by diversifying.

Moreover, it is important to distinguish primary market and secondary market accounting frauds. When the firm is offering securities to investors on the basis of false disclosures, investors overpay for securities and the firm receives the inflated payments. Unless managers (or promoters) immediately pay themselves a bonus or simply steal the money, the firm's stakeholders likely benefit from additional capital. While the misrepresentation will also distort stakeholders' economic decisionmaking and inflict additional losses if it is revealed, in many cases the benefit may exceed the cost. But in the vast majority of accounting fraud cases, where the firm does not directly benefit from the misrepresentation, or where the direct benefit is small, the losses to stakeholders will outweigh any benefits for the reasons described below.

One form of accounting fraud occurs when managers release false disclosures to disguise disappointing performance and buy themselves time to right the course.⁴⁸ False financial statement disclosures are disseminated publicly, not only to the firm's shareholders. A misrepresentation communicates to those who contract with the firm that the firm's financial health is better than it really is, that the firm presents a low credit risk, and that the firm is less likely to terminate employees for business reasons.⁴⁹ Financial statement misrepresentations are usually accompanied by similarly misleading public pronouncements directed at the investment community and the firm's stakeholders.⁵⁰ While creditors have long relied on financial statements to price credit, employees and suppliers also rely on financial disclosures to assess the viability of the firm.⁵¹ In assessing viability, the firm's risk of failure is considered, as

47. *See id.* at 1918–23.

48. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701–03 (1992).

49. Velikonja, *Cost of Fraud*, *supra* note 46, at 1911.

50. *See id.* at 1910.

51. Sometimes suppliers and customers are aware of and assist the defendant firm commit accounting fraud. Those entities are obviously not misled by financial misrepresentations. *See Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* 552 U.S. 148 (2008).

well as the expected payoff from explicit and implicit contracts with the firm.

Second, to avoid detection, managers must change the firm's real actions to match its reported financial health. Managers might sell output at a loss, announce new projects, overinvest in fixed assets, and overhire.⁵² To mask fraud, managers might choose projects with higher cash-flow volatility, known as "lottery tickets," or projects whose returns are not correlated with existing investments.⁵³

Changes in investment, hiring, and product pricing interfere with economic learning by rivals and distort real economic decisions that misreporting firms and their honest competitors make. Accounting fraud is procyclical and exacerbates boom and bust cycles.⁵⁴ Until fraud is discovered, the inflated stock price will continue to benefit managers as well as the firm's current shareholders. The fraudulent firm can make cheap stock-for-stock acquisitions using its overpriced equity, negotiate better loan terms as a result of its perceived lower risk, and hire more talented workers, excited about the firm's bright future.⁵⁵ Shareholders and bondholders who sell the firm's stock and debt in the secondary markets during fraud also benefit from fraud.

Finally, if accounting fraud is discovered, the aftermath—investigations, litigation, and enforcement actions—is very costly for the firm, its stakeholders, and the industry in which the firm operates. Shareholder losses capture all of the attention, but they are a very crude measure of the losses caused. For example, for each shareholder who lost money, there is a shareholder who sold at an inflated price. The following section develops the empirical evidence showing that the losses to stakeholders likely exceed the losses to shareholders.

B. Some Evidence

An earlier paper of mine assembles the empirical evidence on economic consequences of financial statement fraud.⁵⁶ In this Essay, I provide a summary of the most salient findings.

Firm-level evidence beyond immediate stock-price declines is difficult to develop in the accounting fraud context. Several studies report

52. Gil Sadka, *The Economic Consequences of Accounting Fraud in Product Markets: Theory and a Case from the U.S. Telecommunications Industry (WorldCom)*, 8 AM. L. & ECON. REV. 439, 439, 457–58 (2006).

53. See Velikonja, *Cost of Fraud*, *supra* note 46, at 1910.

54. See *id.* at 1908.

55. See *id.* at 1910–11.

56. *Id.*

increased cost of borrowing after a restatement, both by fraud firms and their rivals.⁵⁷ In an oft-cited study, Simi Kedia and Thomas Philippon report that restating firms overhire and overinvest during the period of the misrepresentation and reduce both labor and investment thereafter. The subsequent decline in employment exceeds both the prior increase and the trends in the wider economy. While all nonfarm payrolls increased by 6.7% between 1997 and 1999 and then declined by 1.5% from 2000 to 2002, employment in restating firms increased by 500,000—20%—and then fell by 600,000.⁵⁸ Industries marred by restatements lost jobs permanently, even where rivals reclaimed the restating firms' market share.⁵⁹

Comparison studies between fraud firms and their rivals reveal the extent of the economic distortion from accounting fraud. Fraud firms report considerable negative abnormal returns upon discovery of fraud—between 9% and 38%. But rival firms, too, report losses when their peers are caught manipulating their financial statements. The effect on each rival firm is small, around 0.5% according to various studies, but the aggregate market capitalization losses of rival firms exceed losses to fraud firms by a considerable margin. In one reported case, the restating firm lost \$141 million in market capitalization, while its rivals lost \$581 million.⁶⁰ Rival losses are attributable to impaired economic learning, distorted competition and contagion, and are considerably more pronounced in less competitive industries.⁶¹

Less but not least, financial reporting of fraud is costly for all levels of government. Where the government relies on disclosures by public firms, false disclosures will distort government policy. Even where the effect is not direct, the losses and economic distortions from accounting fraud reduce the tax base and increase the demand for social spending.⁶²

C. Implications for Securities Regulation

It is well understood that shareholders prefer more risk-taking to other constituents because they do not bear the full cost of risk-taking but capture the entire benefit. Risk-taking includes financial reporting of fraud. Shareholders, left to their own devices, will underinvest on com-

57. *See id.* at 1935–37.

58. Simi Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting*, 22 REV. FIN. STUD. 2169, 2193, 2194 fig.3 (2009).

59. *Id.* at 2195, 2197.

60. *See* Art Durnev & Claudine Mangen, *Corporate Investments: Learning from Restatements*, 47 J. ACCT. RES. 679, 699 (2009).

61. *See* Velikonja, *Cost of Fraud*, *supra* note 46, at 1929–32.

62. *See id.* at 1937–38.

pliance and monitoring to reduce the risk of accounting fraud. This observation has several implications for securities regulation.

First, the public interest should drive securities enforcement for accounting fraud, not a concern with investor protection. Enron was bad for its shareholders, but it was worse for those working at the firm and doing business with it. A team production model would enrich our understanding of why accounting fraud is so costly and improve enforcement. It would also provide a more compelling rationale for rigorous securities regulation enforcement in general, certainly better than the rationales of investor protection or shareholder harms.

Specifically, because the economic losses from accounting fraud are large but difficult to measure, efforts should be directed at preventing accounting fraud through *ex ante* measures, not *ex post* liability. The SEC's new automated detection program, which flags financial disclosures that are correlated with accounting manipulation, is a step in the right direction.⁶³

Finally, the analysis suggests that private securities litigation under rule 10b-5 is not inefficient just because it moves money from shareholders' right pocket to the left one (minus legal fees), because it fails to deter fraudulent managers, or both. Rather, private securities litigation under rule 10b-5 is inefficient because it compensates shareholders who can, for the most part, cheaply and easily self-insure against the risk of accounting fraud. Further, it also fails to compensate nonshareholder constituencies who cannot easily diversify or contract around accounting fraud. Rather than compensating nonshareholders for losses they probably cannot prove with sufficient certainty, it might be more efficient to direct payments to the U.S. Treasury.

IV. CONCLUSION

Securities regulation and enforcement focus exclusively on investor losses, both as a matter of positive law and underlying theory. While that focus may be appropriate for most securities misconduct, the analysis of economic consequences of financial reporting fraud suggests that the residual claimant model that underpins securities regulation is inappropriate for at least one class of violations. Accounting fraud should not be prohibited because of the losses to shareholders. It is terrible for the losses it inflicts on nonshareholders. For these reasons, let us hope that *A*

63. See Jerry Arnold, *Automated Detection in SEC Enforcement*, THE HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (May 31, 2014), <http://blogs.law.harvard.edu/corpgov/2014/05/31/automated-detection-in-sec-enforcement/#more-63588>.

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Team Production Theory of Corporate Law will become one of the most heavily cited articles in securities regulation, just as it already is in corporate law.