Legal Risks and the Changing Structure of Business

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Legal Risks

- Class Actions
  - Products
  - Employees
  - Shareholders

- Tort Liability
  - Punitive Damages
  - Loss of Causation
  - Subject (Products Liability, Environmental)

- Workers Compensation
- Occupational Safety
- Contract Risk

- D&O Risks
  - Fiduciary
  - Sarbanes Oxley
  - Pension

- Property
  - Intellectual Property
  - Terrorism
  - Natural Catastrophe
  - Mundane Hazard Losses

- Regulatory
- Tax
- Competitor’s Settlements
Legal Risk Environment

- Competitors
- Suppliers & Outsourcing Partners
- Customers
- Employees
- Debtors
- Insurers
- State/Local/Fed/Intl Governments
- Tax & Regulators
- Neighbors
- Creditors
- Security Analysts
- Former Shareholders
- Pensioners
- Shareholders
Recent Risks are within Corporation’s Control

- Corporate “Fraud” led to Increased Regulation
- Excesses at Enron, Tyco, Worldcom, & Adelphia
- Positive covariance
  - Ultra-technical application of accounting rules
  - Ultra-technical application of law
- But, all of these excesses were arguably illegal and ill-advised from a common sense point of view.
- Compensation policies provided bad incentives.
Legal Risk Environment Has Changed

- Distrust of Corporations: Unbridled Agency Problems
  - High Fliers of the 1990s
  - Mutual Funds

- What is next?
Most organizations have developed fundamental “Rules” to deal with all sorts of agency problems.

- Acceptable use of company assets
- Proper customer care
- Proper dealings with shareholders

These rules are often based upon legal principles, but may be “moral” in nature.

Rules, to be useful, must help managers maximize long-run corporate value.
Three Simple Cases

The Challenger Disaster

Long Term Capital Management

Enron
NASA had a rule which it used to stop countdowns to discuss risks to launch vehicle and to astronauts.

NASA knew about the O-ring issue.

It discussed the O-ring issue prior to Challenger launch and then decided it no longer needed to talk about O-rings and it excepted the O-ring issue from its rule.

People giving launch OK did not know about O-ring failures.

* http://history.nasa.gov/rogersrep/v1ch5.htm
Enron*

- Enron set up new corporations called Special Purpose Entities (SPEs) to securitize certain assets.
- Enron removed rules or did not apply rules about corporate self-dealing and allowed officers to participate in these deals which altered the officers’ allegiances to Enron.

GAO 1999 concluded*: LTCM was able to establish leveraged trading positions of a size that posed potential systematic risk to the US Banking System because LTCMs customers failed to enforce their own risk management standards. LTCM Customers increasingly violated standard risk management practices believing LTCM posed no risk to them – “a staggering lack of curiosity”**.

Legal Risk has Changed, but Risk Mitigation Strategy has Not!

- Common Sense Rules are value maximizing.
- They work well in most cases--often given as the “Default Rule” in law or economics.
- Disabling the application of a common sense rule is a RED FLAG.
- Making more rules is not necessarily the answer (Sarbanes-Oxley), but understanding the value of current rules and using them may be the real solution.