

Legal Risks and the Changing Structure of Business

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Legal Risks

? Class Actions

- Products
- Employees
- Shareholders

? Tort Liability

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

? Workers Compensation

? Occupational Safety

? Contract Risk

? D&O Risks

- Fiduciary
- Sarbanes Oxley
- Pension

? Property

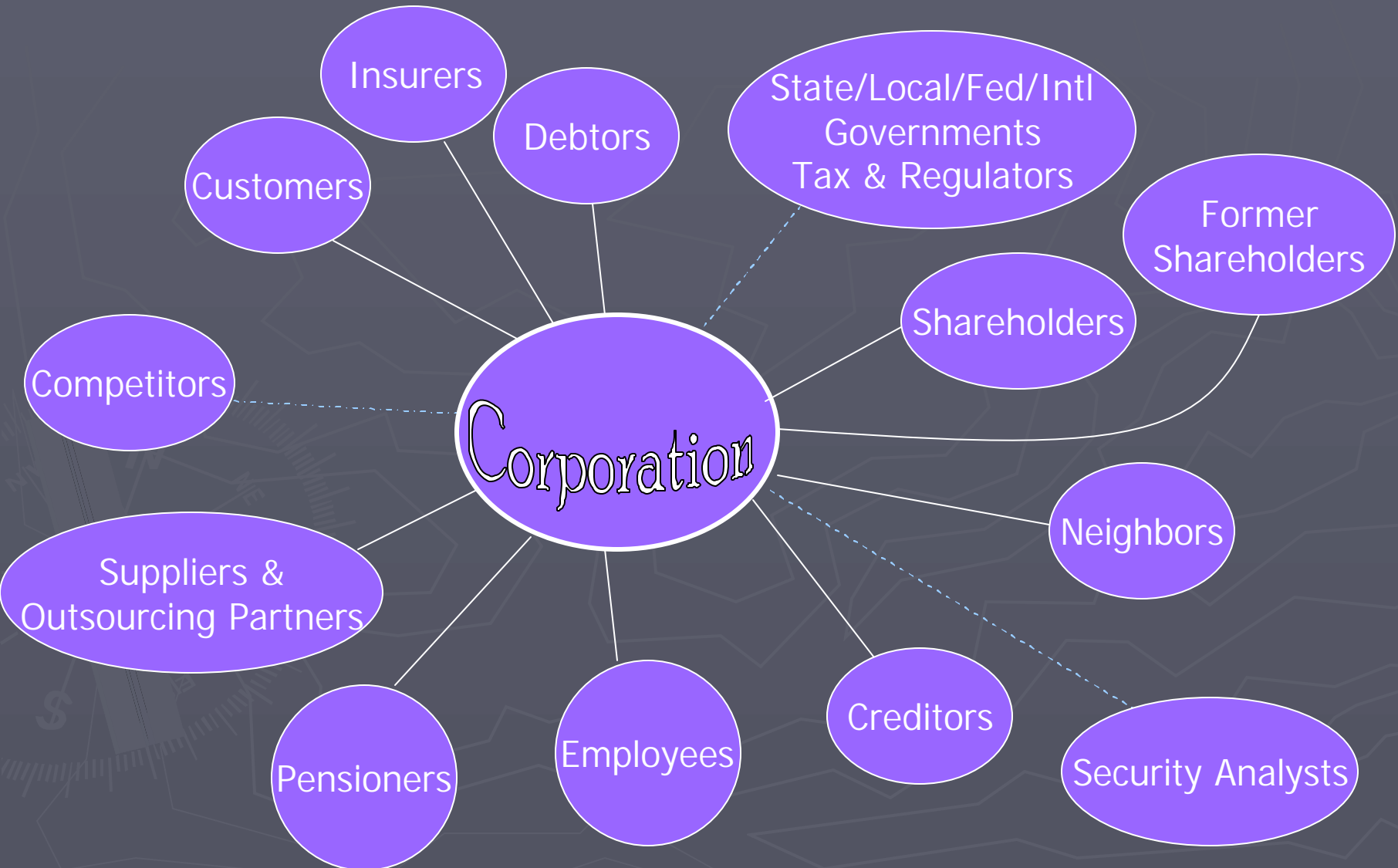
- Intellectual Property
- Terrorism
- Natural Catastrophe
- Mundane Hazard Losses

? Regulatory

? Tax

? Competitor's Settlements

Legal Risk Environment



Recent Risks are within Corporation's Control

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

Legal Risk Environment Has Changed

? Distrust of Corporations: Unbridled Agency Problems

- High Fliers of the 1990s
- Mutual Funds

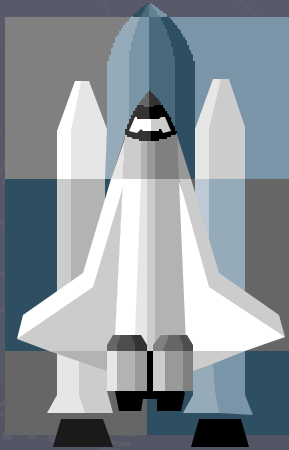
? What is next?

Simple Risk Management

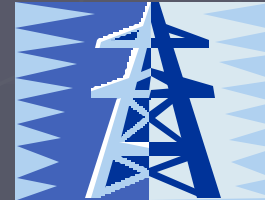
- ? Most organizations have developed fundamental “Rules” to deal with all sorts of agency problems.
 - Acceptable use of company assets
 - Proper customer care
 - Proper dealings with shareholders
- ? These rules are often based upon legal principles, but may be “moral” in nature.
- ? Rules, to be useful, must help managers maximize *long-run* corporate value.

Three Simple Cases

The Challenger Disaster



Enron



Long Term Capital Management

Challenger*

- ? NASA had a rule which it used to stop countdowns to discuss risks to launch vehicle and to astronauts.
- ? NASA knew about the O-ring issue.
- ? It discussed the O-ring issue prior to Challenger launch and then decided it no longer needed to talk about O-rings and it excepted the O-ring issue from its rule.
- ? People giving launch OK did not know about O-ring failures.

* <http://history.nasa.gov/rogersrep/v1ch5.htm>

Enron*

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

* <http://news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>

LTCM

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

* <http://www.gao.gov/archive/2000/gg00003.pdf>

** <http://mondediplo.com/1998/11/05warde2>

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

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