

1-1-2005

Civil Suits and Business: Are Big Verdicts Really a Deterrent

Floyd Norris

Recommended Citation

Floyd Norris, *Civil Suits and Business: Are Big Verdicts Really a Deterrent*, 38 Loy. L.A. L. Rev. 1201 (2005).
Available at: <https://digitalcommons.lmu.edu/llr/vol38/iss3/5>

This Symposium is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact digitalcommons@lmu.edu.

CIVIL SUITS AND BUSINESS: ARE BIG VERDICTS REALLY A DETERRENT?

*Floyd Norris**

October 1, 2004

Thank you Henry. It is a pleasure to be here today, although I must admit to having some doubts about why I was invited. Unlike most of the members of this panel, I am not a law school graduate, and in my work at *The New York Times* I write columns and news stories on business, finance and economics. I am not an expert on the civil justice system.

But I was invited, so I want to give a few thoughts, some of them stimulated by the writings of my very distinguished colleagues on this panel and some by having watched class action securities suits over the years.

It seems to me that the civil justice system often sets out to solve problems when it perceives that no one else is doing so. That is the nature of the common law. Sometimes it works better than others. But when critics of the civil justice system assert it is doing a bad job—as many tort reformers are doing now—their reaction is too often only to try to limit the ability of the court system to do that bad job. Thus we see efforts to force cases out of state courts into federal ones, or to cap damage claims, or to reduce contingency fees in the hope that will keep bad lawsuits out of court.

It seems to me that the correct answer is often to be found by looking outside the civil justice system to seek a better remedy than the one the courts are providing for the real problem that the courts are trying to attack.

With that perspective, let me turn briefly to the alleged crisis in malpractice insurance. Premiums have soared and those costs are

* Chief Financial Correspondent, *The New York Times*.

being passed on, to some extent at least, in the form of higher medical fees and therefore higher medical insurance costs. I presume that excellent doctors, as well as lousy ones, are paying those high premiums.

The response from some defenders of the current system—that the insurance companies are often guilty of bad business practices—is correct, but it misses the real point.

Certainly there are cycles in the insurance industry in which companies write policies that turn out to be uneconomic, and then overcompensate by jacking up rates as some companies withdraw from the market. Part of Warren Buffett's success has come from a willingness to write policies when others are scared, and to walk away from writing policies when excessive optimism has pushed premiums down to unreasonably low levels.

And certainly any long-tail insurance—that is insurance where claims will be paid long after premiums are collected—is going to be priced in part on expected investment returns for the companies that collect those premiums. So when interest rates are high, or equity markets soaring, we can expect companies to charge premiums based on investment assumptions that may turn out to be too optimistic. Those issues have nothing to do with the quality of medical care in the country.

My perspective is that we should ask instead what else could be done to improve the quality of care. If malpractice litigation were having its intended deterrent effect, perhaps we would see fewer and fewer cases filed. We are not seeing that.

What I think is needed is a better, and faster, system of regulation of physicians. My view is colored, let me admit, by the first doctor I ever admired. When I was growing up here in Los Angeles, I had a distant cousin who was a physician, and, my father told me, a very distinguished one. He did not ever treat me. But his role in our family was to vet other doctors. He told me that the medical establishment knew which doctors were any good, and which were not. If a member of my family needed a specialist, we depended on Dr. Norris to check out reputations.

I wondered then, as a teenager, why the doctors who were not so good—or were even bad—were allowed to continue practicing. And I still do. My conclusion is that state medical boards are reluctant to

lift credentials in all but the most egregious cases. So bad doctors go on practicing, and get hit with enough suits to drive up costs for everyone.

I do not know the extent to which malpractice insurance companies weigh litigation histories in deciding whether to insure a particular doctor, or in deciding what premium to charge. If they do not, that suggests a perception—encouraged by the health care industry—that malpractice verdicts are an almost random event, no more foreseeable than lightning strikes. I hope that is not the case.

Before I finish discussing medical malpractice, I would like to say a good word for a suggestion of Philip Howard, which is for specialized courts in medical cases. I don't know whether that would reduce malpractice verdicts and settlements, as I think he hopes, but I think it might make them more predictable and more accepted by the medical establishment. And that might, in turn, lead to a better regulation of the industry, whether by state medical boards or by the insurance companies that are paying the bills.

An essential fact of the tort justice system is that it is supposed to have a deterrent effect and thereby diminish the bad activity alleged in the lawsuits. That will not be the case if those who are supposed to be deterred—or those with power over them—believe that verdicts are random and not indicative of anything but a justice system out of control.

If doctors believe that suits and verdicts stem not from malpractice but from bad outcomes of medical care, some of which are of course inevitable, then we are not likely to see real steps taken to reduce malpractice. A similar problem may exist in another area, that of suits alleging police brutality. In New York, where I lived for many years before moving to Paris this year, I have been told that the city does not pay attention to such suits, even after it pays out big verdicts or settlements, when it comes to taking disciplinary action against police officers.

To return to Mr. Howard's idea of expert courts, it seems to me that in corporate law such an expert system already exists. It is the Delaware Chancery courts. The vast majority of companies are incorporated in Delaware, and while companies sometimes threaten to leave Delaware when the judges there restrict the authority of management, they do not carry out their threats. What Delaware

offers is a group of judges who hear only corporate law cases, and who get to be experts. That helps to make the law predictable. And that is important if the legal system is to have a deterrent effect.

In some other states, such cases may go before any trial judge, who may or may not know much about that area of law, and that does not make it easy to forecast what will or will not be ruled illegal.

In the tort reform debate, we hear thinly veiled suggestions of corruption, largely based on the idea that trial lawyers help judges to get elected who will then rule for the trial lawyers.

That problem may be a real one, but as a student of financial history, I would like to remind you of real judicial corruption, as was shown in the Nineteenth century in perhaps the greatest battle for corporate control ever waged—between Jay Gould and Commodore Vanderbilt for control of the Erie Railroad.

It started with Vanderbilt trying to buy control of the Erie by purchasing shares in the open market. Gould and his allies, who controlled the line, responded by printing new shares and selling them to Vanderbilt, while printing even more for themselves. The fight quickly went to court, where both Gould and Vanderbilt had judges on retainer, who issued competing injunctions against the other side.

With the courts neutered and discredited, the battle went to the New York legislature, some of whose members were happy to take bribes from both sides. In the end, having concluded that both the judicial and legislative branches were too expensive, Vanderbilt and Gould reached a settlement, which the legislature ratified. Those who are distressed at the state of civil litigation today may want to recall that it used to be a lot worse.

The title of this panel raises the question whether the tort system is a “destroyer of business.” To me, that brings up a subject I have covered, which is securities class action litigation. It is an area where business has sought changes, with some success. In 1995, Congress passed the Private Securities Litigation Reform Act over the veto of President Clinton.¹ It seems to me—based on

1. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C. & 18 U.S.C.).

impressions rather than any detailed study—that the legislation has done some good, but not in the way its sponsors expected.

The perception among many companies was—and is—that they will be hit by class action securities litigation if their share price falls, regardless of whether they did anything wrong. They believe that many lawyers who file such suits are leeches who want to force settlements without regard to whether they really have a case.

The Act was intended to make several changes. It was supposed to make it easier to get cases removed to federal courts, which were presumed to be less likely to render outrageous verdicts. It was supposed to make it much easier to get cases dismissed early in the process, before discovery, to prevent lawyers from going on fishing expeditions that might, in themselves, force blameless companies to offer settlements. And it tried to discourage the rush to the courthouse door by saying that judges should name the lead lawyer in class action suits based on the amount of damages allegedly suffered by that lawyers' clients—not by who filed the first suit. There was a perception that some class action lawyers had a stable of plaintiffs who owned a few shares of every company around, so that the lawyer could file within hours or even minutes of the bad news hitting the Dow Jones ticker.

How has that reform worked? It appears to me that it has not done a lot to discourage state claims. But I think it has tended to concentrate the field of class action lawyers—in ways that businesses are not necessarily happy about.

I used to suspect that some securities class action suits were filed by lawyers who were more than happy to settle them quickly on terms that did little for their ostensible clients but a lot for the lawyers' bank accounts. I wondered if in some cases the race to the courthouse door was won by a settlement-inclined lawyer who was tipped off by the company that a negative announcement was coming.

Let me emphasize that I have no proof such a thing was going on. But there were class action lawyers who had reputations for not being very eager to try cases.

So what did the legislation accomplish? First, it probably has deterred some frivolous lawsuits, which is a good thing. But in general such cases did not cost business very much anyway. In the

case of suits with merit, the legislation may have made it worse for companies. A relatively small number of institutional investors—largely but not solely public pension funds—are now willing to serve as lead plaintiff. And given the size of their holdings in almost every company, they are likely to be the biggest plaintiffs around, and therefore able to get the lead plaintiff status if they want it.

Those institutions can afford protracted litigation if they really are determined to do so, so it is not just a matter of how deep the pockets of the plaintiffs' lawyers are in financing a lawsuit. They may be really angry over what some company did—and determined to teach other companies a lesson. So I think that major lawsuits may be less likely to settle at low verdicts now.

Let me turn now to a special class of defendants in securities litigation, one that I have written a lot about over the years—the auditors. For years, they have viewed themselves as victims who get nailed only because they have the deep pockets. In a classic corporate fraud, by the time the suits are filed the company may be bankrupt, and thus judgment proof. The company officials who actually organized the fraud may have little in the way of assets left, at least relative to the damages being claimed. So the lawyers went after the auditors, who viewed it all as horribly unfair. Sure some audits failed to find fraud, they said, but that did not mean the auditors did anything wrong.

Now there are senior officials of auditing firms who privately say that without legal reforms to protect them, it is inevitable that one of the remaining Big Four firms will be driven out of business by a big judgment in some pending case. They want Congress to limit their liability, perhaps to a multiple of the audit fees they received. Such a cap would be a small fraction of the amount that can be lost due to a major fraud, and so far the idea does not seem to have much political traction. The firms had hopes this year that the British government would enact such legislation, but in the end it declined to do so.

Parenthetically, let me say that the most interesting aspect of recent securities litigation is that other deep pockets are being found—the banks and investment banks who arguably have helped companies defraud investors by coming up with financial products intended to deceive. The SEC and the Justice Department have filed

such cases in some high profile frauds, notably Enron, and now we see Parmalat in Italy trying to blame both banks and auditors for its fraud. I know some auditors who are privately gleeful over the fact the banks are now in the same boat, although it is not clear to me how much good that will do the auditors.

To return to the question of auditor liability, I think we have learned in the past few years that bad audits were not always a matter of bad luck. In too many cases, the auditors cut deals with companies to go along with things that mayor may not have seemed justifiable when they began but now seem outrageous. As the SEC noted when it filed civil fraud allegations against Arthur Andersen in the Waste Management case, auditors who sign onto small deceptions one year risk being forced to accept larger ones the next year, because revealing the larger ones would also reveal the smaller ones and clearly expose the auditors to liability.²

Andersen responded to that SEC suit by settling it and then ignoring it. The SEC found evidence from e-mail messages that some senior officials at Andersen had known of fraud and countenanced it. It barred those auditors from auditing public companies, but Andersen chose not to fire them. It put one of them to work revising Andersen's policy on document retention. His policy called on auditors to be vigilant in destroying documents that were no longer needed, and did not specify that such shredding should stop if the firm learned of a possible SEC inquiry. It was that policy David Duncan, Andersen's lead auditor for the Enron account, claimed to be following when he shredded Enron's documents and Andersen's reputation.

The Enron and WorldCom frauds led to the 2002 passage of the Sarbanes-Oxley legislation.³ The most important part of that legislation was the creation of the Public Company Accounting Oversight Board, which would like to be known as the PCAOB but is called Peek-a-boo by many in the industry.

2. E.g., U.S. Securities and Exchange Commission, *Waste Management Founder, Five Other Former Top Officers Sued for Massive Fraud*, Mar. 26, 2004, www.sec.gov/news/headlines/wastmgmt6.htm.

3. Pub. L. No. 107-204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (2002) (to be codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.).

That nickname is apt. Until now, there was no effective regulator of the major accounting firms. The state boards seldom acted, and the disciplinary proceedings of the American Institute of Certified Public Accountants were neither quick nor effective.

For the first time, auditors know that there is a chance that someone else is going to come along and look at their audit, in detail. And that someone will not be a plaintiff's lawyer, who would have to fight a long legal battle just to get the documents and whose expert witnesses can be countered by a parade of other expert witnesses. Instead, it will be by a regulator that has the power to discipline the firms. From what I hear from both auditors and some corporate executives, Peek-a-boo is already producing better audits.

To bring this talk back to where it began, and thus to a conclusion, that precedent is one that might be profitably studied by those worried about high premiums for malpractice insurance.