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Keeping Corporate America Honest

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The Cost of Corporate Failure and the Role of the Private Regulator

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Recent revelations at companies such as Toyota, Massey Energy, Goldman Sachs, and BP have illustrated—in stark terms—how inadequate governance practices can lead to disastrous results. In just the past few years, the consequences of corporate misconduct have spurred a worldwide economic crisis, caused unprecedented environmental damage and have led to senseless deaths. Given these failures, the role institutional investors can play in enforcing the federal securities laws—laws designed to protect not only investors but the public at large—appears more important now than ever before. Good corporate governance and institutional investors' role in demanding it from publicly-traded companies is not some esoteric concept or lofty goal with no real life consequences, but an essential component of our complex economy and society.

Toyota

In January, the public learned that executives at Toyota had concealed safety problems with the company's vehicles that had caused numerous accident fatalities. The vehicle defect hidden by the Company—a phenomenon in which vehicles would suddenly accelerate with drivers powerless to bring them under control—seems like something out of a horror movie.

Internal Toyota documents unearthed through Congressional inquiries praise the company's successful efforts in negotiating an equipment recall with its regulator that "saved" the company "$100M+, w/ no defect found"—revealing a disturbing willingness to put short-term profits ahead of driver safety.

On April 5, 2010, U.S. Transportation Secretary Ray LaHood announced a record fine against Toyota, explaining that the Company "knowingly hid a dangerous defect for months from U.S. officials and did not take action to protect millions of drivers and their families."

Massey Energy

Four days after the Toyota fine was announced, an explosion in a West Virginia coal mine operated by Massey Energy claimed the lives of 29 workers, the worst mining disaster in over 40 years.

In Congressional hearings that followed, Massey miners described how the company refused to take even the most basic safety precautions, waiting until inspectors from the Mine Safety and Health Administration ("MSHA") would actually go into the mine before implementing safety measures that were required by law to be in place at all times. As a Massey miner whose son was killed in the explosion told a Congressional panel, "When an MSHA inspector comes onto a Massey mine property, the code word goes out, 'We've got a man on the property.'" Another worker explained that safety equipment, special curtains that help channel air in the mines to prevent explosions, was only installed if they were tipped to an inspection.

The reason? These basic safety precautions cut into profits. "When MSHA is not present, there is no thought of doing anything other than producing coal," the miner who lost his son explained. "The miners are not allowed to hang curtains or conduct any other safety operations if they would interfere with or delay the production of coal."

Evidence is now emerging that Massey's safety lapses were not just the product of neglect. In fact, the FBI is now conducting a criminal investigation into whether company officials bribed MSHA regulators to look the other way.

Goldman Sachs

A week after the explosion in West Virginia, the Securities and Exchange Commission ("SEC") charged Goldman Sachs & Co. with fraud in connection with a complex financial transaction that, according to the SEC, was designed to fail.

According to the SEC's complaint, Goldman Sachs colluded with an outside hedge fund that had hand-picked risky mortgage-backed securities that were placed into a collateralized debt obligation ("CDO") structured by Goldman Sachs, which the bank then marketed to its clients. According to one senator investigating the bank, Goldman Sachs had helped "build and operate a conveyor belt" of dubious transactions at the heart of the subprime meltdown.

Internal emails from the company's top executives detail the bank's conscious decision to unload risky subprime and other mortgage-related assets onto clients and position itself to benefit from the collapse of the mortgage bubble it helped create. "In a number of ways they contributed to the collapse of this economy," the senator said. "The toxins that Goldman Sachs and others helped inject into our financial system has done incalculable harm." The SEC recently announced a $550 million fine against Goldman Sachs for its role in marketing the dubious CDO, the largest SEC fine in history.

The human cost of corporate malfeasance has been staggering. So have the losses to investors. Toyota's shareholders have lost tens of billions of dollars, Massey Energy shed over 43 percent of its market capitalization, Goldman Sachs shareholders lost tens of billions of dollars, and the value of BP shares has been cut in half.

British Petroleum

Five days after the SEC announced its fraud suit against Goldman Sachs, an explosion at the Deepwater Horizon deep sea rig in the Gulf of Mexico claimed the lives of 11 workers and triggered what President Obama has called "the greatest environmental disaster of its kind in our history." As oil continued to spill into the Gulf—creating an oil slick over hundreds of miles wide, reaching the shores of Texas, Louisiana, Alabama, Mississippi and Florida—the public began to learn how BP's cost-cutting and pursuit of profits created the conditions that led to the disaster and the company's tragically inept response. In media accounts, survivors of the Deepwater Horizon disaster have

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Massey Energy

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Goldman Sachs

SEC charges Goldman Sachs with fraud for structuring CDOs "designed to fail." SEC later levies record $550 million fine.

British Petroleum

British Petroleum deep sea oil rig explodes in Gulf of Mexico killing 11 workers and causing a catastrophic environmental disaster.

described a corporate culture of eliminating necessary staff and ignoring warning signs ahead of the blast, with BP routinely cutting corners and pushing ahead despite concerns about safety. According to BP workers, it was always understood that you could get fired if you raised safety concerns that might delay drilling, and those who chose to speak out found themselves without a job.

Experts now believe the explosion was caused, in part, by a BP official's decision to replace heavy mud, which was used to keep the Deepwater Horizon well's pressure down, with lighter seawater to help speed a process that was costing an estimated $750,000 a day and was already running five weeks behind. In the third quarter of 2009, BP reported over $4.5 billion in profits but elected to forego spending several hundred thousands of dollars on a safety device (known as an "acoustic switch") that some say may have prevented the spill. In sharp contrast to BP's public statements touting a renewed commitment to safety and environmental issues, the Gulf oil spill response plans that BP submitted to the federal Mineral Management Service ("MMS") in 2009 reveal the company's utter disregard for preventing or dealing with an oil spill in the Gulf. For example, BP's 2009 Gulf report listed a national wildlife expert who died in 2005 as a primary contact and included walruses, sea otters, sea lions and seals as "sensitive biological resources" that could be impacted by a potential spill — animals that do not live anywhere near the Gulf. The U.S. Department of Justice has since announced criminal and civil investigations into BP's misconduct.

Shareholder Losses

In each of these examples, the human cost of this corporate malfeasance — aided by what appears to be a complete break-down in the corporate governance practices and polices intended to hold management accountable and prevent such abuses — has been staggering. So have the losses to investors. Toyota's shareholders have lost tens of billions of dollars since the revelations of the company's vehicles' sudden acceleration problems; Massey Energy shed over 43 percent of its market capitalization following the explosion at its West Virginia mine; Goldman Sachs shareholders lost tens of billions of dollars after the SEC filed its fraud suit; and the value of BP shares has been cut in half since the Deepwater Horizon disaster, with some fearing the company may go bankrupt before paying for cleanup costs, civil and potentially criminal environmental liabilities and billions in claims from those in the fishing and tourism industries who have had their livelihoods destroyed. Shareholder lawsuits are now pending in courts across the country, alleging that these companies, and their executives, concealed the practices that have led to such financial ruin, environmental destruction and human suffering.

Federal Securities Law Protections

The principal goal of the federal securities laws is to ensure that publicly-traded companies and other securities issuers provide timely, accurate and truthful disclosures to investors and compensate them for financial harm when they do not. However, when properly enforced and followed, the securities laws protect not only investors, but also other stakeholders—such as employees, competitors, suppliers, and governments—that rely on issuers' honest and ethical conduct. Indeed, the official justification found in the Securities Exchange Act of 1934, passed in the wake of the Great Depression, asserts that the Act also helps protect millions who are not themselves investors, acknowledging that "widespread unemployment and the dislocation of trade, transportation, and industry …are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices." The Supreme Court has likewise recognized the broad policy goals achieved through the market transparency demanded by the Act, noting that the "primary objective of the federal securities laws" was to protect "the investing public and the national economy through the promotion of 'a high standard of business ethics.'"

By requiring prompt, complete and accurate disclosure of all material information, the federal securities laws oblige publicly-traded companies to produce safer products, engage in sound environmental practices, protect the health and safety of their employees, and act ethically and honestly when dealing with clients and customers. For example, an automobile manufacturer that knowingly sells defective vehicles violates the federal securities laws when it conceals from investors that conduct and the material risks—such as lawsuits, governmental prosecution, and reputational harm—that naturally flow from it. When an oil conglomerate knowingly operates its facilities in an unsafe manner, risking an environmental disaster and exposing its business to massive liabilities, regulatory action and cleanup costs, it violates the federal securities laws by concealing this fact from investors. The federal securities laws, when enforced, are intended to provide an additional deterrent to such misconduct by ensuring an avenue for shareholders to recover the losses they incur when the financial consequences of corporate wrongdoing inevitably materialize.

The corporate failures exemplified in the Toyota, Massey Energy, Goldman Sachs, and BP cases also highlight the importance of investor protections in complementing government oversight and enforcement efforts. In each example, the companies' government regulator—the National Highway Traffic Safety Commission, the MMS, the MSHA, and the SEC (which is tasked with protecting the investors of all publicly-listed companies)—either failed to detect the underlying misconduct in time to prevent a disaster or, at worst, appear complicit in permitting dangerous practices to go unchecked. For years, private shareholder lawsuits have been the primary means for enforcing investor protections in the United States.

"Why isn't the government getting tough with banks?"

Courts Criticize More Settlements Between Regulators and Financial Institutions

Federal judges continued to criticize what they deemed to be inadequate government settlements with companies alleged to have violated the securities laws. Federal Judge Emmet G. Sullivan criticized the Department of Justice's (DOJ) proposed settlement with Barclays, asking "Why isn't the government getting tough with banks?" The government's suit had alleged that the British bank helped customers in Iran, Cuba and other sanctioned nations move more than $500 million into the United States, breaking federal law for more than a decade. In the settlement, Barclays admitted to wrongdoing, forfeited $298 million and agreed to improve employee training, while the DOJ agreed not to pursue criminal charges against the bank. Judge Sullivan remarked that "The public looks at this and says, you know, they're getting a free ride here." He reluctantly approved the settlement, stating that it was not his job to supervise government prosecutors. Similarly, Federal Judge Ellen Segal Huvelle refused to approve a proposed settlement between the S.E.C. and Citigroup, stating "You expect the court to rubber stamp, but we can't." Under the proposed settlement, Citigroup acknowledged concealing from shareholders the extent of its investment in subprime mortgages. Judge Huvelle ordered the government to provide more information as to the fairness and adequacy of the settlement. After both sides submitted additional changes to the bank's disclosure policies, Judge Huvelle indicated that she would "ultimately approve" the settlement.
>> *New York Times, August 23, 2010.*

Nearly 20 years ago, then-SEC Chairman Richard Breeden told federal lawmakers that budgetary limitations meant that private class actions must "perform a critical role in preserving the integrity of our securities markets." A few years later, Breeden's successor, Arthur Levitt, admitted that private lawsuits, rather than government prosecutions, had become "the primary vehicle for compensating defrauded investors." Importantly, private enforcement of the federal securities laws not only serves as an important complement to SEC action, but also to the efforts of other regulatory agencies that, in all too many cases, have failed to detect and prevent corporate wrongdoing.

The PSLRA

In 1995, Congress instituted one of the most sweeping changes to the federal securities laws in history when it enacted the Private Securities Litigation Reform Act ("PSLRA"), which reaffirmed the role of private securities class actions in promoting ethical corporate conduct. Indeed, the Conference Report accompanying the bill noted that such litigation "promote[s] public and global confidence in our capital markets and help[s] to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers, and others properly perform their jobs." In reassessing how these goals could be achieved, Congress turned to institutional investors, which many believed were in a unique position to serve the role of "private attorney general" in enforcing investors' rights in securities class action litigation. Congress believed that institutional investors, which have long-term investment timelines and a vested interest in ensuring the predictable and healthy functioning of the capital markets, were best incentivized to promote honest and ethical conduct by public corporations.

Through the PSLRA, institutional investors — many of whom already influence corporate conduct by adopting investment policies and initiating shareholder resolutions that require companies to take environmental, social, and governance issues into account — are provided with a powerful tool to reform practices at publicly-traded companies. Indeed, lead plaintiffs in securities class actions are able to wield the leverage of an entire shareholder class to implement corporate governance changes that address corporate failures that lead to fraud. Many institutional investors, particularly public pension funds, have heeded Congress's call, and have taken on an active role in securities class action litigation and in pursuing reforms that strengthen product safety and quality standards, improve environmental practices, protect workers, and curb excessive risk-taking.

Summary

When serving as lead plaintiffs in securities class actions, institutions are virtually unrestrained in their ability to propose and craft meaningful corporate governance measures. For example, institutional lead plaintiffs can pursue reforms that address a lack of board oversight of regulatory compliance; institute accountability measures for safety violations; establish committees charged with ensuring that cost-cutting measures do not sacrifice worker or product safety; increase transparency by requiring the publication of board committee findings regarding regulatory compliance; provide for an independent corporate monitor to track safety, regulatory compliance or progress on reform measures; and otherwise adopt policies to serve the interests of shareholders instead of executives. Perhaps most importantly, serving as lead plaintiff provides institutional investors with an opportunity to change the belief, held by too many corporate executives, that a myopic pursuit of profits — disregarding the health and safety of workers, the costs to the environment and the economy, and, more fundamentally, the right and ethical thing to do — is the only principle valued by the marketplace.

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