# A REPUTATIONAL THEORY OF CORPORATE LAW

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*How does corporate law matter? This Article provides a new perspective on the longstanding question by suggesting that the main impact of corporate law is not in imposing sanctions, but rather in producing information. The process of litigation or regulatory investigations produces information on the behavior of defendant companies and businesspeople. This information reaches third parties and affects the way that outside observers treat the parties to the dispute. In other words, litigation affects behavior indirectly, through shaping reputational sanctions. The Article then explores how exactly information from the courtroom translates into the court of public opinion. By analyzing the content of media coverage of famous corporate law cases, we gain two sets of insights. First, we learn that judicial scolding does not necessarily hurt the misbehaving company's reputation. The reputational impact of litigation depends on factors such as whom the judge is scolding, what she is scolding them for, and how her scolding compares to the preexisting information environment. Second, we flesh out the ways in which information flows from the courtroom get distorted. Information intermediaries selectively disseminate certain pieces of information and ignore others. And defendant companies produce smokescreens in an attempt to divert the public's attention. Recognizing that corporate law affects behavior by facilitating reputational sanctions carries important policy implications. The Article reevaluates key doctrines in corporate and securities laws according to how they contribute to information production. In the process we refocus timely and practical debates, such as the desirability of open-ended standards and liberal pleading mechanisms and the proper scope of judicial review of the Securities and Exchange Commission's actions.*



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* John M. Olin Corporate Governance Fellow, Harvard Law School. Thanks for helpful comments and discussions go to Jennifer Arlen, Robert Clark, Charles Elson, Tamar Frankel, Howell Jackson, Renee Jones, Kobi Kastiel, Vic Khanna, Harvey Pitt, Edward Rock, Mark Roe, Steve Shavell, Andrew Tuch, Batia Wiesenfeld, and seminar participants at Harvard Law School, Tel Aviv University, Yale Law School, the Corporate Governance Fellows lunch group, and the First Annual Corporate and Securities Litigation Workshop. Financial support was provided by the John M. Olin Center for Law, Economics and Business.

## INTRODUCTION

How does corporate law work? This question has puzzled academics for decades. The puzzle stems from the fact that the managers and directors who are supposed to be disciplined by corporate law almost never pay out of pocket for their misbehaviors.[1] In other words, corporate law lacks sanctions. Without sanctions, where does deterrence come from? The corporate governance literature has suggested in response that deterrence comes not from the law or direct financial sanctions, but rather from indirect reputational sanctions. Managers do their best not because they fear direct sanctions, but rather because they wish to protect their long-term reputation in the labor market or among their peers.[2] But such an answer only generates a second puzzle: how do indirect, reputational sanctions work?[3]

This Article provides a new perspective on these puzzles by arguing that corporate law affects behavior indirectly, through shaping reputational sanctions. In the process of litigation or regulatory investigations, the legal system produces information on the behavior of the parties to the dispute. This information reaches third parties and affects the way that outside observers treat parties to the dispute (regardless and beyond the effects of direct legal outcomes). In other words, information from litigation and investigations shape the market reaction to misbehavior.

The way to solve the aforementioned puzzles is therefore to marry them: look at law and reputation together, as complementing each other. The corporate governance literature has rested on the assumption that reputation matters[4] but has remained remarkably silent on *how* exactly reputation matters. What explains the variation in reputational sanctions? Why do some companies and businesspeople emerge from failure unscathed while others go bankrupt? Some of the answers, this Article claims, can be found in the information-production function of the law. The law serves as an important channel that

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1. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1055 (2006) (noting that, in a span of twenty-five years, only thirteen outside directors paid out of pocket); Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1791 (2001) (stating that directors are more likely to get struck by lightning than pay damages for breaching their fiduciary duties).

2. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1012 (1997).

3. *Id.* ("If the principal sanction is not directly financial but reputational, then one must explain how this sanction works, an account entirely absent from the standard account.").

4. In recent years this assumption has received empirical support. For an overview, see Jonathan M. Karpoff, *Does Reputation Work to Discipline Corporate Misconduct?*, *in* THE OXFORD HANDBOOK OF CORPORATE REPUTATION (Timothy G. Pollock & Michael L. Barnett eds., 2012).

affects the reputation of companies and businesspeople. Reputation therefore matters through corporate law. And corporate law matters through reputation.

Realizing that corporate law affects behavior by facilitating reputational sanctions carries important policy implications. If corporate litigation does indeed generate a positive externality in the form of helping market players get better information, then key doctrines and institutions should be reevaluated according to how they contribute to information production. This Article offers alternative explanations to much-debated features of Delaware corporate law, such as the increased reliance on open-ended standards or the liberal use of pleading mechanisms. The Article also sheds light on previously overlooked dilemmas, such as whether to assess director liability individually or collectively and how to approve settlements in derivative and class actions.

A few words on methodology are in order. The corporate governance literature deals extensively with "hard" market incentives, such as executive compensation, but neglects "soft" market incentives, such as maintaining a reputation for integrity. This is partly because analyzing reputational forces is challenging: they follow fuzzy dynamics and do not easily lend themselves to generalizations. My strategy in fleshing out these important yet understudied factors was to examine them from multiple angles and methodologies. I drew from the fast-emerging literature on reputation across disciplines (mainly economics and social psychology), gained insights from interviewing practitioners who work at the intersection of the court of law and the court of public opinion (mainly crisis management consultants and journalists),[5] and corroborated my arguments with existing statistical data. Then, to make the arguments more concrete and applicable, I delved into specific case studies and conducted content analyses of the media coverage of iconic corporate cases. I came up with several sets of insights as detailed below.

Part I lays down the general theoretical framework. The Part generates two contributions: (i) explaining why reputational assessments are inherently inaccurate and (ii) fleshing out the ways in which the law affects their accuracy. When bad news about a company breaks and the company's stakeholders consider whether to continue doing business with it in the future, they often lack the information or incentives to interpret the news correctly. As a result, the market overreacts to certain misbehaviors and underreacts to others. Stakeholders may stop doing business with perfectly fine companies or ignore warning signals and continue doing business with rotten companies. The

5. The following interviews proved especially insightful: Charles Bakaly, head of the Litigation Communication Department of Edelman (Aug. 21, 2012); Bruce Carton, former senior counsel with the SEC's enforcement department (May 21, 2013); Richard Clary, former head of litigation in Cravath, Swaine & Moore (Nov. 16, 2012); Eric Dezenhall, head of a crisis management firm (July 20, 2012); Michael Fertik, founder of Reputation.com (Feb. 11, 2013) (offering online reputation management services); Guy Rolnik, founding editor of a business journal (Nov. 15, 2013); a representative of Courtroom Connect (June 13, 2013) (Courtroom Connect offers a service of live streaming coverage of litigation). For additional interviews in footnotes, see *infra* notes 34, 79, and 170.

market, when left alone, has trouble calibrating reputational sanctions correctly. But in reality the market rarely is left alone. Market players continuously look for information that is being produced by the legal system to help them revise their initial reputational assessments. Reputational sanctions thus operate in the shadow of the law.

Part II applies the general framework to corporate fiduciary duty litigation in Delaware. I first refocus the debate over the effectiveness of corporate-law enforcement. When measuring enforcement we should look not just at the outcomes (legal sanctions) or content (moral rebukes offered in dicta) of judicial opinions, but also at earlier stages in the litigation process: pleading, discovery, and trial. The litigation process itself affects corporate behavior at least as much as judicial opinions do, through flushing out information and facilitating reputational sanctions.[6] I then offer testable predictions on the reputational impact of litigation by outlining the factors that determine how information from the courtroom translates into reputational sanctions. One counterintuitive takeaway point is that judicial scolding does not necessarily hurt the misbehaving companies' reputation. The reputational outcomes of litigation depend on questions such as whom the judge is scolding (is she singling out an ousted individual or criticizing an unhealthy corporate culture?), what she is scolding them for (honest incompetence or calculated disregard of market norms?), and what her scolding adds to the already existing information environment.

Part III corroborates the theoretical arguments by delving into the famous Disney-Ovitz litigation[7] as a case study. I analyze the content of media coverage of the Disney-Ovitz debacle before, during, and after litigation. By adopting such a methodology we gain two sets of insights that develop the reputational theory of the law. First, we learn about the relative reputational impact of each phase in litigation. For example, we learn that the verdict's reputational impact is much more limited and favorable towards the defendant company than was previously assumed. Second, we learn about the distortions in information flows. A lot of information gets lost in transmission from the courtroom to the court of public opinion. Different information intermediaries, such as mass media or law firms, selectively choose different pieces of information to convey to their respective audiences. And defendant companies try to hijack the information flows by producing smokescreens that divert the public's attention.

Part IV sketches out the normative implications of the reputational theory of corporate law. I reevaluate the desirability of key doctrines such as *Zapata*.[8]

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6. The upshot is that even cases that settle produce reputational sanctions. For empirical support for this argument, see *infra* note 34 and the accompanying text.

7. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

8. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

I then revisit the regulatory competition debate.[9] The existing literature already recognized that if Delaware wishes its law to remain the dominant state corporate law, it has to balance between appeasing the public and Washington in order to prevent federal intervention and appeasing corporate America in order to prevent corporate migration. My reputational perspective adds the angle of *how* exactly Delaware effectively balances this dual threat. By relying on scolding and not on direct sanctioning, Delaware courts make it harder on the public and Washington to decipher how tough the enforcement really is. Delaware courts therefore can *use judicial scolding as a low-visibility favoritism tool*: allowing Delaware to appear tougher on corporate America than it actually is.

Part V applies the theory to a different context by examining the reputational impact of Securities and Exchange Commission (SEC) enforcement actions. Switching from litigation to regulatory investigations allows us to not only enrich the theory but also contribute to a practical and timely debate. SEC enforcement practices have recently faced mounting criticism following the *Bank of America* and *Citigroup* cases[10] and have become the center of national attention. I argue here that the real problem with SEC settlements is not that the SEC leaves money on the table, but rather that the SEC leaves information on the table. Both the SEC and big firm defendants have incentives to settle quickly and for high amounts, in exchange for limiting the public release of damning information. Such information-underproduction dynamics are good for both parties but bad for society overall. I then discuss potential solutions to the problem, including evaluating the proper scope of judicial review of SEC actions.[11]

I conclude by briefly synthesizing the Article's various insights, clarifying their relation to the existing literature, and outlining avenues for further research.

## I. HOW THE LAW SHAPES REPUTATIONAL SANCTIONS: A GENERAL FRAMEWORK

To figure out how the law affects reputation, we first need to understand how reputation works. This Part fleshes out two basic points about the dynamics of reputational sanctioning, which were previously overlooked by

9. The regulatory competition literature deals with the consequences of states' competition over corporate charters: whether state corporate law represents a race to the top or to the bottom (or not a race at all). *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 593-96 (2003).

10. SEC v. Citigroup Global Mkts. Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011); SEC v. Bank of Am., 653 F. Supp. 2d 507 (S.D.N.Y. 2009).

11. The issue of the proper scope of judicial review was recently explicitly addressed by the Second Circuit Court of Appeals in *SEC v. Citigroup Global Mkts. Inc.*, 752 F.3d 285 (2014).

legal scholars.[12] I first show that reputational assessments are inherently inaccurate. Legal scholars often assume that the only issue with reputational sanctioning is whether misconduct is revealed or not: once bad news breaks, the market supposedly reacts automatically. But in reality the market reaction itself is the issue. Market players often lack the information or incentives to accurately interpret revelations of misconduct. As a result, the market underreacts to some types of revealed misconduct and overreacts to others. I then show how the accuracy of reputational sanctions is dictated by the legal system. Because market players find it hard to calibrate reputational judgments on their own, they often look for information coming from the legal system as a second opinion that helps them revise their initial reaction. In other words, the market reaction to revealed misconduct is shaped by the legal system's reaction. The law thus affects behavior indirectly by shaping reputational sanctions. I finish by providing a blueprint for applying this general reputational theory of the law to specific legal fields.

### A. *Reputational Sanctions: How They Work and Why They Are Noisy*

A company's reputation can be defined as the set of beliefs that stakeholders hold regarding the company's quality. Stakeholders cannot directly observe the company's abilities and intentions. As a result, stakeholders form a rough proxy: using the company's past actions as cues, they evaluate how the company is likely to behave in the future.[13] Customers make purchasing decisions based on their expectations about product quality; employees decide whether to apply for a job based on their beliefs about how top management will treat them; and so forth.[14]

A reputational sanction thus is simply the process of updating beliefs and lowering expectations. When news about adverse actions by a company breaks, stakeholders downgrade their beliefs about the company's quality. The company is now perceived as more likely to defect in the future, so stakeholders' willingness to deal with it decreases. For example, investors hearing about a corporate governance scandal will start demanding higher

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12. For references to and critique of the conventional approach, see Christopher McKenna & Rowena Olegario, *Corporate Reputation and Regulation in Historical Perspective*, *in* THE OXFORD HANDBOOK 272 (Timothy G. Pollock & Michael L. Barnett eds., 2012); Juan Jose Ganuza et al., Product Liability Versus Reputation 2 (Feb. 3, 2013) (unpublished manuscript), *available at* http://www.webmeets.com/files/papers/earie/2013/371/EARIE%202013%20FGP%20JJG.pdf.

13. A company's reputation can be thought of as the cash value of the trust that different stakeholders put in the company. Karpoff, *supra* note 4, at 363. I refrain from using the notion of trust here in order to avoid confusion between Bayesian belief-updating models and repeated-interaction models of reputation. *See* Luis Cabral, The Economics of Trust and Reputation (June 2005) (unpublished manuscript), *available at* http://pages.stern.nyu.edu/~lcabral/reputation/Reputation_June05.pdf.

14. Reputation is thus somewhat audience-specific and attribute-specific: when talking about reputation we need to ask "reputation to whom?" and "for what?"

returns for their investment. The aggregate of diminished business opportunities constitutes the reputational sanction for violating market norms.

But the most interesting (and understudied) question remains: How exactly do stakeholders update their beliefs? How many business opportunities are diminished by a given misconduct? After all, we know from everyday experience that not all bad news is created equal. Similar adverse actions cause different reputational outcomes. Some companies weather bad news relatively unscathed while other companies go bankrupt. Some top executives take the fall when their companies misbehave while other executives are unaffected. So what explains the variation in market reactions? For our purposes, it suffices to focus on one important determinant of reputational sanctions: *indicativeness of future behavior*. Stakeholders learning about a corporate misconduct try to infer how indicative of future behavior the specific adverse action is. Remember that reputational sanctions rest on self-interest: stakeholders will punish the company only when they deem the bad news relevant to their own future interactions with the company.

In other words, the revelation of bad news about a company does not automatically translate into reputational sanctions. Public revelation of misconduct is a necessary but insufficient condition. *The process of translating bad news into reputational assessments requires not just facts about what happened but also interpretations of how things happened*. To generalize: when stakeholders believe that the bad outcome resulted from an isolated temporary mistake (such as a rogue low-level employee), the reputational sanction will be relatively low. By contrast, when stakeholders believe that the bad outcome resulted from a deep-seated organizational flaw (such as a total breakdown of checks and balances), the reputational sanction will be relatively high. After all, no one wants to work for, buy from, or invest in companies with deep-rooted problems that likely will resurface.[15]

The next crucial step is to acknowledge that market players often have the wrong perception of how things happened. Stakeholders often interpret an isolated mistake as a deep-seated flaw, and vice versa. Several factors combine to make reputational assessments systematically noisy.

First, stakeholders are asymmetrically informed about the inner workings of the company. While market players may know with some certainty *what* happened, it is usually hard for outsiders to tell exactly *how* things happened:

15. A good illustration of these dynamics of reputational sanctions comes from stock market reactions to airplane crashes. A study found that the market reacts differently depending on how the crash was reported by the press. When the *Wall Street Journal* attributes the crash to internal causes, such as maintenance problems, the stock prices decline dramatically. By contrast, when the *Journal* reports that the crash was caused by external conditions, such as unanticipated weather conditions, the market does not react negatively. *See* Mark L. Mitchell & Michael T. Maloney, *Crisis in the Cockpit? The Role of Market Forces in Promoting Air Travel Safety*, 32 J.L. & ECON. 329 (1989).

what top managers knew, when they knew it, and so forth.[16] Secondly, even when stakeholders have information, they process it imperfectly. Judgment biases sway our reputational assessments. For instance, stakeholders tend to overly focus on salient and available issues and attribute bad outcomes to internal rather than external causes.[17]

Second, those who dispense reputational sanctions have their own private incentives, which diverge from the public interest in accurate reputational assessments. Reputation systems are not operated by public officials. Neither are they simply the aggregate of atomistic individual decisions. Rather, reputational sanctions in mass markets are largely determined by the interpretations and diffusion of information through intermediaries. We form impressions of companies based not just on our direct interactions, but mostly on what we gather from stock analysts, institutional investors, corporate watchdogs, and mass media.[18] These intermediaries have incentives to push the market towards overreacting to some behaviors and underreacting to others. For example, a corporate watchdog may have incentives to publish exaggerated criticisms against salient companies because eliciting a strong market reaction will help the watchdog to win the competition for donors' money and volunteers' time. And a profit-minded newspaper owner may prefer to avoid investing in the risky venture of investigating opaque corporate shenanigans, focusing instead on rebroadcasting publicly available information. In general, even when intermediaries manage to overcome their own biases, they cater to their constituents' biases.[19]

Indeed, recent empirical studies show that the media targets companies based not on the social harm done, but rather on visibility and resentment. For example, the financial media criticize executive stock-option plans based on high value at the exercising date (which is a function of external conditions) rather than at the granting date (which is more related to the strength of

16. Stakeholders are thus asymmetrically informed about "second-level information": we observe the bad outcomes but are unaware of the circumstances that led to them. *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 396 (1985).

17. Both the tendency to overly focus on salient issues and the tendency to overly attribute bad outcomes to internal causes are well-known biases that sway our judgments in many other contexts. On their applicability to the reputational judgments context see, for example, Donald Lange et al., *Organizational Reputation: A Review*, 37 J. MGMT. 153, 173 (2011); Andrea M. Sjoval & Andrew C. Talk, *From Actions to Impressions: Cognitive Attribution Theory and the Formation of Corporate Reputation*, 7 CORP. REPUTATION REV. 269, 274-75 (2004); Roy Shapira, *Reputation Through Litigation: How the Legal System Shapes Behavior by Producing Information*, 90 WASH. L. REV. (forthcoming 2015) (manuscript at Subpart I.B.1).

18. *See* Stefano DellaVigna & Matthew Gentzkow, *Persuasion: Empirical Evidence*, 2 ANN. REV. ECON. 643, 644 (2010).

19. *See* Batia M. Wiesenfeld et al., *The Stigmatization and Devaluation of Elites Associated with Corporate Failures: A Process Model*, 33 ACAD. MGMT. REV. 231, 235 (2008); Shapira, *supra* note 17, at Subpart I.B.2.

corporate governance).[20] Similarly, the media criticize shady accounting practices based on the visibility of companies rather than the size of the discrepancy: large, well-known companies get more negative coverage for more minor deviations.[21]

Taken together, the emerging pieces of evidence suggest that reputational sanctions exact heavy social costs. The costs of reputational sanctions stem not just from instances where the market does not detect corporate misbehavior. Even when market players become aware of corporate misconduct, their reaction to it is often inaccurate. Stakeholders may stop doing business with perfectly fine companies, or they may ignore early warning signs and continue doing business with rotten companies. Most importantly, the evidence suggests that the market *systematically* overreacts to certain misbehaviors and underreacts to others.[22] Not all mistakes in reputational assessments cancel themselves out. As a result, reputational forces distort primary behavior. Companies may pick projects based on their reputational value and not on their "real" value. Reputational incentives push companies to excessively avoid some worthy behaviors (reputational overdeterrence) and excessively engage in some bad behaviors (reputational underdeterrence).

So far we have explained why market players, when left alone, will have trouble producing accurate reputation information. But in reality the market is rarely left alone. Adverse actions are interpreted and assessed not just by market arbiters, but also by legal arbiters. The legal system produces as a by-product an informational public good: a version of what and how things happened in given cases.[23] The next Subpart maps the different ways in which the information coming out of the legal system affects reputational sanctions.

### B. *How Litigation Affects Reputation*

Many Law and Social Norms analyses assume away complementarities between law and reputation, instead treating the two systems as independent of each other.[24] In this Subpart, I challenge the conventional view by fleshing out

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20. *See* John E. Core et al., *The Power of the Pen and Executive Compensation*, 88 J. FIN. ECON. 1, 17 (2008).

21. *See* Gregory S. Miller, *The Press as a Watchdog for Accounting Fraud*, 44 J. ACCNT. RES. 1001 (2006).

22. For an elaboration see Shapira, *supra* note 17, at Subpart I.C (providing, also, examples of biases that lead to over/underdeterrence, such as the state of the overall economy—the market underreacts when the economy is booming and overreacts when the economy is down; the saliency of the issue in question; and the type of harm done—the market underreacts to multiple small harms and concealed harms, and overreacts to harms to easily identifiable victims).

23. *See* Érica Gorga & Michael Halberstam, *Litigation Discovery and Corporate Governance: The Missing Story About the "Genius of American Corporate Law,"* 63 EMORY L.J. 1427-28 (2014).

24. For the conventional approach, see *supra* note 12. To illustrate, consider Polinsky and Shavell's proposal to abolish product liability for widely sold products. The logic of

two channels through which the law influences reputational sanctions: "first-opinion effects," which occur before the market reacts to misconduct, and "second-opinion effects," which occur after the market's initial reaction.

### 1. First-Opinion Effects

The first type of effect that the law generates is that of setting a reputational sanction in motion. The most intuitive and studied example comes from disclosure requirements, which incentivize corporate decision-makers to publicly reveal information relating to corporate misconduct. Whistleblower laws also mitigate the asymmetric information about corporate failures, by incentivizing employees to reveal information about their companies' misconduct. Aside from legislation and regulations, litigation—our focus in this Article—can draw market players' attention to previously unnoticed corporate misbehavior. Sometimes a company breaches its explicit or implicit contractual obligations toward a certain stakeholder, but the harmed party finds it too costly to communicate the violation to third parties. The legal system gives the harmed party a right to sue the company for damages, thus indirectly setting the wheels of reputational sanctions in motion. The mere filing of a lawsuit (not to mention information revealed during litigation) may attract the attention of other stakeholders and propel them to downgrade their beliefs about the company.[25] In all these cases, the law has a "revealing misconduct" effect on the market. When the legal system facilitates the injection of new information into the market, it reduces the *detection costs* of reputation control systems, thus increasing the chances that misbehavior will be punished by the market.

Another channel through which the law sets reputational sanctions in motion is reduction of the *enforcement costs* of reputation control systems: the costs of acting against detected misbehavior.[26] After all, not all revealed misconduct is automatically punished by the market. Sometimes market players know the facts (i.e., learn about a certain suspect behavior) but are unclear about what norms are pertinent to the facts. The legal system helps by

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such a proposal is that if nonlegal forces are strong enough to carry most of the burden of deterrence, then it is not cost-effective to keep a costly adjudication system simply for the sake of an incremental contribution to deterrence. A. Mitchell Polinsky & Steven Shavell, *The Uneasy Case for Product Liability*, 123 HARV. L. REV. 1437 (2010). At the heart of such an argument lies an implicit assumption that the legal system and the nonlegal system are independent of each other. Polinsky and Shavell assume that we can remove the law—remove the background threat of litigation—and the market forces will continue to function just the same.

25. *Cf.* G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221, 271 n.223 (1991) (noting the common practice to search for past and pending legal disputes of potential business counterparties).

26. The terminology follows Robert Clark's typology in Laws, Markets, and Morals (Jan. 2010) (unpublished manuscript) (on file with author).

clarifying—either in legislation or through judicial opinions—the proper standards of market behavior. By demarcating clear norms, judges and legislatures make it easy for market players to realize whether the line was crossed in a given case. Such a "clarifying standards" notion has much in common with rational choice theories of expressive law.[27]

In both instances—revealing misconduct and clarifying standards—litigation can push market players to react to corporate misconduct. But there are many situations where market players do not need any pushing. Misconduct by large public companies is often revealed (and acted upon) long before a legal complaint is even filed. Indeed, a recent comprehensive empirical study found that the filing of a lawsuit was responsible for breaking news about financial misconduct in only 6.4% of revealed violations.[28] Market players often learn about misbehavior from other sources, such as investigative reporters, whistleblowers, or financial reporting. Still, even when the legal system's reaction is lagged, it may nevertheless affect the market, albeit in a different way, to which we turn next.

### 2. Second-Opinion Effects

The same bad news that triggered market reaction may eventually propel plaintiffs' lawyers to file a lawsuit or a regulator to initiate investigations. In the process of determining whether to impose legal sanctions, the legal system often produces information on questions such as what top managers knew and when they knew it. The information produced during litigation or investigations thus creates another "third-party assessment" of the company's behavior, and because such information is often publicly available, it allows market players to reevaluate their initial assessment of the company.

In that aspect, the legal system's lagged version generates second-opinion effects in reputation markets. In the second-opinion analogy, stakeholders face a decision on how to update beliefs about a misbehaving company: market arbiters (media, watchdogs, or analysts) are the first-opinion givers, and legal arbiters are the second-opinion givers. The legal system's version often makes a high-quality second opinion because it is more accurate and nuanced than the market's initial reaction. The value of the legal system's second opinion can stem from the opinion-givers themselves: judges are often perceived as more expert and/or disinterested than are typical market arbiters (such as columnists or watchdogs). More importantly, the legal system vests powers in its players (judges, investigators, or private litigants) to probe and demand inside

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27. *See, e.g.*, Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1269-71 (1999); Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339 (2000).

28. Jonathan M. Karpoff et al., Database Challenges in Financial Misconduct Research 15 (May 30, 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=2112569. The filing of a lawsuit lags the date in which the market first learned about misconduct by a median of twenty-three and an average of 150 days. *Id.* at 16.

information. As a result, the legal system's version often relies on information to which market arbiters were not privy when they made their initial assessments. A classic example comes from the revelation during discovery of intra-company e-mail communications that tell us exactly what top managers knew and when they knew it.

The legal system thus can serve as *a safety valve* for reputation systems. In instances where market players greatly under- or overreacted, the legal system later provides a more balanced perspective of how things happened, thereby allowing market players to go back and correct their initial assessment.

But even more important than correcting specific under- and overreactions ex post, the mere background threat of litigation affects all future reputational assessments ex ante. The possibility of litigation disciplines those who dispense reputational sanctions. Market arbiters anticipate the possibility that nuanced information on the misbehavior in question will later be produced in litigation and invest more in their initial assessments. In that sense, the legal system facilitates a market for corporate watchdogs' reputation. Information produced during litigation helps stakeholders better assess not only the behavior of defendant companies, but also the expertise and integrity of watchdogs.[29] The background threat of litigation also affects those who suffer from reputational sanctions. Faced with the possibility that their denials will be exposed in discovery as lies, misbehaving companies are more disciplined in how they fight accusations.[30]

### 3. Multiple Layers of Reputation Information

One important clarification is in order: I do not claim that the legal system is categorically better and more accurate than reputation systems. Like reputation systems, the legal system's assessments suffer from a plethora of distortions, such as asymmetric information, lack of expertise, strategic behavior, and divergent incentives. Indeed, in many cases we cannot trust the legal system to produce the positive externality of accurate reputation information. So I do not portray the legal and market systems in a horserace over which produces more accurate information. I rather view the two systems as *providing multiple layers of reputation information*.

The combination of two flawed systems (legal and reputation) produces better reputation assessments than each system on its own. This is because the systems' flaws are imperfectly correlated. Some of the distortions of the market's first opinion are cancelled out by the legal system's second opinion, and vice versa. The two systems can be thought of as creating a *diversified portfolio* of reputational assessments, mitigating the risk of extreme mistakes (that is, the risk that stakeholders will boycott perfectly good companies or

29. *See* Shapira, *supra* note 17, at Subpart II.B.3.

30. *See, e.g.*, MICHAEL REGESTER & JUDY LARKIN, RISK ISSUES AND CRISIS MANAGEMENT IN PUBLIC RELATIONS 200 (4th ed. 2008).

interact with rotten companies). Indeed, the literature on second opinions in other contexts has long recognized that a combination of a "hot" first opinion and a "cold" second opinion is often optimal.[31] The market system strikes first and produces information that is more timely and accessible than the version produced by the legal system. The legal system then produces information that is often more accurate and complete than the initial market's version.

Overall, the existence of a well-functioning legal system facilitates better reputation systems. Still, in specific contexts the information produced during litigation has zero or even negative impact on reputational evaluations. In order to predict better the reputational impact, we need to introduce more context-specific details, focusing on one area of market activity and law at a time. The next Subpart shows how to apply the theory to specific legal fields.

### C. *Applying the General Framework to Specific Legal Fields*

What are the conditions that determine the magnitude and direction of reputational consequences? One way to answer this question is to adopt a supply-and-demand framework. The legal system impacts reputational sanctions only when market players are constantly looking to reevaluate their beliefs (high demand) and legal institutions are perceived as a capable and credible source of information (supply meets demand). Many legal disputes—think, for example, about family law or torts committed by individuals—interest only the disputants themselves. The demand for information production in such disputes is virtually zero. In other legal disputes the demand for reputation information may be great, but the legal system fails to supply quality information. Think, for example, about medical malpractice: the reputation of caregivers is important and extremely hard to assess, but since the legal arbiters presiding over medical malpractice disputes are inexpert jurors who do not produce detailed opinions, the legal system supplies little meaningful reputation information.

In the context of corporate and securities litigation, it seems that both conditions of the supply-and-demand equation are met. The demand for credible reputation information is high. Stakeholders have every reason to continuously reevaluate their assessment of companies' abilities and intentions. The combination of high stakes involved in interacting with companies and various asymmetric information problems increases the value of getting second opinions on the quality of management integrity.[32] And private intermediaries such as securities analysts or institutional investors enjoy enough sophistication

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31. *See* Adrian Vermeule, *Second Opinions and Institutional Design*, 97 VA. L. REV. 1435, 1450-51 (2011).

32. *Cf.* JONATHAN R. MACEY, THE DEATH OF CORPORATE REPUTATION 20 (2013) (arguing that in the financial sector it is especially hard to distinguish high- from low-quality players); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005*, 59 STAN. L. REV. 1465, 1489 n.85 (2007) (arguing that bad outcomes cannot be easily attributed to specific companies or directors because of confounding variables).

and resources to mine legal proceedings for second opinions. In other words, players in the market for publicly-traded companies are more interested in the empirical truth and de-biasing of information than are consumers of news in other contexts.[33] Indeed, recent empirical studies show that sophisticated investors continuously monitor and react to information disseminated during litigation.[34]

On the supply side, the main adjudicators of corporate behavior—Delaware courts—are well positioned to provide timely, comprehensible, and thorough reputation information, for several reasons. First, Delaware courts are well respected in the legal and business communities.[35] The nonpolitical appointment process (Delaware judges frequently come from the bar) and the specialized docket allow judges to develop expertise and a broad perspective on market norms. Second, the specialized and small docket enables Delaware judges to adjudicate disputes relatively quickly, producing information in a timely manner.[36] Finally, the legal doctrines in Delaware corporate law—both procedural and substantive—are geared towards providing reputation-relevant information.[37]

The upshot is that corporate litigation is likely to have a meaningful effect on the reputation of businesspeople and companies. The next question, then, is: How, or in what direction? Does litigation necessarily increase the reputational sanction attached to misconduct? Does it affect the reputations of individual managers differently than it affects organizations? The next Part explores these issues in depth, in the context of fiduciary duty litigation.

## II. CORPORATE LITIGATION'S IMPACT ON NONLEGAL SANCTIONS

How does corporate law work? This question has puzzled corporate legal scholarship for decades. The puzzle stems from the apparent lack of legal

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33. *See* Jeremiah Green et al., Business Press Coverage and the Market Pricing of Good and Bad News 3-4 (Jan. 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=1780162.

34. *See* Vladimir Atanasov et al., *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence from Litigation Against VCs*, 67 J. FIN. 2215, 2218 (2012) (arguing that venture capitalists' reputation is affected by information produced in early stages of litigation); Lars H. Haβ & Maximilian A. Müller, Capital Market Consequences of Corporate Fraud (2011) (unpublished manuscript), *available at* http://www.eea-esem.com/files/papers/eea-esem/2012/988/paper.pdf (arguing that the same reputational effect applies outside the VC context). In an interview conducted with a representative of Courtroom Connect—a company that streams online webcasts of Delaware trials—I learned that an important clientele of streaming services is institutional investors who monitor legal disputes in real time and alter investment decisions accordingly. *See* Courtroom Connect, *supra* note 5.

35. *See* Geoffrey P. Miller, *A Modest Proposal for Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 330-31 (2010); Rock, *supra* note 2, at 1102.

36. *See, e.g.*, Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1086 (2000).

37. I elaborate on this point *infra* Part IV.A.

sanctions. Corporate decision-makers practically never pay out of pocket for their misbehavior,[38] so presumably the law lacks teeth. An influential strand of the literature suggested that corporate law's teeth consist in facilitating nonlegal sanctions. But so far the existing accounts have failed to develop a satisfactory theory of how nonlegal forces work or how exactly the law facilitates them.

I start this Part by identifying the gaps in the existing approach. Current accounts focus on how judicial comments induce guilty feelings among misbehaving directors or on social shaming among misbehaving directors' peers.[39] In other words, the current approach deals narrowly with how verdicts ramp up the moral sanctions for misbehaving. In reality, though, verdicts are rare, and the moral rebukes offered in them seldom reach their presumed audiences. It therefore makes sense to shift our focus to how the litigation *process* as a whole (not just verdicts) shapes the *reputational* (not just moral) sanctions for misbehaving. I outline three important factors that determine how information from the courtroom translates into the court of public opinion. The main takeaway point is that, counterintuitively, not every case of judicial scolding hurts the company's reputation. To predict the reputational impact, we need to ask *who* the judge is scolding (an ousted individual or an unhealthy corporate culture?); *what* she is scolding for (honest incompetence or calculated disregard for shareholder interests?); and what her scolding adds to the preexisting information environment.

### A. *Litigation's Impact on Moral Sanctions: "Saints and Sinners" Revisited*

Delaware fiduciary duty litigation features a striking pattern: no sanctioning but lots of talking. Delaware judges usually refrain from imposing legal sanctions on company decision-makers, but they do not shy away from criticizing the directors' behavior whenever they see fit.[40] This fact pattern of lengthy, fact-intensive, judgmental verdicts raises a puzzle: what is the point in preaching if you are not going to sanction? If Delaware courts are not enforcing fiduciary duties, why do they bother talking about them so much?

Several prominent corporate legal scholars suggest a solution to this puzzle: preaching *is* the point, they claim. Preaching is not an afterthought but rather the main function of Delaware decisional law. It is through richly detailed narratives of good and bad corporate behavior that Delaware judges

38. *Supra* note 1. The main justifications for refraining from sanctioning are discouragement of productive risk-taking in businesses, judicial incompetence, and the ability of shareholders to fend for themselves by diversifying risks.

39. *See* Rock, *supra* note 2.

40. For empirical support for the argument that Delaware courts rely heavily on moralism, see John C. Coates, Managing Disputes Through Contract: Evidence from M&A 35 n.54 (Aug. 14, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975423.

control corporate behavior.[41] Once the morality tales of corporate saints and sinners become publicly available, they unleash all sorts of nonlegal forces. In one version of this "saints and sinners" approach to corporate law, directors hate being dressed down in verdicts because it reduces the esteem that they get from colleagues and peers ("external moral sanctions").[42] In another version, directors who are subject to judicial scolding suffer not from disesteem of others but rather from their own sense of guilt ("internal moral sanctions").[43] And because judges elicit the opprobrium of third parties and/or guilt feelings of first parties simply by what they say, they get to sanction and deter misbehavior without imposing legal sanctions.

The saints and sinners theory of corporate law does a great job of spotlighting one indirect deterrence element of corporate law. It correctly directs our attention to the possibility that corporate litigation shapes behavior not just through the *outcomes* but also through the *content* of judicial opinions. But as the following paragraphs explain, the existing approach has too narrow a focus. I propose here a shift in perspective: from focusing just on how judicial comments affect moral judgments[44] to focusing on how the litigation process as a whole affects reputational judgments.

First, focusing just on judicial opinions is problematic because most legal disputes settle. Judges get very few chances to offer moral rebukes in verdicts.[45] Cases that settle do not produce moralistic impact, but they may nevertheless affect the market reaction: not by shaping moral beliefs but rather by shaping factual beliefs. The process itself prior to settlements (pleading, discovery, and trial) sheds light on reputation-relevant information. Indeed, recent empirical studies show that market players monitor and react to events during the early stages of the process.[46]

Second, focusing just on moralistic impact is problematic because the typical verdict sends mixed messages: by legally exonerating defendants, the verdict dilutes the power of any moralistic condemnations made in dicta. The

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41. The two most representative accounts are Rock, *supra* note 2, and Blair & Stout, *supra* note 1. While there are various other accounts of corporate law and social norms that vary in nuances, they all share enough similarities to be grouped for our purposes under the "saints and sinners" umbrella term.

42. *See* Rock, supra note 2.

43. *See* Blair & Stout, *supra* note 1.

44. For acknowledgments that existing accounts focus on moralistic and not reputational consequences, see, for example, Rock, *supra* note 2, at 1013 (focusing on disesteem); David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1814, 1856 (2001) (focusing on moral disapproval). The few analyses that touch the reputational outcomes of litigation do not develop it into a full theory. *See, e.g.*, Gordon, *supra* note 32, at 1489.

45. *See* Miller, *supra* note 35, at 329.

46. *Supra* note 34; *see also* JOHN D. LYTTON, HOLDING BISHOPS ACCOUNTABLE 205 (2008); Gorga & Halberstam, *supra* note 23 (noting that the corporate law literature fails to recognize the importance of discovery in shaping corporate behavior).

magnitude of legal sanctions embodies the blameworthiness of behavior.[47] Directors are less likely to suffer guilt, and third parties are less likely to engage in shaming, when the legal system tells them that the behavior in question is not bad enough to merit legal sanctioning. Reputational sanctions, by contrast, are less strongly correlated with legal sanctions. The trial's outcome is based on specific legal doctrines that may not be relevant to reputational evaluations. Consider, for example, a scenario where the judge rules in favor of the defendant company, yet her opinion contains remarks indicating that the company's misconduct stems from deep-rooted flaws. In such cases, the legal consequences are positive, but the reputational consequences will be negative. Conversely, a judge may assign liability to the company, but her opinion will make clear that the misbehavior was carried out by a rogue employee and is unlikely to reoccur. In such a case, the legal consequences are negative, but the reputational consequences likely will be positive.[48]

Finally, *moral rebukes often get lost in translation*. Directors normally do not read judicial opinions. And the lawyers who summarize the verdicts for directors usually screen out the caustic comments in their memos to their clients.[49] The rebukes rarely reach their presumed audiences. The power of moral rebukes to propel individuals to engage in costly punishing depends largely on striking the right tone and tenor—factors that easily get lost in translation.[50] Reputational information, by contrast, is less sensitive to distorted transmission. Reputational sanctioning is an exercise in self-interest, and sophisticated investors do not wait for someone to strike the right tone and propel them to act. They stand to gain from proactively mining litigation for hard information.[51]

These three problems—lack of opinions, sanctions, and communication channels—illustrate why it makes sense to focus on reputational rather than moralistic impact. The next Subpart proceeds to explain *how* we should focus

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47. *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 446 (2005); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 130 (2006).

48. The fall of Bankers Trust is a case in point. The company fought its clients in litigation and won. But the legal victory proved pyrrhic: information produced in litigation about the cynical and ruthless corporate culture hurt the company's reputation and eventually sunk the company. *See* MACEY, *supra* note 32, at 77-78. To generalize: the legal outcome is usually determined from a backward-looking perspective, while a reputational outcome is usually determined from a forward-looking perspective (how indicative of future behavior the adverse action is). As a result, the correlation between legal and reputational outcomes is very imperfect.

49. *See* Lyman Johnson, *Counter-Narratives in Corporate Law: Saints and Sinners, Apostles and Epistles*, 2009 MICH. ST. L. REV. 847, 868-70; *infra* Part III.B.3.

50. *See Infra* Part III.B.3.

51. *See* Merissa Marr, *Streaming Schadenfreude: Ovitz on Webcast*, WALL ST. J. (Oct. 27, 2004), http://www.wsj.com/articles/SB109882796538656391 (describing investors' monitoring of live webcasts of the *Disney* trial); *supra* note 34.

on reputational impact: highlighting the main factors that determine how information from litigation translates into reputational sanctions.

### B. *Litigation's Impact on Reputational Sanctions: Towards a Novel Approach*

The starting point of a reputational theory of corporate law is a "negative" one, telling us what we cannot do: we cannot simply assume that litigation hurts the reputation of the companies and the businesspeople involved. Reputational sanctions work in fuzzy ways that do not lend themselves to generalizations. Counterintuitively, sometimes judicial scolding may actually help the defendant company's reputation. In this Subpart, I build on insights from the reputation and crisis management literatures in order to take the next "positive" steps for a reputational theory: generate testable predictions. I flesh out three key questions we should ask when trying to predict the reputational outcomes of specific disputes.

First, we should ask "scolding *who*?" There is a huge difference between criticizing singled-out individuals and criticizing the company's systematic failures. In other words, a reputational theory should distinguish between individual- and organizational-level reputations. Second, we should ask "scolding *compared to* what?" In legal disputes with big and visible companies, information coming from the legal system is not read in isolation but rather appears against the background of an already existing market reaction. In most cases stakeholders have already learned about the misbehavior and formed opinions. A reputational analysis of litigation therefore should concentrate on *relative* impact: do not ask whether the judge's version is unfavorable to the company—ask whether it is more or less favorable than the prevalent version accepted in the market prior to litigation. Finally, we should ask "scolding *for what?*" In reputational terms, the type of sin matters: there is a difference between bad outcomes caused by honest incompetence and bad outcomes caused by calculated disregard for market norms.

#### 1. Scolding Who? Individual Reputation vs. Organizational Reputation

Litigation affects the reputation of individuals differently than it affects companies. Legal scholars usually ignore this distinction altogether, implicitly assuming that any judicial scorning of individuals reflects badly on their companies.[52] But the reputation literature suggests that scolding an individual does not necessarily impact the company's reputation negatively. It depends on factors such as the scolded individual's place in the hierarchy, whether she still

52. *But see* Skeel, *supra* note 44, at 1855.

holds office, or what other top managers knew about her actions.[53] Granted, in many cases the intuitive answer applies: dressing down an individual manager does reflect badly on the company. But there also are common scenarios where, counterintuitively, *dressing down specific managers may actually boost the company's reputation* (or at least not hurt it). Consider two examples.

First, the judge often dresses down a manager who is already gone or on her way out of the company. Such judicial finger-wagging would probably damage the ousted manager's labor-market reputation, but it could help repair the *company*'s reputation. This is because singling out one individual as a sinner gives rise to a "scapegoating" dynamic. As the crisis management literature shows, one of the most effective recovery strategies for companies is decoupling: acknowledging the problem while isolating and localizing it.[54] And scapegoating is an especially effective form of decoupling. By attributing the problem to a rogue element that was subsequently purged, the company distances itself from the wrongdoing. Accordingly, when a judge singles out the ousted manager for opprobrium, she lends credibility to the decoupling claims and directs the public's attention away from more systematic problems.

In another typical scenario, the judge scolds a manager for making mistakes out of incompetence. Here again, the individual's labor-market reputation will probably take a hit (who wants to hire an incompetent manager?). But the impact on the company's reputation is not necessarily negative and could even be positive. Crisis management experts maintain that companies in crises stand better chances of repairing their reputation when individual managers are portrayed as less than perfect.[55] If stakeholders perceive the leader as perfect and in total control, they assume that she could have prevented the adverse outcome. As a result, stakeholders will interpret the company's misconduct as intentional and indicative of future behavior (that is, arising from deep-rooted disregard for shareholder interests and market norms in general). By contrast, if stakeholders perceive the leader as less than perfect, they are more likely to interpret the adverse outcomes as a result of more easily fixable mistakes.[56]

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53. *See, e.g.*, ERIC DEZENHALL & JOHN WEBER, DAMAGE CONTROL 141 (2007); E. Deanne Brocato et al., *When Things Go Wrong: Account Strategy Following a Corporate Crisis Event*, 15 CORP. REPUTATION REV. 35, 36 (2012) ("Both theoretical and empirical research on corporate crises suggest that individuals and corporations may be viewed differently when evaluated, following a corporate crisis event.").

54. *See, e.g.*, Anna Lamin & Srilata Zaheer, *Wall Street vs. Main Street: Firm Strategies for Defending Legitimacy and Their Impact on Different Stakeholders*, 23 ORG. SCI. 47, 50-54 (2012).

55. *See* DEZENHALL & WEBER, *supra* note 53.

56. To be sure, in the business world it is sometimes better to be (perceived as) immoral than incompetent. Still, there are areas where incompetence is considered less deep-seated and easier to root out than lack of integrity. *Cf.* KIMBERLY D. ELSBACH, ORGANIZATIONAL PERCEPTION MANAGEMENT 60 (2006); John Hendry, *The Principal's Other Problems: Honest Incompetence and the Specification of Objectives*, 27 ACAD. MGMT. REV.

### 2. Scolding Compared to What? What Information Is Available vs. How It Is Diffused

Misconduct by large publicly-traded firms is usually tried in the court of public opinion before it is tried in courts.[57] As a result, the judge's verdict is often a lagged second opinion. Stakeholders with enough stake and sophistication to mine verdicts for information do not read verdicts in isolation. Rather, they compare the judge's version to existing versions produced by market arbiters. Any analysis of litigation's reputational impact thus should ask what *relative* addition or subtraction of reputational sanctions has been produced by the verdict. Such an analysis requires *understanding the baseline: the pre-verdict information environment*.

It is useful to break down the pre-verdict information environment into two stages: before and after the lawsuit is filed. When bad news breaks, market players react to it almost immediately, while the legal system often takes some time to get involved. And the trivial yet overlooked point is that a lot of information is produced before the legal system gets involved. When the company or issue at hand is salient and attractive enough, private info-intermediaries have incentives to quickly find out the facts about what happened[58] and offer interpretations about how it happened.[59]

Then, after a complaint is filed, more information is produced in the early stages of litigation (post-filing but pre-verdict). Information produced during pleading, discovery, and trial shapes reputational sanctions through two channels: *facts* and *framing*. The process gives market players more raw facts and inside information to work with, such as internal e-mail communications or board minutes that provide details about what top managers did (or did not do) to prevent the failure. The litigation process also produces readily available packaging of the facts. Plaintiffs, defendants, and third-party intermediaries often use tidbits from different stages (complaint, motion to dismiss, expert testimonies) to help their specific interpretations gain traction in the court of public opinion.[60]

Between the information produced by private info-intermediaries and information produced during the litigation process, not much new information (if any) is produced in judicial opinions. Verdicts contain mostly stale information. To be sure, verdicts still matter in the court of public opinion. But

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98 (2002) (identifying contexts where shareholders can more easily replace an incompetent element than root out moral hazard).

57. *See supra* note 26.

58. A typical example comes from interviewing former insiders who deliver juicy details on how things went wrong. *See generally* Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud*, 65 J. FIN. 2213 (2010).

59. A typical example comes from critical editorials that couch the story under some catchable category such as a story about corporate greed or power-tripping CEOs. *See generally* DEZENHALL & WEBER, *supra* note 53, at 15, 39.

60. *Cf.* Lytton, *supra* note 46, at 201 (discussing the framing role of litigation processes in general).

they matter in different and hitherto understudied ways. *The main impact of verdicts is not in introducing new information but rather in affecting how existing information is diffused*.

The last point deserves elaboration. Corporate legal scholars usually ignore issues arising from diffusion of information. We assume that market players either have or do not have information, or that once information is revealed, it will be fully reflected in stock prices.[61] But in reality the way that information is diffused matters. Information intermediaries matter. For example, a burgeoning empirical literature shows that the scope and tone of media coverage affects market reactions to stale information.[62] A classic illustration comes from a study finding that a front-page New York Times article about a biotech company caused the stock prices to skyrocket, even though the article contained no new information and actually repeated information that the Times previously had published in a back-page story.[63]

Accordingly, to the extent that judicial opinions (or more generally litigation) affect the scope and tone of media coverage, they impact reputational assessments even without producing new information. Much like earlier stages in the process, judicial opinions often affect the saliency and credibility of existing information. Judicial opinions add saliency by recalling the attention of the media to a certain issue, providing media reporters with readymade quotes, and reducing journalists' risk of defamation liability.[64] Opinions also add credibility by certifying existing information.[65] After all, not all sources of information are created equal:[66] stakeholders are more likely to update their

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61. *Cf*. Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media*, *in* THE RIGHT TO TELL 108-09 (2002).

62. *See* Brian J. Bushee et al., *The Role of the Business Press as an Information Intermediary*, 48 J. ACCT. RES. 1 (2010) (finding that coverage by mass media affects stock returns even when not breaking new information); Lily Fang & Joel Peress, *Media Coverage and the Cross-section of Stock Returns*, 64 J. FIN. 2023 (2009) (same). The scope of media coverage affects the market by drawing the attention of more investors to information that was previously known only to a small group of sophisticated investors. *See, e.g*., Paul C. Tetlock, *All the News That's Fit to Reprint: Do Investors React to Stale Information?*, 24 REV. FIN. STUD. 1481 (2011); Paul Ma, Information or Spin? Evidence from Language Differences Between 8-Ks and Press Releases (Nov. 29, 2012) (unpublished manuscript), *available at* https://server1.tepper.cmu.edu/seminars/docs/Ma%20Job%20Market%20Paper.pdf.

63. *See* Gur Huberman & Tomer Regev, *Contagious Speculation and a Cure for Cancer: A Nonevent that Made Stock Prices Soar*, 56 J. FIN. 387 (2001).

64. *See* Tamar Frankel, *Court of Law and Court of Public Opinion: Symbiotic Regulation of the Corporate Management Duty of Care*, 3 N.Y.U. J.L. & BUS. 353, 357 (2007); Lytton, *supra* note 46, at 95.

65. *See* Shapira, *supra* note 17, at Subpart II.B.2 (describing how the Salomon Brothers and Arthur Anderson crises illustrate how litigation/investigations can lend credibility or discard the company's version).

66. For studies showing that stakeholders react differently to identical pieces of information coming from different sources, see DellaVigna & Gentzkow, *supra* note 18, at 657; Cass Sunstein, *Breaking up the Echo*, N.Y. TIMES (Sept. 17, 2012), http://www.nytimes.com/2012/09/18/opinion/balanced-news-reports-may-only-inflame.html

beliefs when the information comes from a well-respected judge than when the same information comes from directly interested or less-reputable private parties.

Finally, opinions add framing to existing information. The judge's version helps market players assess the right packaging for an existing set of facts. The next Subpart explains how the framing effects of verdicts work in counterintuitive ways.

### 3. Scolding for What? Incompetence vs. Immorality

The final key question to consider is what type of sin the judge is highlighting. We cannot simply assume that whenever a judge frames the events as indicating that defendants sinned, she hurts the individuals' or companies' reputations. In reality, *the reputational impact varies greatly depending on the type of sin for which the defendants are scolded*. The sin of incompetence is seen differently than is the sin of immorality or total disregard for norms.[67] The sin of breaching contractual commitments is seen differently than is the sin of externalizing costs on third parties, such as polluting the environment or bribing in foreign countries.[68]

Here, one counterintuitive observation is especially intriguing: the judge's version, even when containing caustic criticism, typically supports a framing that is relatively favorable to the company. The preexisting framing is tilted by market and social arbiters' incentives to pile on criticism once bad news breaks and the allegation-driven media's incentives to highlight sound bites from the plaintiffs' lawyers post-filing.[69] As a result, the preexisting version usually makes even caustic verdicts seem nuanced when compared to the baseline.[70]

Therein lies the rub in the saints and sinners approach: people are not exclusively saints or sinners,[71] and judges know that. According to the saints and sinners argument, the judges' role is to help market players realize that

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(arguing people revisit their priors only when information comes from "surprising validators").

67. *See supra* note 56.

68. Empirical studies show that when companies hurt their trade partners (as in breaching contracts), their reputation takes a hit, but when companies misbehave towards unspecified third parties (as in polluting the environment), there is no reputational harm. *See* Karpoff, *supra* note 4.

69. *See* Wiesenfeld, *supra* note 19, at 240-42.

70. To be sure, there are exceptions: cases where the judge's version depicts the defendants in all black. One example comes from a famous corporate philanthropy case, where the directors were sued for approving an $80-million donation to build a museum named after a retiring CEO. The Delaware judge did not directly interfere with the directors' decision, but made it clear that if he were a shareholder he would vote against them. *See* Kahn v. Sullivan, 594 A.2d 48 (Del. 1991); Claire Hill & Brett McDonnell, *Executive Compensation and the Optimal Penumbra of Delaware Corporate Law*, 4 VA. L. & BUS. REV. 333, 357 (2009).

71. *See* LYNN STOUT, CULTIVATING CONSCIENCE 235-36 (2011).

certain defendants are sinners. But in reality the order and roles are reversed: the market reacts first by painting accused businesspeople in black. And the judge often repaints a more richly detailed picture in shades of grey. The court of public opinion tends to categorize businesspeople and companies as complete heroes or complete villains.[72] And judges' interpretations—even when critical of defendants—tend to be more contextual. Accordingly, the relative effect of judicial comments on reputation is not necessarily negative, and sometimes even positive. For the judge's narrative to affect the company's reputation positively, it does not have to be a resounding endorsement of the defendants' behavior. It only has to make the bad situation appear less bad, for example, by showing that the adverse action does not reflect the company's operational philosophy.[73]

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Drawing on theoretical and empirical advancements in the multidisciplinary reputation literature, I flesh out one key point: judicial scolding does not necessarily translate into reputational sanctions. It therefore is not enough to note the phenomenon of judicial scolding; we should shift our focus to identifying what conditions make judicial scolding more (or less) likely to increase nonlegal sanctions. The next Part takes a step in that direction by delving into a case study of the famous *Disney* litigation.

## III. THE *DISNEY* LITIGATION: A CASE STUDY

The *Disney* litigation is one of the most anticipated and discussed corporate law cases in decades.[74] It revolved around the hiring and subsequent firing of Hollywood's agent Michael Ovitz as Disney's president. Ovitz failed to perform satisfactorily and was fired after a year, but not before collecting a $140-million termination package from Disney. Disney's shareholders sued the directors for breaching their fiduciary duties in supervising the hiring and firing of Ovitz.[75] After a lengthy battle at the pleading stage, the lawsuit proceeded to a full-fledged trial. Chancellor Chandler then delivered a 170-page fact-

72. Mass media in particular looks for entertainment value and is therefore allegation-driven rather than nuance-driven. The media screens and diffuses mostly the bits of information that fit into templates. Stories of corporate villains, greed, and conspicuous spending sell more newspapers than contextual explanations. *See* DEZENHALL & WEBER, *supra* note 53, at 52.

73. *Id.* at 169, 187.

74. *See* Johnson, *supra* note 49, at 860; Renee Jones, *The Role of Good Faith in Delaware: How Open-Ended Standards Help Delaware Preserve Its Edge*, 55 N.Y.L. SCH. L. REV. 499, 507 (2011); Jonathan Macey, *Delaware: Home of the World's Most Expensive Raincoat*, 33 HOFSTRA L. REV. 1131, 1131 (2005).

75. *See In re* The Walt Disney Company Derivative Litigation, 825 A.2d 275, 281-87 (Del. Ch. 2003) (describing plaintiffs' allegations).

intensive decision that was filled with caustic criticism but ultimately exonerated the defendants who walked away winning.

Many corporate legal scholars have since hailed the *Disney* decision as a paradigmatic example of the saints and sinners approach: as illustrating how Delaware courts avoid legal sanctions while ramping up nonlegal sanctions, as exonerating while condemning.[76] And this is exactly what makes *Disney* such an interesting case study for our purposes; a deeper look reveals that even this seemingly clear-cut example does not follow the saints and sinners theory's predictions.[77] Instead, it corroborates the alternative theory presented here.[78] The *Disney* saga illustrates the reputational dynamics of big-case litigation: the verdict does not add new information because almost every fact cited by the Chancellor had already been covered by the media. *Disney* also illustrates how a seemingly caustic verdict when read in isolation is actually favorable to the company when considering our three key factors: the preexisting information, who the judge is scolding, and what he is scolding them for.

What distinguishes my reading of *Disney* from the numerous previous dissections of the case is the focus on *relative* nonlegal impact. Many scholars have focused on doctrinal analysis but ignored the decision's nonlegal impact. The scholars who have touched on the nonlegal impact simply note the decision's moralistic tone and assume that it ramps up the nonlegal sanctions and deterrence. I adopt a different methodology that shifts our focus to the *dynamics* of reputational sanctions. Using a content analysis of the media coverage of the Ovitz debacle, I explore how the reputational capital of Disney

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76. *See, e.g.*, Frankel, *supra* note 64, at 363-64; Johnson, *supra* note 49, at 863 ("[T]he opinion was a paragon of how Rock had earlier described Delaware opinion. It was detailed, normatively saturated, judgmental, and laced with scolding, sometimes acerbic, moral reproof."); Miller, *supra* note 35, at 326; David M. Wilson, *Climate Change: The Real Threat to Delaware Corporate Law, Why Delaware Must Keep a Watchful Eye on the Content of Political Change in the Air*, 5 ENTREPRENEURIAL BUS. L.J. 481, 488 (2010).

77. To use the qualitative methodology jargon, I employ the *Disney* case-study here in a "constructivist" mode of research: to illustrate, shed light, and serve as a check on competing theoretical frameworks. Accordingly, I select the *Disney* case (and other cases throughout the Article) not randomly but rather "purposively." The *Disney* litigation serves as a "crucial, 'most likely' case:" since it is widely considered the paradigmatic example for an existing approach (saints and sinners), digging deep into it illustrates the problems in the hegemonic theory and opens up space for my alternative framework. *See* THE SAGE ENCYCLOPEDIA OF QUALITATIVE RES. 69-70 (Lisa M. Given ed., 2008).

78. To clarify: I do not claim that the *Disney* case study and my qualitative empirical work more generally produce conclusive proofs of my theory or generate external validity in the sense used in quantitative studies. What my independent work (interviews, case studies, content analysis) produces, I hope, is a rich theory, one that is valid in the modest sense of *prima facie credibility*. The *Disney* case study, for example, indicates the plausibility of the theory's testable predictions. Moreover, by building on the work done through case-studies and interviews, we can better identify issues and pave the way for subsequent quantitative probes. To go back to the qualitative methodology jargon, this method is called "exploratory sequential mixed methods design": the researcher approaches a new terrain with more qualitative methods, and then once he identifies initial patterns, he can look to corroborate them with a later quantitative stage. *Id.* at 527.

and its top managers fluctuated before, during, and after litigation. The media coverage analysis, supplemented with insights from my interviews with key players,[79] allows us to decipher the relative reputational impact of litigation.[80] In other words, by examining how the court of public opinion treated the Ovitz affair before the verdict, we can tease out the real difference that the verdict made as a second opinion.

### A. *Information Produced Before Litigation Started*

The *Disney* lawsuit was filed in 1997. But by that time the court of public opinion had already been in session for a year. And the company was losing, badly.

The media covered the Disney-Ovitz debacle extensively during 1996. Investigative journalists were the first to uncover the problems with Disney's management. One lead story followed another, and by the second half of 1996, each medium was competing to come up with vivid details about the bad blood between Disney's top managers.[81] The early reports highlighted how Disney's number one (Michael Eisner) ran his own show without checks and balances from the board[82] while Disney's new number two (Ovitz) was in over his head.[83] At the time the company was denying the stories in an attempt to limit their negative reputational impact. But the denials rang hollow when investigative reporters exposed internal documents (such as Eisner's internal memos tarnishing Ovitz) and quotes from former insiders going on record about Disney's governance flaws.[84]

Then in late 1996 the company could no longer deny the problems. Ovitz was fired, and the company had to file press releases and submit information to

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79. I especially benefited from phone interviews with reporters who covered the Disney-Ovitz debacle throughout the years: Corie Brown, who covered the litigation for *Newsweek* (Jan. 20, 2014); Kim Christensen, who covered post-verdict developments for the *Los Angeles Times* (Jan. 17, 2014); Kim Masters, who wrote multiple articles and a book-length account of Disney's debacles (June 14, 2013); and Richard Verrier, who covered the litigation for the *Los Angeles Times* (Jan. 23, 2014).

80. *See* Gerald Ferris et al., *Personal Reputation in Organizations*, *in* ORGANIZATIONAL BEHAV. 222 (2d ed. 2003) (arguing that although media coverage can be used as a proxy to decipher the historical record of reputation, the media does not only record but also affects reputation).

81. *See* Ken Auletta, *Marriage, No Honeymoon*, NEW YORKER, July 29, 1996; Kate Bohner, *Michael Versus Michael*, FORBES, July 1, 1996, at 20; Corie Brown, *Clash of the Titans?*, NEWSWEEK, July 10, 1996.

82. *See, e.g.*, T. L. Stanley, *Definite Difference at Disney,* MEDIAWEEK, Apr. 22, 1996.

83. *See, e.g.*, Ronald Grover & Elizabeth Lesly, *The Humbling of Mike Ovitz*, BUS. WEEK (May 27, 1996), http://www.businessweek.com/stories/1996-05-26/the-humbling-of-mike-ovitz; Bernard Weinraub & Geraldine Fabrikant, *A Mouseketeer with an Attitude: Ovitz's Past Haunts Disney's Future*, N.Y. TIMES, June 10, 1996, at D1.

84. A *Vanity Fair* story, for example, was based on interviews with dozens of former and current Disney insiders. Bryan Burrough & Kim Masters, *The Mouse Trap*, VANITY FAIR (Dec. 1996), http://www.vanityfair.com/society/features/1996/12/ovitz-199612.

the SEC. The injection of new information intensified the market reaction. It was then—via the company's own reporting—that the public learned about the hefty severance package awarded to Ovitz after an unsatisfactory year at the helm. Now market and social arbiters were competing over who would offer stronger condemnations of Disney. Large institutional investors claimed to be enraged.[85] The president of the National Association of Corporate Directors said that Disney's board was "living in the dark ages" and was too beholden to Eisner.[86] And practically all the major newspapers ran editorials that attributed the Ovitz debacle to a corporate culture of total disregard for shareholder interests and societal norms.[87]

Overall, the media coverage of the Ovitz debacle was extensive in scope and unfavorable in tone from the get-go. *Any stakeholder of Disney had the chance to learn about the problems and downgrade her beliefs about the company's management integrity, before a lawsuit was even filed*. Corporate legal scholars treat the 2005 verdict as setting a reputational sanction in motion.[88] But in reality the reputational system was already in motion in 1996. Those involved in the Ovitz debacle suffered a huge initial reputational hit. Before litigation began, the company was already depicted as the poster child for bad corporate governance, and its top managers were ridiculed.[89] In fact, it was the reputational system that set the legal system in motion: the lawyers based their 1997 complaint on facts and interpretations taken straight from the media coverage.[90]

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85. *See, e.g.*, Bruce Orwall, *Disney Holders Decry Payouts at Meeting*,WALL ST. J., Feb. 26, 1997, at A3; Bruce Orwall & Joann Lublin, *The Rich Rewards of a Hollywood Exit*, WALL ST. J., Dec. 16, 1996, at B1.

86. *See* KIM MASTERS, THE KEYS TO THE KINGDOM 380 (2000).

87. *See, e.g.*, *id*. at 376-77; Holman W. Jenkins, *Beavis and Butthead Do the Disney Shareholders*, WALL ST. J., Jan. 7, 1997, at A17 (remarking that, "[N]obody in the real world . . . gets that kind of money for flubbing up after a year on the job," as if the headline was not enough); A.M. Rosenthal, *Hardtack for the Journey*, N.Y. TIMES, Dec. 17, 1996, at A25.

88. Frankel, for example, claims that "[b]y telling the whole world what was happening within Disney the decision allows us to become somewhat of a peeping tom," and that the decision "carves out a process by which the media becomes aware of an issue." Frankel, *supra* note 64, at 365, 367.

89. *See, e.g.*, IESE BUS. SCH. CASE STUDY, MICHAEL EISNER AT DISNEY (2005) (noting in retrospect that Eisner went from being considered a business guru to a regular on Forbes' annual list of World's Worst CEOs, facing a shareholder revolt, and being forced to resign as chairman); ROBERT SLATER, OVITZ 301 (1997) (same); Nikky Finke, *Poof! Mike Ovitz, from Sorcerer to Schmo*, N.Y. OBSERVER, Sept. 23, 1996 (describing Ovitz as powerless and Eisner's whipping boy); *The One Time Lion-King*, ECONOMIST (Sept. 16, 2004), http://www.economist.com/node/3196003 (noting in retrospect that under Eisner, "Disney became a byword for poor corporate governance").

90. *See* John Gibeaut, *Stock Responses*, 89 ABA J. 38, 38 (2003) (noting that the initial lawsuit relied heavily on "conclusory statements from newspaper editorials about Ovitz's highly publicized exit").

### B. *Information Produced During Litigation*

#### 1. The Impact of the Process

Once a complaint was filed, the mere *process* of litigation (pleading, discovery, and trial) affected Disney's reputation. The media coverage of the *Disney* litigation was not limited to the final verdict: it was in full effect in the discovery and trial stages, voluminous in scope and unfavorable in tone. It impacted the defendants' reputation at least as much as the verdict did.

The first question to consider is *what* information was covered. The answer: almost everything. After the complaint finally passed the motion to dismiss stage in 2003, the media turned their attention back to the Ovitz debacle. Major financial newspapers sent designated reporters to Delaware to report daily from the trial. And almost any meaningful tidbit of information submitted to court—such as plaintiffs' experts' reports or internal documents revealed in discovery—found its way to mass media and was quickly and widely diffused.[91]

The second question to consider is *how* information was covered by the press. The answer: negatively. The media used the information produced during litigation to paint an unfavorable picture of the company's corporate governance and the individual directors' competence and integrity. Media reporters spotlighted three themes in particular. First, reporters painted a picture of disregard for "best practices of corporate governance" at Disney.[92] They highlighted multiple descriptions of how Eisner was an imperialist who did not consult the board enough and how board members failed to do their jobs confronting Eisner. A notable example comes from the new revelation (through cross-examinations) that Disney's hiring committee did not even convene before Ovitz's hiring was announced.[93] Second, reporters emphasized how Ovitz was incompetent for the job he was hired to do. The media especially enjoyed covering the juicy details from plaintiffs' experts' testimonies,

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91. *See, e.g.*, Peter Larsen, *Eisner Criticized in Ovitz Report*, FIN. TIMES, Feb. 27, 2004, at 31 (covering experts' reports); Bruce Orwall, *The Mousetrap*, WALL ST. J., Nov. 23, 2004, at A1 (covering internal memos that were exposed during discovery, where Eisner calls Ovitz a psychopath); Christopher Parkes, *Disney Board Backed Ovitz Just Before He Was Sacked*, FIN. TIMES, Nov. 9, 2004, http://www.ft.com/cms/s/0/9f92bf36-31df-11d9-97c0-00000e2511c8.html#axzz3HHJCAnjm (covering internal memos). The point here can be generalized: in most large legal disputes information leaks during the early stages of litigation. *See* Gorga & Halberstam, *supra* note 23.

92. *See* David J. Jefferson, *Back in the Hot Seat*, NEWSWEEK, Nov. 1, 2004, at 38; Larsen, *supra* note 91; Orwall, *supra* note 91 (noting that the trial reveals how Eisner wielded power over the board, operating with "little regard for the conventional rules of corporate play").

93. *See* Christopher Parkes, *The Case of the 140m Dollars Parachute*, FIN. TIMES, Nov. 8, 2004, at 17.

suggesting that Ovitz was a habitual liar and a conspicuous spender.[94] Finally, reporters suggested that the mismatch and eventual breakup with Ovitz could have been anticipated and avoided. Ovitz himself testified that at the time of his hiring, he thought that the "duty of care" applied only to hospitals.[95]

Overall, the onslaught of information substantiated the market's initial (predominantly negative) reaction. The themes highlighted by the media were not new per se. The public knew the main plotlines—the bad blood, Eisner's power-tripping, and Ovitz's powerlessness—before litigation even started. Still, the litigation process added lots of small details and filled in the blank parts of the story.[96] Most importantly, even when litigation did not produce new information, it nevertheless raised the saliency of and removed uncertainty from existing information. Litigation kept the Disney-Ovitz story in the news cycle, recalling the public's attention to it.[97] And it made certain versions of the story more credible and less refutable by giving the public access to direct quotes and internal memos from Disney insiders.

The Disney case study thus illustrates how *the informational role of litigation is not limited to the final outcomes* (that is, not limited to verdicts or settlement announcements). To the extent that the legal system had something to add to market players' assessments of Disney, the additions came largely from the process rather than the verdict. As an anecdote: in Michael Ovitz's Wikipedia webpage, the description of the Disney debacle relies not on quotes from the 2005 verdict, but rather on a 2004 media story covering the depositions.[98] To me, this anecdote indicates how the process itself often makes a lasting reputational impact, regardless of the verdict.

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94. *See* Chad Bray & Bruce Orwall, *Ovitz Performance in Disney Role is Faulted at Trial*, WALL ST. J., Oct. 22, 2004, at B2; Parkes, *supra* note 93.

95. *See* Bruce Orwall & Chad Bray, *Ovitz's Testimony on Disney Tenure Portrays a Thwarted Deal Maker*, WALL ST. J., Oct. 27, 2004, at A1 (describing that Ovitz himself warned Eisner in advance that he would have a hard time adjusting to the running of a public company); Christopher Parkes, *Disney Executives 'Hostile to Ovitz Before He Joined*,' FIN. TIMES, Oct. 27, 2004, at 15 (describing that incumbent top executives clarified from the outset that they would not work with Ovitz); Christopher Parkes, *Ovitz 'Did Not Grasp Executive Position*,' FIN. TIMES, Oct. 22, 2004, at 24; Christopher Parkes, *Ovitz Was Determined 'Not to Be a Loser*,' FIN. TIMES, Oct. 28, 2004, at 26 (noting that Ovitz asked to change his severance package between signing and starting work); Kim Masters, *Deposed*, SLATE (Aug. 16, 2004), http://www.slate.com/articles/news_and_politics/low_concept/2004/08/deposed.html ("The depositions amplify what was obvious from the start: in terms of temperament and experience, Ovitz could not have been more ill-suited for the job.").

96. *See* Orwall, s*upra* note 91 ("The trial, plus interviews from depositions, provides an unusual behind-the-scenes peek . . . .").

97. *See* Richard Morgan, *The Two Mikes*, DEAL.COM (Oct. 18, 2004), *available at* PROQUEST, Doc. No. 220383829 ("The story might have ended there were it not for Milberg Weiss' class action. But now, after years of languishing, the suit has a snowball of interest unimaginable when it was first filed . . . .").

98. *Michael Ovitz*, WIKIPEDIA, http://en.wikipedia.org/wiki/Michael_Ovitz (last visited November 11, 2014).

Recognizing the important informational role of the process also pushes us to rethink the role of verdicts. Judges base their interpretations on information gleaned from discovery, testimonies, and experts' reports. In cases with big firm defendants, such as *Disney*, the same information that the judge relies upon often gets diffused immediately. By the time the judge releases her version, the public is already aware of the information contained in it. Verdicts in big cases thus fulfill a different informational role than previously assumed: they affect reputational sanctions not by providing new information but rather by constructing and disseminating existing information. The next Subpart looks at the *Disney* opinion through such a prism.

### 2. The Real Impact of the Verdict

Now that we understand how the court of public opinion treated the Ovitz affair *prior* to the verdict, we can turn to analyze what difference the verdict really made. Rereading the decision along with the media coverage of it generates one immediate conclusion: the conventional view that sees the verdict as a reputational deathblow to everyone involved is misguided. Granted, Chancellor Chandler's version contains some quotable caustic comments. But it also provides more nuanced and contextual explanations for the Ovitz debacle. Unlike the prevalent preexisting interpretations of what went wrong in Disney, the verdict attributes the bad outcome to rare external conditions rather than to deep-rooted disregard for market norms. And the Chancellor reserves his strongest criticisms for individuals who were already ousted from Disney, thus implicitly creating a separation between bad (ousted) individuals and a good company. As a result, to the extent that the verdict changed stakeholders' beliefs, it probably pushed stakeholders into thinking more *positively* about the company and its incumbent management.

#### a. Emphasizing the Context

The Chancellor opens his version with an explanation of the hiring: why Disney's board rushed to hire someone with no experience in running a large public company, and then on top of that, signed an outrageous severance package provision. Here the verdict's version differs from preexisting versions by *putting more emphasis on the context*. The Chancellor highlights from the outset (and then reiterates constantly)[99] the "perfect storm" that pushed Disney into the Ovitz affair: Disney's previous president died in a helicopter crash; Disney's CEO (Eisner) suffered from a heart condition; and the company was in the midst of major expansions. Due to these unusual circumstances, the company desperately needed a new president to take the burden off the ailing Eisner in the immediate term and to provide an insurance and succession plan

99. *See In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 699, 702, 762, 770, 771, 778 (Del. Ch. 2005).

for the long run. Targeting Ovitz as the quick-fix made sense at the time, since he was considered Hollywood's number one power broker.[100] And promising Ovitz a hefty severance package was necessary in order to lure him from his previous lucrative position and away from Disney's competitors who were courting him.[101]

By making the context more salient,[102] the verdict helps stakeholders overcome biases that plague their reputational assessments. Most notably, the Chancellor opens his decision by explicitly warning the readers from *hindsight bias*: do not ask yourself whether the board's decisions make sense to you now, he tells the reader; ask whether they made sense at the time they were taken.[103] The Chancellor then provides the readers with tools to mitigate their hindsight bias: he extends the timeframe by spotlighting the events that preceded Ovitz's hiring and reminds the reader not to evaluate Disney's management integrity according to twenty-first century best practices (which were not relevant when the Ovitz affair occurred).[104] Most notably, the Chancellor emphasizes that Disney's stock prices jumped through the roof when Ovitz's hiring was announced.[105] Amazingly enough, this important fact was largely missing from the preexisting accounts of the Ovitz affair in the media.

Emphasizing the context also mitigates the readers' *tendency to adopt causal explanations*. Remember that the pre-verdict narratives were predominantly causal: if Disney hired an incompetent president only to cushion his way out after a year with $140 million of shareholders' money, then Disney's decision-makers must lack any regard for shareholders' interests, right?[106] Wrong, says the Chancellor. No one in Disney set out to hurt

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100. *Id*. at 701-02, 764-65.

101. *Id*. at 702. The verdict changed the media coverage's tone dramatically. Prior to the verdict editorials explained Ovitz's severance package as a blatant disregard of market norms. Following the verdict editorials explained the package as a reasonable business decision. *See, e.g*., *The Happiest Board on Earth*, L.A. TIMES, Aug. 11, 2005, at B12 ("That kind of 'downside protection' was central to getting Ovitz to leave CAA for Disney, and it's endemic to the Hollywood way of doing business.").

102. To emphasize: the facts that the Chancellor cites were not new. But by packaging the facts with a seal of approval from a Delaware judge, the Chancellor increased the likelihood that stakeholders would reevaluate their initial assessment. Indeed, the media coverage that never mentioned the "perfect storm" that explains Ovitz's hiring prior to the verdict began emphasizing it after the verdict. *See, e.g*., Laura Holson, *Ruling Upholds Disney's Payment in Firing of Ovitz*, N.Y. TIMES, Aug. 10, 2005, at A1.

103. *See Disney*, 907 A.2d at 698. The media echoed the call to beware of hindsight: Holson, *supra* note 102; Kathy M. Kristoff, *Ovitz Ruling Is a Limited Win for Directors*, L.A. TIMES, Aug. 10, 2005, at C1; *Regulating Fantasyland*, Aug. 12, 2005, N.Y. TIMES, at A18.

104. *See Disney*, 907 A.2d at 697.

105. *Id*. at 708 (noting how Disney's market capitalization increased by more than $1 billion upon announcement).

106. *See supra* note 84.

shareholders.[107] In fact, Disney decision-makers—along with the rest of the world, as the stock price reaction indicates—thought that they were creating shareholder value by hiring Ovitz.[108]

b. Scolding for Honest and Transient Mistakes

After explaining the hiring, the Chancellor turns to explaining the firing. How come Ovitz performed miserably at Disney? Why was he not fired earlier? Most importantly, why was he not fired "for cause," which could have saved the need to pay his severance package? Here, the Chancellor's answers focus on "mismatch of cultures." Ovitz and the incumbent managers wanted the experiment to work, the Chancellor tells us, but Ovitz simply experienced difficulties assimilating to Disney. Ovitz was flashy, conspicuous, and tried to "agent" his colleagues while the corporate culture was more blue collar and no-nonsense.[109] Corporate legal scholars viewed the Chancellor's vivid descriptions of the mismatch as humiliating the defendants.[110] But such a view misses two important aspects of reputational sanctions: it ignores the baseline (how does the Chancellor's version compare to preexisting ones?) and the distinction between individual- and organizational-level reputations.

Attributing the failure to unanticipated mismatches and misperceptions is relatively favorable to the *company*'s reputation. Remember that most preexisting versions talked about how Ovitz's failure was well anticipated: Disney's incumbent management hired an obviously incompetent guy and then intentionally tripped that guy.[111] Moreover, according to the preexisting versions, Ovitz was not fired for cause simply because Eisner wanted to protect his personal reputation at the expense of shareholder interests or, worse, because Eisner and Ovitz cynically plotted to transfer millions from shareholders' pockets to Ovitz's.[112] The Chancellor rejects these versions: Ovitz actually made some positive contributions to the company, he tells us,

107. *See Disney*, 907 A.2d at 762 ("[C]onsiderations of improper motive are no longer present in this case.").

108. This is another point that the media coverage ignored prior to the verdict and embraced after the verdict. *See, e.g.*, Kim Christensen & Richard Verrier, *Judge Rules in Favor of Disney in Ovitz Case but Criticizes Eisner*, L.A. TIMES, Aug. 10, 2005, at A1 ("Ovitz's 1995 hiring was hailed at the time as a coup for Disney and Eisner . . . . Ovitz was a near-mythical figure then, frequently dubbed Hollywood's most powerful executive . . . .").

109. *Disney*, 907 A.2d at 713-14; Christensen & Verrier, *supra* note 108 (emphasizing the mismatch-in-cultures point).

110. *See, e.g.*, Frankel, *supra* note 64, at 358 ("[The Chancellor made Ovitz] look like an incredibly stupid man, who [was] inexperienced in the politics of corporate Hollywood. . . . [T]his description undermines Ovitz's reputation more than any criticizing of his behavior would. . . . He was the punished bad boy . . . .").

111. *See supra* note 91.

112. *See, e.g.*, Bruce Orwall & Joann S. Lublin, *Fading Magic*, WALL ST. J., Mar. 1, 2004, at A1; James B. Stewart, *Partners*, NEW YORKER, Jan. 10, 2005, at 46, 53 (suggesting that Eisner foresaw the failure five weeks into Ovitz's hiring).

and neither side was intentionally tripping or foreseeing the failure.[113] At one point the Chancellor describes in detail a seemingly irrelevant tidbit: a company meeting where all the top executives rode the company bus while Ovitz insisted on being chauffeured in his private limo.[114] Legal scholars viewed the inclusion of such a gossipy story as tarnishing Ovitz's reputation.[115] Well, maybe. But how does such a story affect the *company*'s reputation? For stakeholders thinking about whether to interact with Disney in the future, framing the debacle as a story about one greedy executive who did not fit in with the rest of the down-to-earth managers (and was subsequently fired) is not alarming; rather, it is assuring.

To answer the "scolding for what" question: the Chancellor is *scolding Disney and its directors not for calculated disregard for shareholder interests, but rather for honest, temporary mistakes*. Prior to the verdict, market and social arbiters framed the Ovitz debacle as a clear-cut story of corporate villains: managers becoming too entrenched and greedy, losing regard for shareholder interests or societal norms. The verdict, however critical of Disney's directors, tells a markedly different story: a story about making mistakes while pursuing shareholder value.[116]

c. Scolding Individuals Who Were Already Ousted

Up to now I have focused on how the verdict generates a more nuanced and favorable version. But there are specific parts in the verdict that cannot be viewed as favorable to the defendants' reputation. The Chancellor scolded Eisner for disregarding corporate governance and scolded other top executives for not stepping up and raising red flags. His judicial scolding was done in such a catchable manner and came from such a credible source that it captured front pages of major newspapers, increasing public awareness and recalling attention to the defendants' flaws.[117] But while the reputation-damaging effects of these comments were widely recognized, one aspect of them has been grossly overlooked: the identity of the targets.

113. *See Disney*, 907 A.2d at 693, 759, 762, 778; *see also supra* note 99 and accompanying text.

114. *Disney*, 907 A.2d at 713.

115. *See* Frankel, *supra* note 64.

116. The media picked up the honest mistakes theme. *See, e.g.*, Ben White, *Disney Executive's Severance Ruled Legal*, WASH. POST, Aug. 10, 2005, at A1 ("[W]hile Ovitz's employment turned out to be a disaster, it was reasonable for directors to think, given the agent's reputation as among the most powerful men in Hollywood, that it could have succeeded.").

117. One sentence made it to the pantheon of judicial scolding and was cited endlessly, describing how Eisner "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom." *Disney*, 907 A.2d at 763.

The Chancellor reserved his strongest criticism for six individuals. He laid most of the blame at Eisner's feet[118] and then named three directors who should have done more to prevent the debacle: Irwin Russell, who did not negotiate hard enough on behalf of the company,[119] and two members of the compensation committee—Ignacio Lozano and Sidney Poitier—for not being involved enough.[120] The Chancellor also scolded two nondirectors: Sandy Litvack, the general counsel, for not informing the board on the possibility to avoid paying Ovitz his severance package;[121] and Graef Crystal, an outside expert hired to help the compensation committee, for providing a faulty and incomplete report.[122] All of *these six scolded businesspeople have one thing in common: none of them were any longer an integral part of Disney when the verdict was issued*. The Disney 2005 board contained many directors who were part of the company in the Ovitz debacle days. Yet none of the retained individuals were scolded. The scolding was reserved for individuals who were already ousted or on their way out.

The *Disney* verdict thus illustrates how singling out individuals as sinners may actually help the company. Indeed, the media quickly picked up the scapegoating theme promoted by the verdict. The coverage of the verdict highlighted a contrast: a victory to Disney and its board and a blow to Eisner's scorecard on his way out of the company.[123] More generally, the verdict's singling out of ousted individuals contributed to the company's ability to convince stakeholders that the company had learned from its past and changed its ways. The media and institutional investors bought into the recovery message, presenting Disney as the perfect example of a corporate governance turnaround: the bad company of the 1990s turned into the role model of the 2000s.[124]

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118. *Id*. at 760 (writing that Eisner was the "instigator and mastermind" behind the hiring); *id*. at 763 n.488 (noting that Eisner was imperial and Machiavellian, surrounding himself with yes-men). Every major newspaper's front-page story about the verdict contained a sentence explicitly mentioning that Chandler saved his strongest criticisms for Eisner. *See infra* note 123.

119. *Disney*, 907 A.2d at 763, 764.

120. *Id*. at 766-67, 771.

121. *Id*. at 777.

122. *Id*. at 770.

123. One L.A. Times front-page headline is illustrative: Christensen & Verrier, *Judge Rules in Favor of Disney in Ovitz Case but Criticizes Eisner*, *supra* note 108; *see also* Rupert Steiner, *Record Profits Put the Smile Back at Disney*, SUNDAY BUS., Aug. 14, 2005, at C9 (describing the verdict as "good news" for Disney, while "hardly a valediction for [Eisner's] leaving card"). The fact that the sinner—Eisner—was on his way out was highlighted in media coverage. *See, e.g*., Holson, *supra* note 102 (referring to Eisner as the "departing" CEO, stepping down soon).

124. *See Iger Wins Over Wall Street and Main Street*, DOW JONES, Dec. 6, 2006, *available at* http://money.cnn.com/news/newsfeeds/articles/djf500/200612060126DOWJONESDJONLINE000236_ FORTUNE5.htm#TOP ("Disney has gone from a poster child for bad governance to a model for reform, according to corporate watchdogs."). Disney itself fueled the turnaround theme by feeding the media shortly after the verdict with announcements of

Aside from illustrating how the scolding of individuals does not necessarily translate into reputational damages to the company, *Disney* also generates a much more counterintuitive observation: judicial comments do not automatically translate into reputational damages to the *individual* either. The reputational outcomes to the individual depend, again, on the baseline and the type of sin for which the individual is scolded.

To illustrate, let us consider Chancellor Chandler's treatment of Ovitz. The baseline—the pre-verdict reputational capital of Ovitz—was close to zero. When legal scholars claim that the verdict humiliated Ovitz by presenting him as a powerless whipping boy,[125] they ignore the fact that these depictions were already publicly available and widely accepted in the court of public opinion.[126] The verdict could not have reduced Ovitz's already deflated reputational capital by much (if at all). In fact, the Chancellor's narrative resembles (and thus lends credence to) the narrative that Ovitz himself promoted in an attempt to recover his lost reputation.[127] Unsurprisingly so: it is better for Ovitz to be perceived as powerless or incompetent in a given task than as someone who cynically disregards shareholder interest or is inherently useless. As one *Wall Street Journal* columnist quipped: "if Mr. Ovitz does not come out smelling like a rose, he at least gets some of his reputation back."[128]

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Overall, the *Disney* litigation illustrates how judicial comments do not automatically translate into an increase in reputational sanctions. To the extent that the verdict impacted stakeholders' beliefs, it probably convinced them that Disney's problems are less deep-rooted and more easily fixable than they previously thought. This is not to suggest that the litigation was all fun and games for the defendants. In fact, it probably was a nightmare for them. After all, they were dragged through discovery and cross-examinations, and some of them were publicly scorned by the judge. But remember that from a

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strengthening of corporate governance. *See* Kim Christensen, *Disney Board Gives Shareholders More Clout*, L.A. TIMES, Aug. 19, 2005, at C2; Kim Christensen, *Disney Chief Brings Calm to Firm Famed for Discord*, L.A. TIMES, Sept. 28, 2005, at A1; Laura M. Holson, *Disney Renovation: A Master Plan to Restore the Kingdom's Magic*, N.Y. TIMES, Aug. 15, 2005, at C1.

125. *See, e.g.*, Frankel, *supra* note 64.

126. *See* ERIC DEZENHALL, NAIL 'EM! 128-38 (1999); Dominick Dunne, *Sorcerer's Apprentice*, VANITY FAIR, Feb. 2005 ("Ovitz is probably the most humiliated Hollywood figure of the last decade."); Orwall & Bray, *supra* note 95 ("[Ovitz] seemed intent on using the witness stand as a platform to repair a reputation that has taken a beating since he left Disney.").

127. *Compare* SLATER, *supra* note 89, at 328, *and* Orwall & Bray, *supra* note 95, *with In Re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 716 (Del. Ch. 2005).

128. *See* Holman W. Jenkins, Jr., *Beavis and Butt-Head, Revisited*, WALL ST. J., Aug. 17, 2005, at A11; *see also* Christensen & Verrier, *supra* note 108 ("Chandler's decision provides some comfort for Ovitz, who had sought to use the case to finally tell his side of the story publicly.").

reputational perspective, Disney and its managers took a lot of criticism for the Ovitz debacle prior to the verdict. Once the verdict got out, it actually silenced some critics by giving a more nuanced and contextual version, allowing the company to turn over a new leaf. And the parts of the verdict that fueled new criticism were directed at individuals who no longer were part of the incumbent management.[129]

### 3. Lost in Translation: Additional Comments on Information Flows

The *Disney* case study offers many insights about how information from courtrooms flows into the market, beyond the big-picture lessons we have covered thus far. This Subpart elaborates on two extra takeaway points: how different types of intermediaries cover verdicts differently and how companies try to control information flow.

#### a. Different Types of Intermediaries Cover Verdicts Differently

Information from the courtroom does not simply fall on stakeholders like manna from the sky. Information flows through intermediaries who select what parts to highlight and then add their own take. Three types of intermediaries play an especially important role in transmitting information from corporate litigation: business media, "regular" media, and law firms. Analyzing the coverage of *Disney* suggests that each type of intermediary chooses to highlight different aspects of the verdict.

Media coverage differed from law firms' memos by putting more emphasis on judicial comments and less on legal doctrines. The Chancellor's vivid descriptions of how things happened featured prominently in newspaper coverage, but not in law firms' memos. Law firms took an all-rules approach in their memos to their clients. They emphasized what the decision meant for directors facing a similar hiring and firing decision (that is, what decision-making process future directors need to adopt in order to avoid legal liability). Even among media outlets, there were clear differences in the tone and scope of coverage. The business media's coverage was more favorable to Disney than was regular media's coverage. Business newspapers painted the verdict as delivering a victory for Disney and its directors[130] and associated the bad parts

129. The Chancellor's interpretation bears similarity to the way in which companies typically explain their own misconduct: attributing the problem to external and uncontrollable conditions, or to rogue elements that were purged. *See* Sjoval & Talk, *supra* note 17, at 271.

130. *See* Bruce Orwall & Merissa Marr, *Judge Backs Disney Directors in Suit on Ovitz's Hiring, Firing*, WALL ST. J., Aug. 10, 2005, at A1; Christopher Parkes, *Disney Board in the Clear Over Firing of Ovitz*, FIN. TIMES (Aug. 10, 2005; 3:10 AM), http://www.ft.com/intl/cms/s/0/c3768dc2-093b-11da-880b-00000e2511c8.html#axzz3SzdkhtCI.

of the verdict (caustic criticisms) almost solely with the retiring Eisner.[131] Regular newspapers, by contrast, painted the verdict as delivering crushing criticism to everyone involved.[132]

Such variation in the coverage of verdicts translates into variation in reputational outcomes. *The reputational outcome depends on who the target audience is and what intermediary is being tapped for information by the audience*. Roughly speaking, the reputational outcomes for Disney were zero for audiences relying on law firms' coverage; negative for audiences relying on regular newspapers; and mixed (or even positive) for audiences relying on business newspapers.[133] Future analyses of the reputational impact of litigation thus should acknowledge that reputation is multifaceted and distinguish between different types of audiences.[134]

b. Companies Affect the Information Flows from the Courtroom

The verdict was not the only newsworthy event affecting Disney's reputation at the time. Disney actually timed the issuance of a quarterly report to the exact day of the verdict's release, announcing strong earnings growth.[135] The company's seemingly unrelated press release drew some of the media's attention away from the verdict. The positive announcements got comingled and presented together with the verdict as a "good day overall for Disney."[136]

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131. See, for example, the titular claim of Christopher Parkes, *Eisner's Disney Reign Cut Down in Court: Although the Outgoing Chief Executive Was Not Found Guilty of Fiduciary Neglect, His 'Machiavellian' and 'Imperial Management Style' Was Put Under the Spotlight*, FIN. TIMES (Aug. 15, 2005, 5:14 PM), http://www.ft.com/cms/s/1/38d063d2-0cdd-11da-ba02-00000e2511c8.html#axzz3SzdkhtCI.

132. Compare the opening sentences in the front-page stories of *The Happiest Board on Earth*, *supra* note 101; White, *supra* note 117; and *Regulating Fantasyland*, *supra* 103; with Jenkins, *supra* note 128; and Parkes, *supra* note 130.

133. The reputation literature suggests that media coverage makes stakeholders change their attitudes towards a company only when the coverage is predominantly negative; a mixed coverage does not increase reputational sanctions. Rebecca Reuber & Eileen Fischer, *Organizations Behaving Badly: When Are Discreditable Actions Likely to Damage Organizational Reputation?*, 93 J. BUS. ETHICS 39, 45-46 (2010). The *Disney* verdict coverage contained some unfavorable quotes but also some favorable themes and was overall mixed.

134. Any analysis of reputational impact should ask "reputation to whom?" and "for what?" Companies and businesspeople may exit litigation with a stellar reputation among one group of stakeholders but a tarnished reputation among another.

135. *See* THE WALT DISNEY CO., THE WALT DISNEY COMPANY REPORTS RESULTS FOR THE QUARTER AND NINE MONTHS ENDED JULY 2, 2005 (Aug. 9, 2005), *available at* http://thewaltdisneycompany.com/sites/default/files/press-releases/pdfs/2005-08-09%20Earnings.pdf.

136. *See* Kate Kelly, *Disney Earnings Jump on Gains from TV Division,* WALL ST. J., Aug. 10, 2005, at A3 ("Disney's upbeat earnings announcement came on the heels of another victory for the company: a Delaware judge's ruling that Disney's directors didn't breach their fiduciary duty . . . ."); Steiner, *supra* note 123 ("[H]ours after [Chandler's] ruling all eyes from Wall Street were on the media group's stellar third-quarter results.").

This previously overlooked fact represents another important lesson that can be generalized: reputational sanctions are not a one-sided event. Much like legal control, reputational control is a function of ongoing interactions where the regulated parties try to affect the regulators.[137] Companies try to distort the flow of unfavorable information before it reaches the court of public opinion. Any discussion of the informational role of the law therefore should consider the conditions that make information flows more (or less) likely to get hijacked by companies. I conjecture that companies control the information flows from verdicts better than they control information flows from continuous discovery or trial processes. Verdicts are one-time, isolated events, so companies can more easily produce a timely smokescreen, issuing an unrelated press release to steer media attention away from the verdict.[138]

### C. How Generalizable Are the Lessons from *Disney*?

Some may claim that we cannot extract general lessons from *Disney* because the case is so singular: no other corporate dispute would similarly capture the public's attention. My response to this argument is twofold. Firstly, remember that I use *Disney* to make a point about the state of current literature. Corporate legal scholars use *Disney* as a paradigmatic example of the saints and sinners approach, so it makes sense for me to attack them on their own terms. By showing that even this supposedly clear-cut case does not behave according to the existing theory's predictions, I illustrate the need to adopt an alternative framework.[139] The saints and sinners' proponents claim that litigation ramps up nonlegal sanctions, especially in big-firm defendant cases.[140] But it is exactly in these big and visible cases that the reputational dynamics flip sides: the verdict does not play a role of informing market players about the bad corporate sinners, if only because the market has already learned about the misconduct and painted the company and businesspeople as sinners. It is actually in the less visible cases of corporate misconduct that litigation stands to ramp up market sanctions, by reducing the detection costs. Future analyses of the indirect deterrence role of corporate law should consider the preexisting

137. The "New Governance" scholars emphasized this point for legal control. *See* Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1174 (2010). It is time we flesh it out for reputational control as well.

138. An emerging literature in finance fleshes out the different ways in which firms try to control the information flow of bad news to the market: bundling bad news with good news, releasing bad news at times when investor attention is distracted, etc. *See, e.g.*, Lauren Cohen et al., *Playing Favorites: How Firms Prevent the Revelation of Bad News* 22 (Harvard Bus. Sch. Working Paper No. 14-021, 2013), *available at* http://dash.harvard.edu/bitstream/handle/1/11508220/14-021.pdf.

139. On the value in using qualitative case studies to illuminate problems in existing theories and develop alternative hypotheses, see Harry Eckstein, *Case Study and Theory in Political Science*, *in* CASE STUDY METHOD 80 (2009).

140. *See* Frankel, *supra* note 64, at 376.

nonlegal sanction, which is a function of the type of company and the misconduct involved.

Secondly and more fundamentally, *Disney*'s uniqueness is a matter of degree, not substance. Recent empirical studies show that nowadays most corporate misconduct is being revealed and punished by the market before litigation ensues.[141] Even though other legal disputes are not as extensively debated in mass media as *Disney* was, they nevertheless are tried in the court of public opinion, with the legal system relegated to a second-opinion role. To illustrate how the Disney dynamics exist in other cases, consider another iconic corporate law case: *Caremark*.[142]

The bad news that ignited the *Caremark* litigation was the company's failure to comply with healthcare regulations, specifically by paying "kickbacks" to physicians. Shareholders sued Caremark's directors for breaching their fiduciary duty in not monitoring and stopping the illegalities. Like the *Disney* decision, Chancellor Allen's decision in *Caremark* was seen by corporate legal scholars as a "saints and sinners" maneuver: avoiding legal sanctions while generating nonlegal sanctions.[143] But much like in Disney, a deeper analysis of the Caremark saga reveals the same dynamics that resist the saints and sinners assumptions. Firstly, the judicial opinion does not contain new information. By the time Chancellor Allen released his version, Caremark's stakeholders had already formed opinions about the kickbacks debacle and what it meant. The existing information environment was molded by social arbiters ("a spate of negative press");[144] market arbiters (rating agencies lowering Caremark's ratings);[145] and regulators (after the company pled guilty to several criminal counts, the government released a "statement of facts" detailing Caremark's violations).[146] Similarly to *Disney*, the legal complaint was actually based on information gathered from preexisting media coverage.[147] Chancellor Allen's decision thus did not affect what information was available but, at most, how available information was diffused. Again, the lesson is that analyses of big corporate legal disputes should adopt a second-opinion perspective, considering the baseline.

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141. *Supra* note 28.

142. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

143. *See, e.g.*, Mae Kuykendall, *Producing Corporate Text: Courtrooms, Conference Rooms, and Classroom,* 55 N.Y.L. SCH. L. REV. 593, 609 (2010) (suggesting that Caremark's decision makers paid "psychic costs" for serving as the poster children for law breaking).

144. *See* John Kimelman, *Caremark: Worst Case Looks Fine*, FIN. WORLD, Mar. 28, 1995, at 20.

145. *See Moody's Cuts Rating on Caremark's Notes*, WALL ST. J., Mar. 25, 1996, at C24.

146. *See* Thomas M. Burton, *Caremark Paid Physicians to Obtain Patients, Governments Documents Say,* WALL ST. J., June 19, 1995, at B4.

147. *See Caremark*, 698 A.2d at 964.

Secondly, in *Caremark* too the Chancellor's version is actually favorable to the company when compared with how market and social arbiters previously interpreted the events. Chancellor Allen spends most of his opinion emphasizing how Caremark's problems resulted from rogue, mid-level employees (who were subsequently fired) rather than from systematic breakdowns. He describes in detail how Caremark's directors were proactive in their efforts to stop the problem once they recognized it.[148] Here, too, the Chancellor's narrative comes close to something a company's spokesperson would dictate: acknowledging a problem but isolating and localizing it, thereby assuring stakeholders that the likelihood of future debacles is low.

## IV. IMPLICATIONS: THE INDIRECT DETERRENCE FUNCTION OF DELAWARE CORPORATE LAW

### A. *How Key Doctrines Contribute to Information Production*

If we agree that reputation matters in the corporate world and that the legal system affects reputation, then we need to reevaluate legal institutions by factoring (inter alia) how they contribute to the production of high-quality information. The need to reevaluate key features of corporate law along these lines is emphasized by the corporate legal scholarship conundrum: most scholars assume that the primary function of corporate litigation is deterrence,[149] yet we have not yet fully developed answers on how to evaluate deterrence. Existing accounts often assume that deterrence can simply be measured through the outcomes of verdicts—through looking at the imposition of legal sanctions. The saints and sinners approach adds the angle of measuring deterrence also through the content of verdicts—through looking at indirect deterrence through moralistic comments. My analysis, by contrast, does not limit itself to the outcomes or content of verdicts. I propose to consider also indirect deterrence through information production (reputational sanctions), which occurs throughout the process. This shift in perspective—adopting the informational and reputational lens—offers unique insights into key procedural and substantial doctrines in Delaware corporate law.

#### 1. Procedural Doctrines: Pleading Mechanisms and Settlement Approvals

The most basic implication from acknowledging the information production role of litigation is that *procedure matters*. Most academic corporate law analyses revolve around substantive doctrines. We debate endlessly the

148. *Id.* at 962-63, 971.

149. *See* Darian M. Ibrahim, *Individual or Collective Liability for Corporate Directors?*, 93 IOWA L. REV. 929, 952 (2008) (compiling references).

nuances of what standard of review applies to given sets of circumstances. But in reality, procedural doctrines shape corporate behavior at least as much.

a. The Pleading Stage

Think for example about the "good faith" doctrine and its impact on corporate behavior. Countless analyses of the *Disney* litigation touted Chancellor Chandler's treatment of the duty of good faith as holding the promise to revolutionize corporate law. From now on, scholars told us, the enforcement of fiduciary duties will be ratcheted up: Delaware courts will not confine themselves to sanctioning just extreme cases of conflicted interests (duty of loyalty) or recklessness (duty of care); they instead will use the flexible duty of good faith to scrutinize a much wider array of misgovernance, including over-deference to the CEO.[150] In retrospect, we know that the duty of good faith did not deliver on its presumed promise: courts still refrain from imposing sanctions on directors.[151] But it would be a mistake to suggest that the good faith notion did not make a difference for enforcement. Sure, good faith may not have altered the legal outcomes of Delaware litigation, but it did shape enforcement indirectly, through allowing for more relevant information production in the process of litigation.

Good faith is best seen not as a substantive doctrine but rather as a pleading mechanism.[152] Following the enactment of section 102(b)(7) of the Delaware General Corporation Law, most Delaware companies put in their charter an exculpatory provision shielding directors from claims of mismanagement. As a result, most lawsuits used to have trouble surviving motions to dismiss. Good faith then emerged as an antidote to the pleading gambit of defendants: when plaintiffs manage to frame their complaint in ways suggesting bad faith, they stand a chance of advancing to discovery. And once a case proceeds to discovery, the horses are out of the barn; it is in discovery where most reputation-relevant information is produced. Through discovery, the legal system manages to tell market players things they do not already know about the company and businesspeople. So even though the threat of legal sanctions stays the same—most Delaware cases still settle, and in the few that do not, defendants win—the threat of reputational sanctions gets a boost from the liberal use of good faith to advance cases beyond the pleading stage.

The point here goes beyond the doctrine of good faith. A liberal use of pleading mechanisms in cases against big-firm defendants is crucial if a legal system wishes to produce reputation-relevant information. Delaware fits the bill

150. Gordon, *supra* note 32, at 1489 n.88.

151. *See* Hill & McDonnell, *supra* note 70, at 371-72 (recounting the rise and fall of the good faith doctrine as the great white hope of increased legal enforcement).

152. *See* Hillary A. Sale, *Good Faith's Procedure and Substance:* In re Caremark International Inc., Derivative Litigation, *in* THE ICONIC CASES OF CORPORATE LAW 279 (Jonathan R. Macey ed., 2008).

nicely: it uses a lax standard of review when determining whether to impose legal sanctions but a more stringent standard of review in the pleading stage. In other words, Delaware courts let big cases proceed to discovery and trial even when the odds that these complaints will ultimately win are slim. This is the essence of famous doctrines such as *Zapata*,[153] which applies an enhanced standard of review to the special litigation committee conduct, or *Kaplan*,[154] which makes the question of how much discovery to accord to plaintiffs a matter of court discretion. Delaware decisional law therefore is geared towards flushing out disputes. While courts usually defer to the business judgment of directors, they gladly interfere when directors use their judgment to stifle litigation.[155]

b. The Settlement Stage

Another example of procedural mechanisms that affect corporate behavior (without being appreciated for doing so) comes from the body of practices and doctrines on how to treat settlements. The overwhelming majority of legal disputes settle, so the reputational outcomes of litigation depend on what information emerges from settled cases. The quantity and quality of information production in settlements is a function of when the case was settled. If courts allow cases to proceed beyond pleading and to discovery, reputation-relevant information may emerge even when the case is settled before trial.

The legal system also shapes the reputational outcomes of cases after they settle, through various channels. Most basically, the issue of settlements' secrecy is paramount to information production; the parties have incentives to keep settlements secret, but the public may have an interest in openness. If litigation produces an informational public good, then secret settlements are a public bad.[156]

Another issue concerns judicial approval of settlements. Because most corporate disputes are filed as class and derivative actions, most settlements are subject to judicial approval. As a result, Delaware judges get an opportunity to voice their opinion—to give their own version of how things happened—even

153. Zapata Corp. v. Maldanado, 430 A.2d 799 (Del. 1981).

154. Kaplan v. Wyatt, 499 A.2d 1184 (Del. 1988).

155. Delaware's approach stands in contrast to that of other jurisdictions such as New York, which defer to special litigation committees. *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 392 (4th ed. 2012); *see also* Kuykendall, *supra* note 143 (arguing that Delaware's pleading standards contribute to the ability of judges to produce texts).

156. *See* Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 605 (1997). To be sure, information production is just one factor to consider among many, and it is hard to assess all the ex ante effects of barring secret settlements. My purpose here is not to categorically advocate against secret settlements, but rather to introduce previously overlooked costs and benefits that should be taken into consideration.

when the parties themselves have settled. *Caremark* is a case in point: Chancellor Allen developed legal doctrines and generated reputation-relevant information (evaluating the quality of internal checks and balances and directors' conduct) even though he was merely approving a settlement in a derivative action. In general, when judges assess whether to approve settlements, they supposedly already incur the costs of gathering information about the dispute. This puts them in a position to provide valuable information to the market. One policy implication, then, is that we should encourage more detailed reasoning in judicial approvals of settlements.[157]

### 2. Substantive Review: How to Assess Director Liability and the Role of Indeterminacy

#### a. Should Director Liability Be Assessed Individually or Collectively?

Corporate legal scholars deal endlessly with what the standard of review for directors' behavior should be but ignore the question of how to apply the analysis: whether to assess directors' conduct one director at a time, or to look at the whole board collectively.[158] Here again, *Disney* serves as a great case study. Perhaps the most important yet overlooked doctrinal development in *Disney* is the application of a director-by-director analysis, detailing and grading each individual's behavior.[159] The switch from a collective to an individual mode of analysis carries potential legal implications that have been analyzed elsewhere,[160] but I want to focus rather on its reputational implications: how does mode of analysis affect information production?

At first glance, an individual mode of analysis is good for reputational deterrence since it generates more credible reputation information. A judge who analyzes each director's conduct individually helps market players avoid a "clarity of responsibility" problem. Under a collective mode of analysis, individual directors can hide behind the others in an attempt to limit the reputational harm. By contrast, under an individual mode of analysis, market players who read the verdict (or the media's coverage) get credible information on the specific quality and share of the blame for each director.

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157. Of course, there is a tradeoff here, with many other considerations. Gathering information in a preliminary stage with no adversarial conflict may be costly. The judge's third-party assessment may thus be worthless. *Compare* Jonathan Macey & Geoffrey P. Miller, *Judicial Review of Class Action Settlements*, J. LEGAL ANALYSIS 167, 182 (2009), *with* BARBARA J. ROTHSTEIN & THOMAS E. WILLGING, MANAGING CLASS ACTION LITIGATION: A POCKET GUIDE FOR JUDGES 10-15 (2d ed. 2009).

158. For a notable exception, see Ibrahim, *supra* note 149.

159. Chancellor Chandler's choice to adopt an individual mode of analysis is rare in cases of the *Disney* kind, and can be explained by the reliance on the good faith notion and intentionality. *Id.* at 939-40, 959-69.

160. *Id.*

However, a deeper look reveals contrasting dynamics. An individual mode of analysis actually may be bad for reputational deterrence under certain circumstances. One example that we already touched on (as is evident in *Disney*) is the potential for "scapegoating" dynamics.[161] The individual mode of analysis may deflect attention away from more systematic problems at the company level, giving the media ready-made villains to feed the public. Moreover, directors will anticipate the possibility of being specifically named and compared to other colleagues, and this anticipation may perversely affect the board's day-to-day dynamics ex ante—such as in hurting the collegial atmosphere or promoting paper trails and incentives not to know.

The issue of how to assess directors' conduct therefore is much more important than for which we give it credit. At the risk of making general predictions on such a complicated topic, I conjecture that switching to an individual-based mode of analysis (as in *Disney*) will be good for moral deterrence but bad for reputational deterrence. Director-by-director analysis allows for better social shaming or guilt-inducing since it gives those who dispense sanctions a clearer picture of the blameworthiness of each individual. At the same time, an individual mode of analysis creates a sharp separation between individual-level and organizational-level reputations, thereby diluting the power of reputational forces to control corporate behavior.[162]

b. The Role of Indeterminacy

A well-recognized feature of Delaware substantive review is the reliance on judge-made, open-ended standards that are applied in a highly case-specific manner. Many scholars and practitioners agree that such a feature creates indeterminacy in Delaware corporate law, and the debate revolves around whether such indeterminacy is good or bad for overall welfare.[163] Here again, the information-production perspective offers alternative (complementary rather than mutually exclusive) insights into a well-debated issue.

One previously overlooked aspect is that legal indeterminacy contributes to the accuracy of market sanctions. Firstly, indeterminacy increases the *quantity* of information production through inducing more litigation. Scholars have previously argued that Delaware's reliance on open-ended standards is bad because such standards create indeterminacy, indeterminacy creates a lot of

161. To be precise, Chancellor Chandler actually applied a hybrid approach in *Disney*: he analyzed the conduct of several directors individually and the rest of the board collectively. Not coincidentally, the directors who were targeted individually were the ones who were already out of the company. *See infra* Part III.B.

162. *See* MACEY, *supra* note 32 (arguing that reputational forces lose their power when individual reputations are separated from corporate reputations).

163. *See* Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1233-34 n.120 (2001) (compiling references).

litigation, and a lot of litigation creates overdeterrence of market activities.[164] But if litigation indeed generates a positive externality of credible reputation information, then litigation intensiveness is not necessarily a bad thing. In other words, intensive litigation does not necessarily create overall overdeterrence. Sure, intensive litigation may create legal overdeterrence, but at the same time it mitigates *market* overdeterrence.

Secondly, reliance on open-ended standards also contributes to the *quality* of information production through shaping the richness and relevancy of judges' verdicts. When judges rely on flexible doctrines such as good faith, they are relatively free to select the facts and create a version of the events that they deem most relevant.[165] Moreover, an analysis that focuses on good faith notions emphasizes reputation-relevant distinctions, such as whether directors' misconduct was intentional or whether the problems that directors should have monitored are deep-rooted.[166]

### B. *How the Content of Corporate Law Is Determined: A "Make It Look like a Struggle" Theory*

Shifting our focus from legal outcomes (direct deterrence) to nonlegal outcomes (indirect deterrence) necessitates a reevaluation of the endless debate on how the content of corporate law is determined—on whether state corporate law is a race to the top, to the bottom, or not a race at all.

Those who subscribe to a saints and sinners approach usually advocate against a race-to-the-bottom view. The main argument of the saints and sinners approach, after all, has a normative flavor: it calls for a shift of focus from how seldom legal sanctions are imposed to how many nonlegal sanctions are inflicted (through judicial sermons).[167] Such a description of Delaware law is hard to reconcile with a race to the bottom: why should a race-to-the-bottom judge dress down and inflict nonlegal pain on incumbent managers?[168] The

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164. *See* Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters*, 112 YALE L.J. 553, 601-02 (2002) (compiling references).

165. Here again *Disney* serves as a case in point: Chancellor Chandler's reliance on good faith allowed him to convey a fact-intensive, coherent narrative in a way that could not have happened had he couched the legal questions as concerning strictly loyalty or care. *See* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 22-23 (2005).

166. See Hillary Sale's analysis of the *Caremark* case, *supra* note 152, at 292, on the issue of what standards apply to directors' duty to identify red flags.

167. *See* Fairfax, *supra* note 47, at 445 ("[Saints and sinners] scholars argue that legal opinions obviate the need for legal sanctions because communities rely on the norms articulated by such opinions to regulate director conduct.").

168. To use *Disney* as illustration: a state that is racing to the bottom and is captured by corporate America could have thrown away the complaint at the motion to dismiss stage; or at least refrain from humiliating directors with caustic judicial commentary. *See* Macey, *supra* note 74, at 1134.

infliction of nonlegal pain is seen in this version as proof that judges do not cater to managers.

I want to offer here an alternative perspective. While I agree that Delaware decisional law generates nonlegal sanctions, I think that the saints and sinners proponents miss a crucial distinction between perceived sanctions and real sanctions. When legal enforcement is done indirectly (through scolding), it becomes far less transparent than when it is done directly (through legal sanctions). The public can easily assess how much a $100 million fine hurts a company. But the public has a hard time assessing how much verbal scolding actually hurts a company or individual. *The reliance on judicial scolding creates a wedge between perceived and real enforcement*. This wedge, in turn, allows Delaware to be perceived (by the public and Washington) as tougher on corporate America than it actually is.

My argument starts from a general assertion: under certain plausible conditions, it makes sense for a captured regulator to scold his capturers (regulated entities) in public. If Delaware judges do indeed cater to corporate America, then it is in the interests of both sides to be perceived as fighting each other. The emphasis here is on *perceived as*. If Delaware really fights and hurts corporate America, it risks losing incorporation fees. If, on the other hand, Delaware is perceived by the public as not fighting corporate America at all, it risks a political backlash and eventually getting overruled by Washington.[169] To be perceived as enforcing without really enforcing, the enforcer has to adopt *low-visibility favoritism*: to treat managers favorably but not openly favorably. In other words, both the regulator and the regulated industry want to "make it look like a struggle."

We all know what "make it look like a struggle" means, even if we are unfamiliar with the exact term. We have seen it played out in countless films or novels.[170] The story is simple: our hero is captured by some bad guys. The guy who guards our hero, however, wants to let him escape. The problem is that the guard does not want the other bad guys to think of him as a traitor (in our terminology, as catering to the hero). As a result, the hero and the guard come to an agreement: "give me a black eye to make it look like a struggle"/"knock me out with a blow to the head"/"trash the room to make it look like a burglary." You get the idea. And you probably also get the analogy: Delaware—or any other state trying to remain on top of a regulatory race—needs to find a method for being perceived by the public and Washington as delivering vicious blows to corporate America while not really hurting companies. And

169. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (arguing that any state that wins the regulatory competition is subject to the risk of being overruled by Washington).

170. See multiple examples of the make-it-look-like-a-struggle trope in the online wiki page for tropes: TV Tropes Found., LLC, *Make It Look Like a Struggle*, TV TROPES, http://tvtropes.org/pmwiki/pmwiki.php/Main/MakeItLookLikeAStruggle (last visited Feb. 27, 2015); Telephone Interview with Shai Biderman, Professor in the Film and Television Dept., Tel Aviv University (May 21, 2013).

judicial scolding makes for an effective low-visibility favoritism method, for several reasons.

First and foremost, scolding is salient to the public. As the *Disney* case study illustrates, mass media highlights caustic comments much more than it highlights the nuances of judicial decisions and legal doctrines. Scolding grabs headlines. The result is a public perception of Delaware judges being fed up with corporate America and going after the bad corporate villains. Such a public perception reduces the chances of political backlash, keeping Washington at bay and maintaining Delaware's powers. However, what bystanders view as an all-out attack on corporate America actually is not that hurtful to those who are being attacked. Recall our discussion of typical scenarios where scolding is directed at already ousted individuals, or targets less reprehensible sins. Second, scathing commentary makes a good make-it-look-like-a-struggle tool because its damage is easily reversible. Scolding is a more flexible enforcement tool than are legal sanctions because it has no precedential value. When judges respond to a wave of corporate scandals by imposing more liability, they somewhat constrain their future behavior by creating precedents. By contrast, when judges ratchet up (perceived) enforcement via caustic comments, they can easily reverse the enforcement intensity once the economy is better and public attention drifts away from corporate governance.[171]

The point about reversibility also illustrates, more generally, why enforcement through scolding may be good for Delaware companies *as a group*. A given company or director that suffers uninsurable reputational damage probably hates judicial scolding (ex post). But ex ante, Delaware companies and businesspeople as a group are better off with scolding than with legal liability because scolding allows the enforcer not to commit to harsh responses down the road.[172] It makes favoritism more sustainable.

As with any other theory about Delaware's motivations, it is hard to offer conclusive proof that Delaware judges intentionally pursue a make-it-look-like-a-struggle strategy. What I can offer in support of my hypothesis (aside from logic) is circumstantial evidence, such as the explanations that Delaware judges themselves give. For example, when Chancellor Chandler was asked whether his *Disney* decision proves that Delaware courts are too favorable to corporate defendants, he responded: "how come, then, I get attacked on all sides? . . . maybe that's the best measure that I'm doing right."[173] To me, such an answer indicates that even if Chandler does not intentionally try to make it look like a struggle, he is aware of the dynamics. Delaware judges understand that the best

171. *Cf.* Griffith, *supra* note 165; Jones, *supra* note 74, at 500; Wilson, *supra* note 76, at 505-06.

172. *Cf.* Kuykendall, *supra* note 143, at 599.

173. *See* Roy Harris, *Delaware Rules*, CFO MAGAZINE (Aug. 1, 2006), http://ww2.cfo.com/risk-compliance/2006/08/delaware-rules.

way to protect their unique reputation with the public and Washington is to give corporate America something to attack them for, and vice versa.[174]

To clarify, I do not claim that make-it-look-like-a-struggle dynamics are necessarily bad for overall welfare. When the risk of market or regulatory overreaction looms large, a make-it-look-like-a-struggle strategy actually can increase overall welfare by mitigating the perverse consequences of populism.[175] My goal is rather to present a tool that the Delaware judiciary (or other regulators) can use to fend off threats to their reputations. I cannot predict with certainty whether judges employ this tool cynically or public-spiritedly.[176] But we nevertheless can glean important insights from shifting our focus to the perception and visibility of enforcement methods. Most basically, we learn that recognizing a pattern of judicial scolding is not the same as proving a race-to-the-top theory. Judicial scolding may sometimes go hand in hand with a race-to-the-bottom theory (or a Delaware-Washington competition theory): *by reducing the visibility of favoritism, scolding may help incumbent managers extract more rents*.

## V. THE REPUTATIONAL CONSEQUENCES OF SEC ENFORCEMENT ACTIONS

The current Part explores how SEC enforcement actions affect behavior not just through imposing fines but also through producing information. The effectiveness of SEC-settlement practices is currently at the center of a heated national debate.[177] This Part provides a fresh perspective on how to measure the effectiveness of SEC enforcement and evaluate the proper scope of judicial review of SEC actions.[178] Switching our focus from Delaware litigation to SEC investigations is not just timely and practical, but also theoretically interesting: it enriches our understanding of the reputational theory and illustrates its broad applicability. Most notably, we learn how regulatory enforcement actions generate different reputational dynamics than litigation.

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174. Consciousness is not needed for make-it-look-like-a-struggle dynamics to be in play. Judges or regulators do not have to be fully aware of or able to verbalize the dynamics. They only have to *act as if* they recognize the dynamics. The strategy of appearing to be tougher than you truly are can survive as a crude decision rule, based on past experiences of the judges.

175. Another positive effect of the make-it-look-like-a-struggle strategy is in limiting "reputational spillover effects." The revelation of bad news about one company may cause stakeholders to lose trust in the whole industry or market. These cascading dynamics, caused by biases such as availability heuristics, are bad for the economy as a whole. And to the extent that Delaware manages to convey a message of keeping corporate America in check, it can restore some of the trust and avoid unnecessary punishing of good companies.

176. To emphasize: I do not claim that Delaware judges act with Machiavellian intentions to slow down Washington (or reputational markets) by making it look like a struggle. It is plausible that Delaware judges employ scolding because they believe that the alternative—intervening and imposing legal sanctions—is too costly.

177. *See infra* note 188.

178. *See* SEC v. Citigroup Global Mkts. Inc., F. Supp. 2d 328 (S.D.N.Y. 2011); SEC v. Bank of America, 653 F. Supp. 2d 507 (S.D.N.Y. 2009).

I start by providing background on the current debate over the effectiveness of SEC settlements. I then offer my new perspective: shifting our focus from whether the SEC collects enough awards in settlement (it does) to whether SEC produces valuable information that facilitates market deterrence (it does not). I detail the ways in which SEC settlements underproduce information and explain the reasons behind the information underproduction problem. I conclude by examining potential solutions and evaluating the proper scope of judicial review.

### A. *Judge Rakoff vs. SEC Settlement Practices: The Existing Debate*

Most SEC enforcement actions follow a similar pattern: the SEC learns about an alleged misconduct, investigates the matter, and then brings actions (files a complaint) only to simultaneously announce a pre-negotiated settlement with the defendants.[179] The typical settlement contains a three-pronged obligation by the defendant company: paying a fine,[180] agreeing to an injunction barring similar misconduct in the future, and agreeing not to deny the allegations. In return, the SEC terminates the action and allows the company not to admit the allegations. The agreement is then brought before a federal judge who signs it and turns it into a consent judgment (also known as a "consent decree").[181]

This longstanding practice of neither-admit-nor-deny settlements went unchecked for many years,[182] until Judge Rakoff of the Southern District of New York started raising questions vocally. In a sequence of three notable opinions—*Bank of America*,[183] *Vitesse*,[184] and *Citigroup*[185]—Judge Rakoff decried the practice in general and refused to sign specific consent pacts.[186] Other judges quickly followed suit, sparking a trend of increased scrutiny of SEC settlements.[187] In no time, SEC-settlement practices had become the

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179. *See* Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement against Broker-Dealers,* 67 BUS. LAW. 679, 698 (2012); Ross MacDonald, *Setting Examples, Not Settling*, 91 TEX. L. REV. 419, 421 n.16 (2012).

180. "Fines" denote here any monetary remedy, including disgorgement orders.

181. Consent decrees/judgments are basically judicially-enforced settlements. *See generally* Judith Resnik, *Judging Consent*, 1987 U. CHI. LEGAL. F. 43, 45.

182. *See* Matthew Farrell, *A Role for the Judiciary in Reforming Executive Compensation*, 96 CORNELL L. REV. 169, 188 n.141 (2010).

183. SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507 (S.D.N.Y. 2009).

184. SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304 (S.D.N.Y. 2011).

185. SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011), *vacated and remanded*, 752 F.3d 285 (2d Cir. 2014).

186. Roe, *supra* note 9, at 653-56; *Vitesse*, 771 F. Supp. 2d at 309.

187. For recent examples, see *Rakoff's Revenge*, ECONOMIST (Apr. 13, 2013), http://www.economist.com/news/finance-and-economics/21576132-rejections-settlements-financial-institutions-are-catching-rakoffs. For earlier examples, Samantha Dreilinger, Is There A Crowd? The Role of the Courts in SEC Settlements 5 (Oct. 2010) (unpublished manuscript), *available at* http://works.bepress.com/samantha_dreilinger/1.

center of national attention.[188] A heated debate ensued over the effectiveness of SEC enforcement and the proper scope of judicial review.

Those who argue against current SEC-settlement practices (and consequently are in favor of enhanced judicial scrutiny) typically claim that the SEC plays favorites with big-firm defendants, allowing them to get off with small fines and not admitting wrongdoing. The SEC and opponents of enhanced judicial scrutiny counter with two types of arguments.[189] First, they claim, there is nothing wrong with the amount of awards collected in settlements. When evaluating whether the collected amount makes sense, one needs to consider the alternative to settling: wasting limited resources on a costly litigation while risking not proving violations and collecting nothing. Second, the SEC claims, SEC settlements contribute to sanctioning and deterrence not just through imposing fines but also through producing information. The SEC announces settlements with a press release that details the allegations, thus putting market players on notice about how the defendants behaved. And since defendants are barred from denying the allegations,[190] the SEC's version goes uncontested and is considered reliable.

In this Article, I focus only on the second type of arguments: evaluating whether SEC settlements do indeed inform market participants about wrongdoing. I leave aside the first type of arguments not only because of scope but also because I think that there is no real reason to question the SEC's official line.[191] The SEC has incentives to maximize the amounts it collects even without judicial scrutiny because this is how the SEC's monitors—in the press, Congress, or academia—measure its success.[192] Take the *Citigroup* case as an example. The absolute maximum that the SEC could have collected had it fought and won a trial is $320 million;[193] the amount that the SEC got in settlement was $285 million. The SEC did not leave money on the table with *Citigroup*. It rarely does.[194] Moreover, federal judges are not well positioned to decide questions such as whether to settle and for how much: such decisions

188. *See* Dreilinger, *supra* note 187, at 2-3 (providing examples of intensive media coverage); *Examining the Settlement Practices of U.S. Financial Regulators: Hearing before the Comm. On Fin. Services*, 112th Cong. 2 (2012).

189. *See* Brief for Appellant at 14-15, 19, 24, SEC v. Citigroup Global Mkts., Inc., 673 F.3d 158 (2d Cir. 2012) (No. 11-5227) [hereinafter SEC's Brief]; Robert Khuzami, *Remarks Before the Consumer Federation of America's Financial Services Conference*, U.S. SECURITIES AND EXCHANGE COMMISSION (Dec. 1, 2011), *available at* http://www.sec.gov/news/speech/2011/spch120111rk.htm.

190. 17 C.F.R. § 205.5 (2014).

191. Another good reason to focus on the indirect outcomes of SEC settlements is that most commentators have focused solely on direct outcomes—the severity of fines obtained. *See* David M. Becker, *What More Can Be Done to Deter Violations of the Federal Securities Laws?*, 90 TEX. L. REV. 1849, 1867 (2012).

192. *See* MACEY, *supra* note 32, at 13.

193. *See* SEC's Brief, *supra* note 189, at 50-51.

194. *See* Danné L. Johnson, *SEC Settlement: Agency Self-Interest of Public Interest,* 12 FORDHAM J. CORP. & FIN. L. 627, 661, 672 (2007); MacDonald, *supra* note 179, at 427.

require not only factoring the particulars of the case at hand but also prioritizing the budgetary constraints and caseload pressures of the SEC.[195] On the other hand, we have plenty of reasons to question the SEC's claim that its settlements provide useful information. They do not. The next Subpart explains why.

### B. *Identifying the Problem: How SEC Settlements Underproduce Information*

The SEC's argument about the informative value of settlements misses an important distinction between the quantity and quality of information. More information does not necessarily translate into a better information environment. The SEC is right to suggest that its settlements produce more information than other settlements—as is manifested in summarizing the allegations in press releases and making detailed complaints available. But *the information that the SEC typically releases is not reputation-relevant*. It does not help market players distinguish between good and bad actors. In order for SEC settlements to impact market players' beliefs and facilitate better reputational sanctioning, they have to provide new facts or credible interpretations. The typical SEC settlement fails to do that for several reasons.[196]

First, putting the public on notice is helpful only if the public has not already noticed the wrongdoing. When the wrongdoing is done on a large scale and by visible companies, the media usually covers it long before the SEC releases information.[197] In the *Bank of America* settlement announcement, for example, every piece of information was stale.[198] The informative value of putting the public on notice thus depends on the baseline. The notice has an informative value in actions against small broker-dealers, where but for the SEC announcement the violation would not have been noticed. Conversely, notice by itself has little informative value in settlements of the *Bank of America* and *Citigroup* kind, where the public had already noticed that something wrong had happened and the role of the SEC was to focus on explaining *how* exactly things went wrong: What specific control weaknesses

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195. *See* SEC's Brief, *supra* note 189, at 43; Sanford Weisburst, *Judicial Review of Settlements and Consent Decrees: An Economic Analysis,* 28 J. LEGAL STUD. 55, 67, 98 (1999).

196. *See* Samuel Buell, *Potentially Perverse Effects of Corporate Civil Liability*, *in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 87, 99 (Barkow & Barkow eds., 2011).

197. *See* Karpoff et al., *supra* note 29, at 15.

198. *Compare* Press Release, SEC, SEC Charges Bank of America for Failing to Disclose Merrill Lynch Bonus Payments, (Aug. 3, 2009), *available at* http://www.sec.gov/news/press/2009/2009-177.htm, *with* Susan Beck & Andrew Longstreth, *All Sides of the Fence,* 31 AM. LAWYER 13 (Apr. 2009) (summarizing the media coverage four months prior to the SEC's release).

led to the wrongdoing? Was it really just a low-level rogue employee or a more pervasive problem?

Second, the reputational impact of settlement announcements is further diluted by the SEC's tendency to target whole industries.[199] Announcing that company X allegedly engaged in wrongdoing does not really help market players if all company X's competitors face similar allegations. Stakeholders cannot take their business elsewhere—cannot dispense reputational sanctions—unless the SEC provides details that distinguish between one alleged wrongdoing and another: which are attributed to technical errors and which reflect more deep-seated issues.[200]

Third, *the SEC often lets defendants shape the content of announcements*. Most of the settlements are pre-negotiated, and the SEC lets big-firm defendants minimize the reputational impact in two ways.[201] The simultaneous announcement of complaint and settlement limits the negative publicity exposure to only one event. And, more importantly, the pre-negotiation allows defendants to shape the public perception of the SEC's allegations by affecting the language of SEC announcements. The *Citigroup* case illustrates how the SEC's public version is watered down compared to the SEC's internal version. In *Citigroup*, the same misconduct (material misstatement) led to two complaints: one against the company and one against an employee (Brian Stoker). Yet for some reason, the language used to describe the misconduct was different. The complaint against the company emphasizes that no bad intentions were involved while the Stoker complaint does indicate intentionality.[202] The complaint against Stoker mentions the gross revenues collected by Citigroup in the toxic transaction while the complaint against Citigroup uses only the less damning net-profits figure. Both aspects—the degree of intentionality involved and harm done—are important determinants of reputational sanctions. The framing of the *Citigroup* complaint therefore limited the reputational damages to the company.

Finally, the SEC argues that settlement announcements are informative even without containing admissions, simply because defendants are barred from denying the allegations. But *in reality the "no denial" requirement is not (and perhaps cannot be) enforced*. The information contained in the SEC allegations is open to interpretation and disagreement, if only because

199. *See* MACEY, *supra* note 32, at 225, 236.

200. *Id*. at 23-24; Jesse Eisinger, *Needed: A Cure for a Severe Case of Trialphobia*, PROPUBLICA, Dec. 14, 2011, http://www.propublica.org/thetrade/item/needed-a-cure-for-a-severe-case-of-trialphobia ("[The announcement] renders the settlement little more than turning on the light in a kitchen full of roaches. . . . [T]he settlements merely show how the bad actors are scattered everywhere."); Johnson, *supra* note 194, at 674).

201. *See* Johnson, *supra* note 194, at 665; Dreilinger, *supra*, note 187, at 12-13.

202. *See* Brief of Amicus Curiae former SEC General Counsel and Chairman Harvey Pitt in Support of Affirmance of District Court's Ruling at 26, SEC v. Citigroup Global Mkts., Inc., 673 F.3d 158 (2d Cir. 2012) (No. 11-5227) [hereinafter Harvey Pitt Brief].

companies find ways to implicitly contest the allegations.[203] Indeed, SEC Commissioner Luis Aguilar himself decried the common practice of "the press release issued by a defendant after a settlement explaining how the conduct was really not that bad or that the regulator overreacted."[204] Other current and former securities regulators agree that there is no such thing as a "no-spin zone": defendants find various ways to bypass the requirement.[205]

The upshot is that SEC settlements with big companies underproduce relevant information. The next question is why. SEC investigations generate internally high-quality information on how things went wrong, so why does the SEC not publicly convey information in a comprehensible and thorough way? Why does the SEC leave information on the table in settlements? The following Subpart locates the roots of the information-underproduction problem in the reputational incentives of both parties to SEC settlements.

### C. *Explaining the Problem: Why the SEC Trades Information for Fines*

Large publicly-traded companies have incentives to pay slightly higher settlement awards as long as they can prevent unfavorable information about them from reaching the market. This is because negative information may generate reputational ramifications,[206] which are more risky for large companies than legal sanctions are. Emerging evidence suggests that the typical reputational sanction attached to revealed misconduct dwarfs the equivalent legal sanction.[207] Moreover, many types of legal sanctions are paid by insurance companies, while reputational damages are less easily insurable. Large companies therefore fear an uptick in reputational sanctions more than they fear an uptick in legal sanctions.

As for the SEC's incentives, here the story gets more complicated. One could argue that the SEC decision-makers' incentives are aligned with the public interest, so whenever the SEC blocks information from getting to the

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203. *See* SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 308 (S.D.N.Y. 2011).

204. *See* Luis Aguilar, Speech Before International Trade Center, Setting Forth Aspirations for 2011, (Feb. 4, 2011), *available at* http://www.sec.gov/news/speech/2011/spch020411laa.htm.

205. *See Examining the Settlement Practices of U.S. Financial Regulators: Hearing Before the Comm. on Fin. Services*. 112th Cong. 45 (2012); *see, e.g.*, Bruce Carton, *Settling SEC Defendants Never 'Admit' Wrongdoing but They Sometimes Later 'Deny' It*, COMPLIANCE WEEK (Dec. 7, 2011), *available at* http://www.complianceweek.com/settling-sec-defendants-never-admit-wrongdoing-but-they-sometimes-later-deny-it/article/218356; *Still More on Defendants' Post SEC-Settlement Statements*, COMPLIANCE WEEK (Feb. 15, 2011), http://www.complianceweek.com/still-more-on-defendants-post-sec-settlement-statements/article/196413/ (providing specific examples by former SEC staffer Bruce Carton in a series of blog posts). *But see* Johnson, *supra* note 194, at n.119.

206. *See* Brief of Defendant-Apellee-Cross-Appellant at 6-7, SEC v. Citigroup Global Mkts., Inc. 673 F.3d 158 (2d Cir. 2012) (No. 11-5227) [hereinafter Citigroup's Brief]; Becker, *supra* note 183, at 1860-61.

207. Karpoff, *supra* note 4.

market, it is only because the benefits from settling early and for larger amounts outweigh the informational benefits. From that perspective, information underproduction is not really a problem but rather a welfare-enhancing tradeoff. But such an argument misses how the incentives of agents work in a multitasking environment. When agents make tradeoffs between multiple tasks, they tend to overemphasize the tasks that are being closely monitored by principals.[208] The SEC's constituencies—the general public and congressional overseers—evaluate the SEC mostly according to readily observable yardsticks, such as the amount of fines collected or the number of cases brought.[209] The public and Congress have difficulties in observing and attributing the indirect benefits from information production to the SEC. The logic of incentives therefore suggests that the SEC will prioritize the number of cases brought and the amount of fines collected. Indeed, the SEC's own communications reflect such emphasis,[210] and former SEC staffers acknowledged that the SEC tilts the fines and information tradeoff against providing information and to the detriment of the public interest.[211]

The upshot is that even well-meaning SEC officials face reputational pressures to favor fines over information. The next Subpart sketches solutions to this information-underproduction problem.

### D. *Solving the Problem: Can Enhanced Judicial Scrutiny Help?*

Armed with a fresh perspective on SEC settlements, we can revisit the timely question of the proper scope of judicial review. As a starting point, we should switch from arguing "for or against" SEC settlements to concentrating on what type of SEC settlements we want. The solution to current problems with SEC settlements is not more litigation,[212] but rather better-designed settlements and prioritizing of cases. SEC settlements can and should provide

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208. *See generally* Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design,* 7 J.L. ECON. & ORG. 24 (1991). For applications to regulators' behavior, see Moshe Maor & Raanan Sulitzeanu-Kenan, *The Effect of Salient Reputational Threats on the Pace of FDA Enforcement,* 26 GOVERNANCE 31, 32, 37 (2013).

209. *See supra* note 189.

210. See, for example, the SEC Director of Enforcement's public reaction to Judge Rakoff's decision in *Citigroup*. Jonathan Macey, *The SEC's Publicity Hounds,* DEFINING IDEAS, July 7, 2011, *available at* http://www.hoover.org/publications/defining-ideas/article/84831.

211. *See* Becker, *supra* note 191, at 1871; Brief of Amici Curiae Securities Law Scholars at 15 n.15, SEC v. Citigroup Global Mkts., Inc., 673 F.3d 158 (2d Cir. 2012) (No. 11-5227). Another reason for the SEC's reluctance to reveal information in settlements or to litigate stems from the tension between the SEC's two roles: preventing scandals ex ante and adjudicating scandals ex post. If the full picture of the scope and pervasiveness of the financial sector's problems gets revealed, the SEC's reputation as protector of markets may suffer greatly.

212. *See* Harvey Pitt Brief, *supra* note 202, at n.14 (claiming that for an agency that initiates hundreds of proceedings, settling most of them becomes a necessity).

market players with more credible information on how exactly companies misbehaved. And the SEC should prioritize differently among its enforcement cases—by concentrating resources on cases that produce big informational benefits (disputes with giant financial firms), even at the expense of amassing complaints and litigating against smaller firms or low-level employees.

Judicial review, however, is a very imperfect method for improving SEC settlements. Judges themselves are fallible and may interfere even when the SEC makes the right considerations.[213] My point here is not to advocate for more judicial scrutiny, but rather for better judicial scrutiny. To the extent that the newfound enhanced judicial scrutiny is here to stay, we need to develop clear guidelines for its application.[214] I offer two simple guidelines. First, judges should generally maintain deference to the SEC. Interference raises the costs of settlements and limits the range of mutually beneficial bargains between the regulator and the regulated entities. Second, the main trigger for judicial intervention in rare cases should be information production and not severity of fines. Judges should interfere whenever the settlement withholds quality information on a topic that is of wide interest to the market.[215]

In fact, the SEC already seems to be trending in the right direction. Under the leadership of Chairman Mary Jo White the SEC changed its settlement policy to require more admissions from certain defendants.[216] For example, in September 2013, it announced twenty-three neither-admit-nor-deny settlements with firms accused of short selling,[217] and two days later a settlement where JPMorgan not only paid $200 million but also admitted wrongdoing.[218] To me, these two announcements represent the right priorities going forward, based on the type of violations and the companies involved. The alleged violation in short-selling cases does not require intent, and the firms involved are not

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213. Federal judges enjoy life tenure, but they are not immune from seeking esteem, influence, or promotions. They too may advance their own reputation at the expense of overall welfare. *See* Fredrick Schauer, *Incentives, Reputation, and the Inglorious Determinants of Judicial Behavior,* 68 U. CIN. L. REV. 615, 629-33 (2000).

214. *See* Dreilinger, *supra* note 187, at 6 n.33.

215. The doctrinal hook for demanding more information production comes from the requirement to consider "the public interest" when reviewing SEC's decisions. *See* SEC v. Randolph, 736 F.2d 525 (1984). Note that any form of judicial scrutiny should consider the unintended consequences on parallel private litigation: before making settlements more informative one should consider limiting the issue preclusion and estoppel effects. Buell, *supra* note 196, at 100-01.

216. *See* James B. Stewart, *S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES (Jun. 21, 2013), http://www.nytimes.com/2013/06/22/business/secs-new-chief-promises-tougher-line-on-cases.html?pagewanted=all.

217. *See* Press Release, SEC, *SEC Charges 23 Firms with Short Selling Violations in Crackdown on Potential Manipulation in Advance of Stock Offerings* (Sept. 17, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539804376#.Uu-8ntGA3IU.

218. *See* Press Release, SEC, JPMorgan Chase Agrees to Pay $200 Million and Admits Wrongdoing to Settle SEC Charges (Sept. 19, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539819965.

household names. By contrast, when a giant like JPMorgan is charged with misstating financial results and lacking internal controls, it becomes essential that the public gets credible detailed information on how things went wrong.

To borrow an analogy from communication science: *the SEC needs to shift to a "burglar alarm" mode of reporting*. In the past decade, scholars have been advocating a shift from the traditional "all the news that's fit to print" mode of journalism to a burglar-alarm approach.[219] The idea is that nowadays, with the advancement of information technologies, citizens can easily access information on all issues. What citizens need is not more information but rather someone to sift the information for them: a reputable intermediary that will direct citizens' scant attention to the few pieces of information that are more relevant and critical. The same can be said with regard to SEC settlements. Nowadays market players learn about financial misconduct from multiple sources. The SEC therefore should switch from merely putting us on notice that lots of bad things are happening to flagging the more problematic cases—providing detailed information on the most important cases and directing market players' attention to instances where they greatly under- or overstated problems.

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A quick update is in order. In June 2014, shortly after this Article was originally submitted, the U.S. Court of Appeals reached a decision in the *Citigroup* case, vacating Judge Rakoff's refusal to approve the settlement.[220] Seen from the informational perspective developed here, the Court of Appeals decision sets a bad precedent: it focuses the permissible scope of judicial review on the procedural aspects of the consent decree and explicitly limits the judge's ability to demand more information on what and how things happened. It remains to be seen how the two recent contrasting trends mentioned above—the SEC's move toward a more informative approach and the courts' move toward a less informative approach—will affect the ability of market (reputational) forces to deter misbehavior in securities markets.

## CONCLUSION

This Article makes one overarching point: corporate law shapes behavior not through imposing liability, but rather through producing information. In the course of fleshing out this point and examining the interactions between law and reputation, the Article contributes to various debates that have been at the center of academics' and practitioners' attention. In this Part, I offer a brief synthesis of the Article's contributions as they relate to existing literatures, before outlining future research.

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219. *See* John Zaller, *A New Standard of News Quality: Burglar Alarm for the Monitorial Citizen*, 20 POL. COMM. 109, 116 (2003).

220. SEC v. Citigroup Global Mkts. Inc., 752 F. 3d 285 (2014).

First, the Article advances our understanding of how reputational forces work. The Article's original contribution is not in telling us that reputation matters or that the law matters for reputation,[221] but rather in exploring *how* the law matters for reputation. Specifically, the Article is the first to examine at length the reputation-shaping implications of information that is produced in the process of litigation or regulatory investigations. The existing literature tells us that on average litigation and regulatory investigations are bad for a defendant-company's reputation, whereas I shed light on the cross-section: why some disputes do not hurt or even help the defendant-company's reputation.

Second, the Article challenges the conventional assumption among law and social norms scholars that the legal and reputational systems are independent of each other.[222] The focus on interdependencies between formal and informal systems of control makes this Article closely related to several recent working papers that analyzed the informational role of the law.[223] My approach differs from theirs along two dimensions: namely, by examining what gap in market knowledge the legal system is filling, and how it is filling the gap. Firstly, existing accounts assume that market players are not aware of corporate misconduct and that the role of the legal system is to reduce the detection costs of reputational sanctions.[224] My account, by contrast, assumes (following recent empirical studies) that in disputes with big-firm defendants, market players become aware of and react to misconduct before the legal system gets involved, so the real role of the legal system is to produce second opinions on how things happened.[225] Secondly, existing accounts focus on the informational role of legal *outcomes*[226] while I focus on information disseminated in the *process* of determining legal outcomes. Two SEC enforcement actions (or Delaware trials) with identical legal outcomes may generate completely different reputational outcomes.

Third and most basically, the Article revisits the debate over how corporate law matters. My approach is related to and complements the influential saints and sinners theory. Most notably, I develop the transmission-of-law point that

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221. We already knew that. *See* Karpoff, *supra* note 4 (providing an overview of the extant empirical literature on the reputational outcomes of enforcement events).

222. *See supra* note 20 and accompanying text.

223. *See* Edward Iacobucci, *On the Interaction Between Legal and Reputational Sanctions* (Jan. 23, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1990552; Scott Baker & Albert Choi, Reputation and Litigation: Using Formal Sanctions to Control Informal Sanctions (Aug. 20, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2195749.

224. *See also* MACEY, *supra* note 32, at 12; Fairfax, *supra* note 47, at 443.

225. The reputational impact of litigation therefore depends on the type of misconduct and companies involved, and the identity of harmed parties. *Cf.* Skeel, *supra* note 44, at 1864.

226. *See* Iacobucci, *supra* note 223 (noting that the size of legal sanctions affects the reputational signaling equilibrium by affecting firms' initial decisions whether to commit wrongs or not); Baker & Choi, *supra* note 223 (arguing that firms can opt to submit themselves to formal sanctions and thus facilitate better informal control).

Ed Rock and others have left for future research.[227] That is, *instead of describing just what Delaware judges say, I analyze what market players are actually hearing*. Because most people do not read judicial opinions, the role of the media and other information intermediaries in selectively diffusing information from the courtroom becomes especially important.[228] In the process of analyzing the content of media coverage, several insights stand out: the earlier stages of litigation impact the court of public opinion just as much as verdicts do; verdicts do not necessarily hurt defendant-companies' reputation; and moral rebukes often get lost in translation and do not reach their presumed audiences.[229] The upshot is that corporate law affects behavior mainly through shaping factual beliefs (information-producing role), rather than through shaping moral beliefs (finger-wagging role).[230] To be sure, there are still finger-wagging elements in Delaware opinions, but the information-production elements are ultimately more important in today's environment. The Article outlines specific factors that limit the impact of finger-wagging, such as lack of verdicts, sanctions, and communication channels. And more generally, in an environment with diffused and atomistic participants and super-strong economic incentives, it makes sense to highlight reputational rather than moral sanctions.[231]

The fourth set of insights is normative: reevaluating the desirability of key corporate law institutions according to their contribution to information production. The main original contribution stems from refocusing the well-debated question of how to get better deterrence: whether to "leave things to the market" or "ramp up legal sanctioning."[232] Those who oppose legal intervention fail to recognize the importance of the legal system for the functioning of market deterrence, while those who advocate for more legal

227. *See* Rock, *supra* note 2, at 1106.

228. On the gap in the literature regarding the corporate governance role of the media, see Dyck & Zingales, *supra* note 61.

229. My heavy emphasis on the role of earlier stages of litigation corresponds with Gorga and Halberstam's recent paper. *See supra* note 23. The main distinction between our approaches is that they focus on the implications of information production on internal policing by the company insiders, while I focus on the implications for reputational policing by the company's outside stakeholders.

230. The focus on belief-updating also separates my account from most expressive law theories, which highlight the *preference*-shaping role of the law. The line between belief- and preference-shaping is murky, however, as is evident from our discussion on how noninformative components in verdicts affect stakeholders' beliefs through framing and salience. *See* DellaVigna & Gentzkow, *supra* note 18, at 656. Another way to describe the distinction is that existing papers tell us how courts provide information about what the market norms are, while I focus on how courts provide information about whether given norms were violated in specific instances (i.e., what the facts pertinent to norm-violation were).

231. *See* Iacobucci, *supra* note 223, at 8 (arguing that in large atomistic markets collective action problems usually make costly punishment measures—such as guilt or shaming—less viable than punishment that relies on self-interest—such as reputational sanctions).

232. *See* Fairfax, *supra* note 47, at 428-32.

sanctions fail to recognize the ability of the legal system to contribute to deterrence *indirectly*, without interfering with business decisions. The most effective and realistic way to promote deterrence is not by increasing judicial intervention and legal sanctions, but rather by increasing the quantity and quality of information production. Consequently, the overlooked procedural doctrines of pleading standards, settlement approvals, and openness of proceedings affect corporate behavior just as much as endlessly debated substantive doctrines do. To clarify, I do not claim that we should necessarily lower the pleading standards or write lengthy judicial opinions when approving settlements. What I claim is that when making such decisions, we should consider also the previously overlooked set of costs and benefits stemming from information production.

Another set of insights comes from applying the theory to the hotly debated SEC enforcement practices. By applying the insights of the reputation literature, I provide a fresh perspective on the claim that SEC settlements are informative. The main takeaway point is that SEC settlements do produce lots of information but that they are not informative. The SEC does not fulfill its potential to facilitate market control: the information it produces does not help market players distinguish between high- and low-quality companies.

Finally, the Article contributes to our understanding of regulators' behavior. The bulk of the Article focuses on how the actions of law enforcers (Delaware judges and SEC commissioners) affect the reputations of regulated entities. But enforcement actions also shape, and are shaped by, the reputations of the enforcers themselves. The existing literature has recognized that both Delaware and the SEC try to balance between catering to the general public and political overseers by being tough on corporate America, but not so tough as to alienate the regulated entities. My original contribution comes from explaining how exactly regulators engage in such a balancing act. I identify the tradeoffs that regulators face when choosing between enforcing directly (imposing sanctions) and enforcing indirectly (producing information). Both Delaware and the SEC seem to pick the method of enforcement that makes them look tough in the eyes of outsiders but is actually less hurtful to the regulated entities.[233]

To be sure, even with all these contributions the Article represents only a starting point in our efforts to understand the interactions between law and reputation. Considerations of scope and clarity dictated leaving several angles of this vast topic for future research. Specifically, future research should put more emphasis on the normative and empirical angles. For example, when I make here the descriptive claim here that fiduciary duty litigation produces

233. To recast the *Disney* example: existing accounts view *Disney* as a show trial meant to convince the public that Delaware got the burning issue of inflated executive pay under control. My contribution is in adding that "no incumbent managers were harmed during the filming of this show." Delaware got the presumed mitigating-backlash benefit without really hurting Disney.

reputation information, an important question remains as to whether litigation is the *optimal* way to enhance the accuracy of reputational sanctions. Social planners may think of more effective ways to produce credible information that do not involve costly litigation, such as granting stakeholders liberal access to inspection of company books and records. And while the case studies and examples that I explore are illuminating and interesting, future research should try to corroborate or discard the testable predictions of the reputational theory more systematically.[234]

I started this project with the motivation of researching how exactly reputation matters. Somewhere along the way, my emphasis changed: I was not just describing how corporate reputation works; I was describing how corporate *law* works. It became clear that information production as a by-product of litigation is in many cases the de facto primary function of corporate law. In other words, to understand how corporate law works, we need to develop a reputational theory of the law.

234. For example, future research could test over a large sample of cases the following hypothesis: when the judge criticizes defendants for honest temporary mistakes, the reputational outcomes would be more favorable than in cases where the judge scolds defendants for calculated disregard. However, one should proceed with caution when measuring reputational outcomes with standard event-studies methods. Nowadays information about corporate misbehavior flows to the market constantly from multiple sources. As a result, researchers cannot designate neat event windows. The filing of a lawsuit is almost never the first time that market players hear about misbehavior by large companies. And the information contained in verdicts is usually stale, having already been leaked to the market during earlier stages. *See* Karpoff, *supra* note 28.