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Competing Normative Frameworks and the Limits of Deterrence Theory: Comments on Baker and Griffith's *Ensuring Corporate Misconduct*

Jodi L. Short

TOM BAKER and SEAN J. GRIFFITH. 2010. *Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation*. Chicago: University of Chicago Press. Pp. viii + 285. \$33.19 cloth.

This essay reviews the contributions to deterrence theory that Tom Baker and Sean Griffith make in Ensuring Corporate Misconduct (2010) and argues that their work highlights the limits of deterrence theory for shaping corporate conduct. Baker and Griffith extend the deterrence framework to account for the mediating effect of third-party institutions, like insurers, on deterrence calculations, and they suggest how corporate governance decisions, such as what type of insurance coverage to purchase, encode signals about corporations' compliance motivations and capacity. Although these insights might prove useful for enhancing the efficacy of deterrence regimes aimed at white-collar crime and other types of corporate misconduct, they suggest the difficulty of shaping corporate conduct that is influenced not only by the norms embodied in securities law, but also by the alternative normative system of shareholder value maximization. I discuss the failure of deterrence theory to address adequately noncompliant behavior that springs not solely from material self-interest, but from adherence to an alternative set of norms, and I explore the possibility of viewing corporate compliance as a norm-change project.

INTRODUCTION

In *Ensuring Corporate Misconduct*, Tom Baker and Sean Griffith persuasively argue that directors and officers (D&O) insurance, as it is currently structured, virtually eliminates the deterrent effect of shareholder litigation on corporate misconduct. Their analysis represents an important contribution to deterrence theory by extending this framework to consider the mediating effect of third parties on deterrence calculations and contemplating how information signals encoded in corporate insurance choices might be leveraged to enhance the deterrent effects of a sanctions regime. At the same time, however, their work suggests the limitations of deterrence for shaping corporate conduct.

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From its beginnings (Beccaria [1764] 1986; Bentham [1789] 1988), through many of its most sophisticated contemporary iterations (e.g., Ayres and Braithwaite 1992; Haines 1997; Etienne 2011), the central problem for deterrence theory has been securing conformance with collectively articulated norms in the face of contrary self-interest. The problem with this framing is that it does not adequately address behavior that is subject to multiple and conflicting normative frameworks. Behavior that transgresses the norms embodied in a given sanctions regime may not always spring from self-interested calculations, but may instead arise out of allegiance to an *alternative* normative system. Corporate financial behavior, for instance, is influenced not only by the material self-interests of individuals and organizations, but by their adherence to the collectively articulated and widely shared norm of shareholder value. Irrespective of insurance arrangements, sanctions regimes that aim to deter corporate behavior that is perceived to maximize shareholder wealth will have only limited effects unless they are able to address this competing normative vision.

Baker and Griffith do not directly address the issue of norm conflict, instead framing their analysis squarely within the rubric of deterrence theory. They begin from the premise that the underlying purpose of shareholder litigation is to deter conduct on the part of corporate actors that would harm investors. Investors who believe that they have suffered losses due to illegal behavior by corporate actors may bring claims against corporate officers and directors, or the corporation itself, under federal securities laws or state corporate law. These claims are most commonly based on misrepresentation theories alleging that corporate actors released false or misleading information that induced investors to buy company shares at an artificially inflated price, resulting in investor losses when the information was later revealed to be false (Loss and Seligman 2004). Baker and Griffith estimate that publicly traded companies have about a 2 percent chance of being the subject of the most common types of shareholder litigation in any given year (Baker and Griffith 2010, 22). The average settlement value of such claims in 2008 was more than \$38 million. Since 2008, shareholder suits arising out of the global financial crisis have sought enormous sums in compensation. Bank of America shareholders, for instance, are seeking \$10 billion in compensation for misleading statements that the bank made in connection with mortgage-backed securities.

The deterrence rationale for shareholder litigation is that the prospect of liability will prevent individual corporate actors from engaging in actions prohibited by securities laws and will encourage corporate entities to adopt good governance practices to ensure that their officers and directors comply. Deterrence theory posits that rational actors will avoid harmful behavior when the expected costs of engaging in it exceed whatever benefits it might produce (Bentham [1789] 1988; Becker 1968). The purpose of shareholder litigation, from this perspective, is to attach sufficient costs to securities law violations to make them prohibitively expensive to commit. As Baker and Griffith describe the mechanism: “a prospective wrongdoer, recognizing that he or she will be forced to pay the full cost of any harm he or she causes . . . therefore forswears the harmful conduct” (Baker and Griffith 2010, 9).

Although this is how deterrence is supposed to work, the authors explain that D&O insurance interrupts this mechanism. Standard D&O insurance coverage arrangements will pay all the costs incurred by directors, officers, and the corporate entity itself in defending and settling shareholder litigation (Baker and Griffith 2010,

48).¹ In a typical shareholder suit, this constitutes the vast majority of costs incurred by insureds, as most shareholder litigation settles within policy limits (Baker and Griffith 2010, 10). The effect of these arrangements is to “[transfer] shareholder litigation risk away from individual directors and officers and the corporations they manage to third-party insurers” (Baker and Griffith 2010, 10). Thus, the costs shareholder litigation seeks to attach to legal violations are borne *not* by those individuals and entities whose behavior it seeks to influence, but by their insurers. If corporate actors and the entity that employs them are insulated from the costs of shareholder litigation, these costs are unlikely to inform their decision making and deter law-breaking behavior.

The question Baker and Griffith ask in their book is whether the D&O insurers, the entities that *do* bear these costs, are doing anything to prevent legal violations by their insureds. The authors suggest that there are a number of ways in which insurers might act as “deterrence mediators,” passing the costs (and thus the deterrent effects) of shareholder litigation through to their insureds. First, D&O insurers could screen potential insureds in advance for poor governance practices and price premiums based on an assessment of liability risk. Second, for the duration of the policy, insurers might monitor the governance practices of their insureds, educate insureds about best practices, and condition policy benefits on the adoption of these practices. Finally, on the backend, D&O insurers can proactively manage the defense and settlement of shareholder claims to impose greater costs on corporate defendants who have engaged in genuine wrongdoing. Currently, D&O insurers settle the vast majority of shareholder claims without regard to their merits. Insurers could better incentivize law-abiding behavior if they were more discriminating in their defense and settlement of claims, for instance, by vigorously litigating (instead of settling) frivolous or weak shareholder claims and by withholding insurance benefits from directors or officers found to have engaged in actual fraud.² Despite the deterrence mechanisms available to insurers, Baker and Griffith’s extensive interviews with key participants in the D&O insurance and securities litigation fields show that D&O insurers do little to pass through to their insureds the deterrence signals sent by shareholder litigation. Under these circumstances, they conclude that D&O insurance “transforms” liability risk in ways that “reduce or even destroy the deterrence function of shareholder litigation” (Baker and Griffith 2010, 20).

Baker and Griffith argue, however, that these deterrent effects might be reconstituted through a combination of strategies that calls on D&O insurers to play a more active deterrence role and leverages the structure of D&O policies as a mechanism for identifying which corporate actors are most likely to have good-quality governance

1. The amount paid by the insurer excludes deductibles or coinsurance and is capped by the policy limit. Baker and Griffith explain that these policy arrangements carry little, if any, deterrent effect because deductibles are not risk rated to reflect the varying corporate governance quality of different insureds and the vast majority of shareholder litigation settles within policy limits, so no additional out-of-pocket payments are made by individual or corporate insureds.

2. Most D&O policies contain an explicit term that excludes policyholders from receiving insurance benefits when they have actually engaged in fraud. “Because the core allegation of a great many shareholder claims focuses on misrepresentations or fraud, robust application of the fraud exclusion would seem to enable insurers to avoid payment for a large number of claims” (Baker and Griffith 2010, 186). As Baker and Griffith explain, however, insurers rarely invoke this exclusion to deny coverage.

systems in place. Baker and Griffith's proposals include a restructuring of coverage to exclude corporate entities (as opposed to individual corporate actors), a more active role for insurers in the defense and settlement of claims that would reflect the culpability of corporate defendants, and a disclosure regime that would require corporations to make public their D&O insurance coverage arrangements.

In their analysis of the problem and their prescriptions for reform, Baker and Griffith make three important contributions to deterrence theory. First, they push beyond deterrence theory's traditional focus on regulators and regulated entities to illuminate the ways in which the deterrence threat of legal sanctions is often mediated through third-party institutions such as insurance companies. Second, they add to a small, but growing, body of literature that seeks to leverage the deterrent effects of sanctioning regimes by attending to the informational signals embedded in corporate governance arrangements. Finally, although they meaningfully extend the deterrence framework, Baker and Griffith's analysis also highlights the inadequacies of a deterrence-based approach to corporate misconduct that may itself be driven by the deeply ingrained, alternative normative regime of shareholder value.

INTRODUCING INTERMEDIARIES INTO THE DETERRENCE EQUATION

At least since Gary Becker's (1968) foundational economic model, deterrence theory has focused primarily on two actors: the sanction setter and the potential object of the sanctions. The sanction setter calibrates punishment for a given transgression to a particular magnitude and implements an enforcement regime that determines the probabilities with which these punishments will be imposed. The target of a given regulatory regime calculates the expected costs of being punished,³ weighs them against the benefits of transgression, and selects the behavior that will produce the greatest net benefit (Becker 1968). Baker and Griffith expand the universe of actors relevant to this equation by demonstrating how the deterrent effects of legal sanctions are mediated through institutional actors *other than sanction setters and targets*.

To be sure, the existing deterrence literature has long recognized that there are many sources of mediating effects on the deterrence calculus. However, this literature has focused almost exclusively on how sanction setters and targets themselves mediate the objective properties of deterrence regimes. The studies in this literature fall into three broad categories. First, researchers have addressed how the deterrence signals embodied in law are filtered through the subjective perceptions of deterrence targets (Waldo and Chiricos 1972; Geerken and Gove 1975; Gibbs 1975). Many studies have shown that the deterrence calculus is distorted by cognitive biases that may cause deterrence targets to discount the possibility of being apprehended (Shover 1996; Horney and Marshall 1992; Tunnell 1992; Anderson 2002) and the severity of potential legal punishments (Zimring and Hawkins 1973; McClelland and Alpert 1985; Apospori

3. Expected costs are a function of the sanction's objective magnitude (severity), the likelihood that it will be applied (certainty), and the swiftness (celerity) with which it will be applied (Gibbs 1975).

and Alpert 1993; Anderson 2002; Kleck et al. 2005; Paternoster 2010) or to weigh the benefits of rewards more heavily than the costs of penalties (Dugan and Chenoweth 2012). Deterrence targets' perceptions are also mediated by social factors, like their understandings and expectations about how peers perceive and respond to a given sanctions regime (Gibbs 1978; Grasmick and Green 1980; Braithwaite 1989; Lott and Mustard 1997).

A second body of research demonstrates how regulatory authorities, or sanction setters, actively mediate the perceptions of regulatory targets through the design and implementation of sanctions regimes (Gunningham, Thornton, and Kagan 2005; Shimshack and Ward 2005; Kennedy 2009; Short and Toffel 2010). For instance, researchers have suggested that the New York Police Department's adoption of a "zero-tolerance" policy for minor offenses such as panhandling and fare jumping was designed not only to increase the objective probability of apprehending low-level offenders, but to "serv[e] notice that the police were vigilant about all crime" (Paternoster 2010, 791; Kelling and Coles 1996). Similarly, a study on environmental self-policing found that polluting firms in heavily inspected industries improved their compliance irrespective of their actual probability of being individually inspected (Short and Toffel 2010). Studies have also shown that regulators can enhance the perceived legitimacy and the practical efficacy of their sanctions regimes by inviting public participation in their adoption and implementation (Tyler 2006).

Finally, a related body of literature examines how the objective properties of legal deterrence regimes are mediated by the adoption and implementation practices of deterrence targets themselves. Edelman (1992), for instance, shows how firms' adoption of standards and practices in the form of internal corporate compliance policies came to shape legal understandings of what it means to comply with antidiscrimination law. Subsequent studies have demonstrated how auto manufacturers used alternative dispute resolution to redefine what it means to comply with consumer protection laws (Talesh 2009) and how schools helped construct the parameters of legal liability for peer sexual harassment (Short 2006). Edelman and Suchman (1997) discuss the range of mechanisms through which regulated entities influence the subjective and objective properties of the deterrence regimes that regulate them.

Although this literature has complicated and enriched the foundational deterrence model by examining how it is mediated by the practices and perceptions of sanction setters and targets, it has paid relatively little attention to the ways these practices and perceptions are also mediated by actors and institutions that are not the immediate subjects or objects of the sanctioning regime (but see Edelman, Abraham, and Erlanger 1992). This omission is glaring in light of the complex institutional relationships that exist in contemporary regulatory regimes and the multifarious and often prominent roles played by intermediaries like lawyers, auditors, raters, and media.

This has begun to change in the wake of recent financial crises that highlighted the pivotal role these intermediaries played in shaping the practices and perceptions of regulators and regulated entities in meeting and enforcing regulatory obligations. For instance, scholars have discussed how the Sarbanes-Oxley Act, a financial reporting law enacted in the wake of Enron's collapse, relies heavily on the regulatory role of intermediaries like lawyers and accountants to monitor and certify the compliance of their corporate clients (Bainbridge 2012).

There is also a developing body of scholarship on how financial intermediaries like credit rating agencies (CRAs) influenced the way regulators and regulated entities perceived and responded to risky financial activities leading up to the global financial crisis (Hill 2009; Partnoy 2009; Coffee 2011). Scholars have argued that CRAs helped fuel the crisis by bestowing undeserved triple-A ratings on risky financial instruments and have described how their role was amplified by the way they were embedded into the financial regulatory system (Partnoy 2009). CRAs were originally designed to assess and certify the quality of financial products on behalf of private investors, but their role shifted as regulators began to incorporate ratings into various state and federal regulatory schemes. For instance, regulators used CRA-generated ratings to create indices measuring the quality of various financial instruments and the adequacy of bank capital requirements. They then keyed to these indices a set of mandatory investment rules that forced certain investors to purchase only highly-rated bonds. These institutional arrangements constituted CRAs as *de facto* regulatory licensors (Partnoy 2009) that unlocked markets and that shaped (if not defined) perceptions among securities regulators and regulated corporations about what constituted safe and law-compliant investments.

These kinds of layered institutional arrangements complicate the deterrence story significantly. However, until now they have not been analyzed systematically from a deterrence perspective. Baker and Griffith's study not only describes the intricate relationships between D&O insurers and the companies they insure, but demonstrates how these relationships temper the potential deterrent effects of shareholder litigation. The authors also recognize that these relationships could be structured differently and that mediating institutions like insurance companies could amplify, or at least reconstitute, the deterrent effects of shareholder litigation. Their approach suggests important avenues for future research in this area.

LEVERAGING DETERRENCE THROUGH SIGNALS

Among their policy recommendations for restoring the deterrent effect of shareholder litigation, Baker and Griffith suggest a disclosure regime that would require companies to make public the key terms of their D&O insurance policies. They argue that:

Even if the cost of D&O insurance does not provide a sufficiently strong incentive to spur a corporation to optimize its governance structure, the cost and structure of a firm's D&O coverage package nevertheless encodes important information about its governance quality. Most basically, the more a corporation pays for its D&O coverage package, all other things being equal, the greater the shareholder liability risk it poses. (Baker and Griffith 2010, 203)

In other words, a company's D&O insurance premium is a signal, or a "valuable proxy for information that is not otherwise available" (Baker and Griffith 2010, 204). In economic theory, signals communicate hidden information indirectly, through actions rather than through explicit disclosure (Akerlof 1970; Daughety and Reinganum 2008).

Baker and Griffith suggest that the disclosure of D&O insurance premiums would reveal not only direct information about what those premiums are, but indirect information about the quality of corporate governance at insured corporations, since higher premiums would mean that the insurer had judged the company to be at higher risk. In jurisdictions where such disclosure is currently required, D&O insurance premiums have, in fact, been found to be a significant predictor of corporate governance quality (Core 2000).

Baker and Griffith suggest that if information about D&O premiums were more widely available, it would be incorporated into the financial analyses of fund managers, arbitrageurs, and other professional investors as a proxy for governance quality. These analyses would discount the share price of firms perceived to have poor governance practices and this increase in the cost of raising capital would prompt governance improvements at these firms.

This approach adds to an emerging body of literature that seeks to leverage the value of signals in deterrence regimes. Traditionally, deterrence theory has focused on *incentives*, or the combination of costs and benefits that will induce compliant behavior. Unfortunately, there are limits to the kinds of behavior that even well-designed incentive systems can reach. Although incentives can be valuable in shaping mutable behavior that deterrence targets can readily choose and change, they are less effective at addressing the more intractable characteristics of deterrence targets (Kirmani and Rao 2000).

So, for instance, the incentives embodied in a deterrence regime may inform corporate actors' conscious deliberations about whether to comply with a given set of legal obligations in a particular situation. However, incentives are less likely to alter (at least in the near term) a corporation's *capacity* to comply or its entrenched *will* not to. Signals can mitigate this incentive gap in regulatory regimes. From the signaling perspective, an entity's behavior is not an *object* of regulation to be molded through incentives, but an *artifact* of the entity's unobservable intentions that reveals information about the *type* of entity it is (Akerlof 1970; Spence 1974; Meyer 1979; Posner 2000). Sorting entities by type can help regulators administering deterrence regimes to target their enforcement resources at the individuals or entities that are most likely to be noncompliant (Helland 1998).

Recent studies have explored how regulators might develop more finely grained targeting heuristics to distinguish firms with the will and capacity to comply from their less willing or able counterparts. They have suggested that firms' behavior in response to a given set of choices in a deterrence regime can reveal important information about their motivation and capacity for compliance. For instance, Raskolnikov (2009) has proposed a dual-track tax penalty regime that would identify cooperative and normatively motivated taxpayers by allowing them to opt into an enforcement regime with draconian terms that would impose severe penalties for violations in a swift and certain manner. The theory is that only taxpayers with the capacity and sincere intention to comply with tax laws would opt into such a regime because they would be confident that they would never be subjected to its penalties. By contrast, taxpayers who wished to game the tax system more aggressively would remain outside the draconian regime because running afoul of it would be too costly. Similarly, Toffel and Short (2011) suggest that self-reported legal violations can help regulators identify firms that are

effectively self-regulating their environmental compliance. They argue that unlike firms' positive disclosures about their participation in voluntary environmental programs, which often amount to nothing more than green-washing, disclosures of legal violations carry a cost that firms without the will or capacity to self-regulate going forward will not be willing to bear. In both cases, actions taken by deterrence targets—selecting an enforcement regime or disclosing a legal transgression—convey information to regulators that may help them sort regulated firms by their compliance capacities and motivations.

Similarly, firms' choices about D&O insurance coverage, and insurers' choices about how to price this coverage, could provide securities regulators with information that would help them target their enforcement resources. The insurance pricing information that Baker and Griffith argue would inform financial analysts' assessment of firms' governance quality could likewise be used by regulators to identify which firms lack the governance capacity to comply with their legal obligations. Similarly, firms' choices about whether to purchase D&O insurance for the corporate entity, as well as for individual officers and directors, might communicate hidden information about a firm's confidence in its ability to comply. This latter disclosure has the added benefit of being more difficult to obscure with creative insurance packaging and pricing arrangements. Both types of disclosures have the potential to reveal information that would enhance the efficacy of existing corporate and securities law deterrence regimes by identifying which companies are more or less likely to comply. And the proposal highlights the importance more generally of attending to signaling effects in deterrence regimes.

THE SHAREHOLDER VALUE NORM AND THE LIMITS OF DETERRENCE

Even as Baker and Griffith expand the boundaries of deterrence theory, their case study illuminates its limits as applied to corporate conduct in the contemporary socio-legal context of US regulatory capitalism. Since its inception, deterrence theory has assumed a clear dichotomy between right and wrong, compliance and transgression, cooperation and defection. On one side of the deterrence equation is conformance with collectively articulated norms; on the other is the pursuit of naked self-interest. Beccaria suggested that the “motivation to commit crime was found in ubiquitous self-interest” and that these motives “had to be countered by punishments” (Paternoster 2010, 768). Bentham similarly saw human behavior as “directed by the twin goals of the attainment of pleasure and the avoidance of pain” (Paternoster 2010, 770).

The most influential contemporary deterrence paradigms retain the residue of this foundational dichotomy, pitting the collective normative aspirations of the sanctions regime against the material or hedonistic motivations of self-interested individuals. In his breakthrough work *To Punish or Persuade*, John Braithwaite struggles to reconcile warring perceptions of corporate actors as “basically good” or “essentially bad” (Braithwaite 1985, 100), but he ultimately retains the dichotomy and complicates it by suggesting that these two motivational states are situational rather than innate (Braithwaite 1985, 100). In *Responsive Regulation*, Ayres and Braithwaite seek to

develop a more complex understanding of corporate actors' multiple and often conflicting motivations for behavior, but they nonetheless continue to characterize these motivations as falling into the two dichotomous categories: law-compliant behavior is driven by "a higher calling" (Ayres and Braithwaite 1992, 24) or a concern "to do what is right" (Ayres and Braithwaite 1992, 22) and noncompliant behavior is driven by "baser motivation" (Ayres and Braithwaite 1992, 25) like "economic interest" (Ayres and Braithwaite 1992, 24). In economic models of deterrence, the choice of whether to comply or not (Becker 1968), to cooperate or defect (Scholz 1984), is likewise binary.

This stark dichotomy between normatively-driven compliance and calculatively-driven noncompliance fails to capture an important category of behavior: namely, behavior that is subject to more than one norm. Corporate financial conduct (not unlike many other kinds of conduct) is subject to multiple and potentially conflicting normative systems (Boltanski and Thevenot 2006). Two are relevant to this discussion. One set of norms is embodied in the federal securities laws, which broadly prohibit fraudulent conduct like misstatements and misrepresentations in connection with the purchase or sale of securities (Securities Exchange Act of 1934). The norms embodied in this legal regime include honesty, fair dealing, and investor protection. Shareholder litigation is one important mechanism for enforcing compliance with them.

A second normative system governing behavior in the contemporary corporation is the maximization of shareholder value, narrowly conceived as wealth and often operationalized as short-term, quarter-to-quarter gains. Although the precise contours and normative desirability of the shareholder value norm are fiercely contested, it has all the hallmarks of a robust normative system. First, the shareholder value norm has been articulated not merely as a management or financial accounting philosophy, but in explicitly normative (if not overtly moral) terms. Corporate managers are said to have a normative obligation, or a "responsibility" to increase the wealth of shareholders (Rappaport 1986, 1; Friedman 1970). Shareholder value maximization is also said to be normatively desirable for the economy's overall performance and for social welfare. It has been widely argued that "when the corporate enterprise maximizes shareholder value, everyone—workers, consumers, suppliers and distributors—will, as a result, be better off" (Lazonick and O'Sullivan 2000, 27; Easterbrook and Fischel 1991). Based on these premises, there has been a "rapid convergence on the standard shareholder-oriented model as a *normative* view of corporate structure and governance" (Hansmann and Kraakman 2001, 443, emphasis added).

Second, some version of the shareholder value norm is widely shared not only among powerful corporate actors, but also among retail investors. Julia Ott (2009, 2011) describes how the concerted efforts of the New York Stock Exchange made the United States into a "mass investment society" in which the majority of US households own financial securities (Ott 2011, 222) and she demonstrates how citizens' experience of stock ownership transformed their political consciousness into one that is broadly supportive of the shareholder value norm. Before mass stock ownership, stock trading was viewed by the public with suspicion and reproach: "Bonds, stocks, and the malefactors that traded them seemed to subvert the work ethic and to divert capital from productive, entrepreneurial pursuits" (Ott 2009, 48). However, as the investing class expanded, "citizen shareholders" began to see their interests as aligned with those of the

stock and bond traders and began to see securities markets not as illicit gambling dens, but as essential to the maintenance of foundational values like “liberty, democracy, and individualism” (Ott 2009, 69).

Ott argues that before mass stock ownership, US debates about corporate accountability focused on “corporations’ proper relationship to consumers, employees, competitors, and local communities” (Ott 2011, 131–32). By contrast, as more and more citizens became shareholders, corporate accountability was discussed almost exclusively in terms of management’s responsibilities to shareholders (Ott 2011, 132). By the late twentieth century, shareholders themselves, management theorists, and “even economic reformers conceded shareholder value as the benchmark for managerial performance” (Ott 2011, 223).

Third, the norm of shareholder value is not merely informal, but is embedded in US corporate law (Bainbridge 1992; Mitchell 1993). To be sure, corporate law doctrine encompasses other norms, most prominently contract and business judgment, that are often in tension with shareholder value maximization orthodoxy and that allow corporate actors some amount of flexibility to consider nonshareholder-related interests of the corporation.⁴ Nonetheless, shareholder value provides a foundational decisional norm in corporate law. *Dodge v. Ford Motor Co.* is often cited for its early articulation of this norm and is widely taught in law schools (Stout 2008). In that case, the Michigan Supreme Court invoked the shareholder value norm to prevent Henry Ford from curtailing special dividends for shareholders in order to invest Ford’s large capital surplus in new plants, increased production, expanded employment, and price reductions for consumers. The court explained:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

Although there is an active debate about the importance of shareholder value relative to other corporate law norms (Stout 2008, 2012), it continues to animate decisions to the present day. For instance, the Delaware Chancery Court recently invalidated a defensive voting rights plan that was adopted by the board of the online classified ad forum, craigslist, to protect itself from the possibility of a hostile takeover by its powerful minority shareholder, eBay. Craigslist claimed that it adopted the rights plan to preserve the company’s corporate culture, which it characterized as a commitment to providing nonmonetized classified services to people across local, national, and global communities. The court said that craigslist could not adopt defensive measures to preserve its culture if that culture was not cultivated toward the end of producing value for shareholders.

4. The business judgment rule, for instance, insulates directors from liability in the vast majority of cases, even where they have acted without regard to shareholder wealth maximization, giving directors some freedom to consider the interests of other stakeholders (Bainbridge 1992).

Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The “Inc.” after the company name has to mean at least that. Thus, I cannot accept as valid for the purposes of implementing the Rights Plan a corporate policy that specifically, clearly, and admittedly seeks *not* to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders. (*eBay v. Newmark* 2010, 60–61)

The court enforced the norm of shareholder value even though eBay had invested in craigslist with knowledge of that company’s commitment to free online community service and had explicitly professed its support for these values in negotiating its relationship with craigslist.

Fourth, apart from corporate law, there is a robust informal enforcement regime that effectively promotes compliance with a market-driven, short-term version of the shareholder value norm (Dallas 2011). Not only has the investor class expanded, as described above, but it has become largely consolidated in large institutions like pension funds and mutual funds, which control around 70 percent of the publicly traded shares in the United States (Strine 2010, 10). This gives institutional investors tremendous leverage to enforce their perceived interests. As it turns out, the agenda of institutional shareholders “has not involved a keen focus on the avoidance of excessive risk, the avoidance of firm failure, and an emphasis on long-term growth. It has been on increasing stock prices as fast and as much as possible, even if that requires financial gimmickry and risk” (Strine 2010, 17). Institutional investors, as well as arbitrageurs and hedge fund managers that share this agenda, have used their massive market power, as well as the market for corporate control, to discipline corporate management that fails to pursue short-term share price maximization strategies. The effect of these enforcement mechanisms is to raise the cost of capital for nonconforming corporations and to eject nonconforming managers from their positions.⁵ The result is a brutally effective deterrence regime that imposes swift, certain, and significant costs on corporations and managers that violate the shareholder value norm, at least as it is conceived by these powerful shareholders.

Finally, shareholder value is normative in the sense that it “is central to management’s socialization” (Bainbridge 1992, 1441), defining a social role, or identity, for corporate actors that fundamentally shapes and constrains their conceptions of appropriate behavior and the meanings they attribute to their actions. “[P]eople’s conception of appropriate action and even of their ‘interest’ is very much a function of the particular social role in which they find themselves” (Sunstein 1996, 911–12). Many leading corporate law scholars and advocates have suggested that management pursued the high-risk/high-return strategies that fueled the global financial crisis, at least in part,

5. In fact, a similar dynamic appears to be disciplining insurers’ behavior with respect to their corporate clients. Baker and Griffith suggest that the primary reason insurers do not pass through deterrence signals to their insureds in the form of more active risk management practices is that corporate clients do not want these services from their insurers and will purchase their coverage from insurers who do not force clients to accept them. Insurers are, in other words, making their own bottom-line calculations that they stand to lose more in premiums than they stand to gain with better risk management.

because they saw their role as serving the interests of shareholders who validated these strategies (Lipton, Lorsch, and Mirvis 2009; Bratton and Wachter 2010). Martin Lipton, a leading corporate lawyer, has suggested that managers' actions leading up to the financial crisis were shaped and constrained by shareholders who "pushed companies to generate returns at levels that were not sustainable" (Lipton, Lorsch, and Mirvis 2009). Leo E. Strine, a prominent member of the Delaware Court of Chancery, argues that it is difficult for corporate managers to avoid excessive risk taking in the face of shareholder expectations: "why should we expect corporations to chart a sound long-term course of economic growth, if the so-called investors who determine the fate of their managers do not themselves act or think with the long term in mind?" (Strine 2010, 1–2). The American Bar Association has suggested that the short-term focus of the most powerful shareholders may literally "impede the capacity of the corporation" to make "long-term investments and decisions necessary for sustainable wealth creation" (American Bar Association 2009).

Of course, the shareholder value norm is very much entwined with material self-interest, both in its theoretical genealogy and in the institutional arrangements of the modern corporation. It is based on neoclassical economic theories of efficiency and welfare maximization that are, themselves, grounded in the pursuit of rational, individual self-interest. And, as a practical matter, compensation arrangements at many companies give corporate managers a "personal interest in boosting the market value of their companies' stock" (Lazonick and O'Sullivan 2000, 25). But the presence of individual or material interests hardly disqualifies a system of beliefs as normative. Shareholder value, like other normative frameworks, purports to provide a vision of the "substantive 'good'" toward which corporations and their agents should strive (Mitchell 1993, 1481; McCall 2011). It forms a key part of what has been characterized as a broader "business morality" that often stands in tension with "the morals applicable outside the marketplace" (Mitchell 1993, 1484). Even if there are cogent moral objections to be made to the norms embodied in shareholder value maximization, it is dangerous to dismiss them as non-normative.

My contention in this essay is that the challenge for securities law deterrence regimes runs much deeper than the distortionary insurance arrangements identified by Baker and Griffith. Even if the incentives created by D&O insurance are realigned in accordance with Baker and Griffith's suggestions, securities law deterrence regimes are potentially undermined by shareholder value norms that exert a powerful, independent influence on the behavior of corporate actors. The shareholder value norm, at least as it has been articulated and enforced by the most powerful shareholders, is in tension with, and sometimes in outright conflict with, the norms embodied in securities law deterrence regimes. Of course, these two sets of norms are designed to, and often do, reinforce one another. Antifraud statutes are designed to protect the investments of shareholders by ensuring that they are based on the true value of the corporation, not on the chicanery of its executives, and in many (perhaps most) contexts, these two sets of norms pull in the same direction. Under these circumstances, there will be few violations of law and those that occur will be of the type traditionally addressed by deterrence regimes: bad actors transgressing collectively articulated norms for personal gain. However, there are also numerous situations in which the two normative regimes are in tension with one another. For instance, a corporate executive's decision to inflate

an earnings report to meet quarterly projections will often be driven by a normative sense of obligation to produce gains for shareholders (Dallas 2002), as opposed to (or in addition to) any material calculation to transgress antifraud norms for personal gain.

The decision to abide by one set of norms instead of another is qualitatively different than the decision to transgress a unitary set of norms in favor of “baser motivation” like material self-interest. If some significant subset of securities law violations are motivated, at least in part, by what I have characterized here as the normative considerations of shareholder value, then it is necessary to develop an enforcement strategy that goes beyond simple deterrence to address these conflicting norms. Although the development of such a strategy is beyond the scope of this essay, I conclude with a brief survey of the literature on the use of law to change social norms and explore the challenges and possibilities of viewing corporate and securities law as a “norm change” project rather than a straightforward deterrence project.

Norm change regulation recognizes that noncompliant behavior often results not from a decision to deviate from a unitary set of norms based on a calculation of costs and benefits of deviation, but from a decision to obey one set of norms rather than another. This kind of normative multiplicity in motivations presents at least three distinct sets of challenges for the deterrence framework. First, the existence of conflicting norms makes it difficult, even for actors with the purest of motivations, to comply with all their social and legal obligations, or “to figure out what the ‘right’ action is” (Babcock 2009, 956). This “noise” about appropriate behavior significantly complicates what is already a fraught path from sanction to deterrence.

Second, decisions made on the terrain of what is “right” or “appropriate” in a given situation are less susceptible to molding through the incentives of deterrence regimes (Bernstein and Cashore 2007). Normatively motivated decisions are often characterized precisely by their disregard of the material costs and benefits of the action. For instance, the motivation for dueling among elite gentlemen in the antebellum US South has been characterized as a readiness to seek honor-based vengeance “without regard to the balance of costs and benefits” (Posner and Rasmusen 1999, 382). Even the most exquisitely designed and implemented deterrence regime cannot reach behavior that eschews cost-benefit calculation (Posner and Rasmusen 1999, 382).

Finally, the imposition of sanctions for violating one set of norms might actually serve to reinforce the competing set of norms motivating the behavior. For instance, a southern gentleman’s willingness to suffer legal penalties for dueling to defend his honor may have had the perverse effect of *enhancing* his social status and reputational rewards (Posner and Rasmusen 1999). Dan Kahan describes a similar dynamic afflicting antigun programs in inner-city public schools. He describes how, among certain social groups, “[p]ossessing a gun confers status because it expresses confidence and a willingness to defy authority” (Kahan 1997, 363). In such a social context, deterrence policies usually fail because “when authorities aggressively seek out and punish students who possess weapons, their behavior reinforces the message of defiance associated with guns” (Kahan 1997, 364). In both cases, not only do sanctions have no deterrent effect, but they also serve to amplify the social status of the undesirable behavior conferred by the competing norm.

In sum, when an entrenched norm is motivating behavior, simple deterrence is not enough to change the behavior and may actually be counterproductive. Instead,

regulators who wish to alter such behavior must change the social meanings associated with the behavior (Lessig 1995; Sunstein 1996; Vandenberg 2004). “If, for example, smokers seem like pitiful dupes rather than exciting daredevils, the incidence of smoking will go down. If people who fail to recycle are seen as oddballs, more people will recycle” (Sunstein 1996, 911). The norm change literature contains numerous examples of regulatory interventions that have changed the social meanings of normatively motivated behaviors. For instance, regulatory interventions that barred southern gentlemen from public office for dueling tended to be more effective than those that imposed fines or jail time because these men saw the public office bar as *compromising* rather than *enhancing* their honor (Lessig 1995). Restrictions on smoking in public places changed peoples’ habits and experiences in ways that reinforced messages about the dangers of smoking to nonsmokers and transformed social meanings about the social status of smoking (Lessig 1995). It was seen as less glamorous to stand outside smoking in the rain than to do so sitting at dinner, sipping cognac. Regulatory interventions aimed at reducing the spread of AIDS through risky sexual behaviors began to succeed only when they addressed the deep normative roots of these behaviors and their role in constituting gay male identities.⁶ They did so by enlisting participants in risky sexual subcultures as “norm entrepreneurs” to educate and persuade their peers on the normative value of safer sex practices in ways that reinforced rather than undermined these identities (Lessig 1995).

These kinds of norm change interventions rely on a constellation of techniques that includes education and persuasion (especially by peers or insiders); time, place, and manner restrictions on the normatively motivated behavior; and the expression of alternative norms through law (Lessig 1995; Sunstein 1996; Babcock 2009; Feldman 2011). It is worth thinking about whether and how norm change strategies might be adapted to engage the shareholder value norm and change the social meaning of the corporate conduct it motivates.⁷ Prominent corporate law scholars have described the community of corporate actors as one that is norm driven: “surprisingly small and close-knit” (Rock 1997, 1013), deeply concerned about reputation (Skeel 2001), and responsive to the “sermonizing” of Delaware Chancery Court judges, who “preach” about appropriate behavior for corporate managers and directors (Rock 1997, 1016; Fairfax 2005). These characteristics suggest that there are real opportunities to engage, clarify, and, if necessary, revise the norms that govern the community.

Some Chancery Court judges as well as prominent academics and corporate law insiders have, indeed, preached about the evils of short-term shareholder value, arguing that it actually *undermines* the interests of most shareholders. Chancellor Strine, for instance, has admonished that the focus of institutional investors “on quarterly earnings and other short-term metrics is fundamentally inconsistent with the objectives of most of their end-user investors, people saving primarily for two purposes, to put their kids through college and to fund their own retirements” (Strine 2010, 12). Stout (2012)

6. See Bersani (1987) on the normative content of promiscuity in certain communities of gay men.

7. The corporate law literature already recognizes the central importance of norms in shaping the behavior of corporate actors (Rock and Wachter 2001). However, this recognition has most commonly been invoked to suggest that norms facilitate private ordering within and among corporate actors, rendering legal interventions ineffectual or unnecessary (Black 2001; Blair and Stout 2001; Milhaupt 2001; Rock and Wachter 2001) rather than to explore how these norms might be changed by law.

cautions that the idea of “shareholder value” is dangerously misleading because companies that espouse this norm as the lodestar governing their decisions tend to do more harm than good for their investors. Bratton (2002) has argued that Enron’s relentless focus on short-term share price gains caused it to misjudge the economics of transactions that led to the firm’s collapse, causing devastating losses for its investors.

There is some evidence that alternative normative visions are influencing corporate boardrooms. Fairfax (2005), for instance, documents how pervasive sermonizing about the alternative norm of “stakeholder value,” or the view that corporations have responsibilities to a broader range of stakeholders beyond shareholders, has shaped the way that corporate actors *talk* about their obligations. But it is far from clear that this kind of sermonizing has changed the actions, motivations, fundamental understandings, or normative orientations of the broader corporate community. Further research is necessary to determine precisely how shareholder value norms influence corporate behavior, what exactly those norms mean to corporate actors, and what kind of influence competing normative visions have.

In the meantime, the norm change perspective on financial regulation responds to Baker and Griffith’s concern that shareholder litigation has no justification if it fails to deter. Even if shareholder suits fail to prevent the targeted conduct in the near term, they offer opportunities to express alternative norms through law. Deterrence regimes and the standards of behavior they articulate can educate people about what type of behavior is socially and morally appropriate and potentially change “people’s moral evaluation of an act” (Feldman 2011, 21; Sunstein 1996). These messages should be particularly powerful coming from shareholders themselves.

CONCLUSION

Deterrence theory has only begun to incorporate insights about norm conflicts (e.g., Gezelius 2002; Parker 2006; Etienne 2011; Nielsen and Parker 2012) and has yet to do so in any sustained or systematic way. This omission may spring not only from the theory’s grounding in the tension between collective norms and individual self-interest, discussed above, but also from a broader disinclination on the part of many social scientists to characterize market behavior as normative (rather than self-interested). Although there may be sound disciplinary or political reasons for declining to characterize market behavior as normative, the failure to do so seriously undermines the possibility of regulating it. Addressing the kinds of behaviors that securities laws seek to deter entails not only individual behavior adjustment through the proper calibration of incentives, but also a collective reassessment of the broadly accepted shareholder value norms that support these individual behaviors. Until that happens, corporate misconduct will be ensured.

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