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## It's Deja Vu All over Again: Using Bounty Hunters to Leverage Gatekeeper Duties


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# "IT'S DÉJÀ VU ALL OVER AGAIN"* USING BOUNTY HUNTERS TO LEVERAGE GATEKEEPER DUTIES

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* Yogi Berra, *The Yogi Book* 30 (Workman Publg. 1998) ("My comment after Mickey Mantle and Roger Maris hit back-to-back home runs for the umpteenth time.").

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## I. INTRODUCTION

*"[C]orporate fraud is sort of like grass, it grows, it gets cut down, and it grows again. Corporate fraud has been with us forever; corporate fraud will be with us forever."*

–Kurt Eichenwald[1]

Imagine that. Another financial/corporate scandal/crisis. But which of the current "scandals" or "crises" are we talking about? There are, after all, so many. They include the implosion of the American auto industry, the various Ponzi schemes that have recently come to light,[2] the insider trading ring revolving around hedge fund Galleon Group,[3] incomprehensible derivatives and securities, and the banking and subprime crisis.

I am sympathetic to the many employees and shareholders who are feeling pain as a consequence of recent events. However, I am skeptical of the federal government's ability to provide a grand fix that will prevent the types of events that have caused this pain in spite of the many scholars and legislators offering blueprints to do this. In this article, I will attempt to put the current situation into an historical context, discuss briefly how some prior crises and scandals have led to new legislation (including federal laws and rules intruding into the traditional role of states in providing the rules of corporation law) and, finally, suggest two ideas worthy of consideration as ways to fairly assign the responsibility for securities fraud and promote the uncovering and mitigation of future corporate and financial misdeeds.

## II. PRELUDE: WE'VE SEEN IT ALL BEFORE

*"What has been will be again, what has been done will be done again; there is nothing new on Earth."*

–Ecclesiastes 1:9[4]

One of the notable points about the current financial crisis and this set of corporate scandals is that there isn't much that is actually new. We've seen it all before; maybe on a smaller scale, but still qualitatively the same. A few of the many prior acts[5] in this theater include:

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1. Kurt Eichenwald, *The Last Two Years: The Momentous Changes in Corporate America*, 45 S. Tex. L. Rev. 245, 246 (2003).

2. These include not only the infamous Madoff Ponzi scheme, but also a number of other Ponzi schemes that have come to light including: (i) the Stanford Financial Group, an alleged $8 billion fraud involving certificates of deposit; and ii) the alleged $1.2 billion Ponzi scheme by Scott Rothstein, a Florida lawyer who has pled guilty to selling stakes in fictitious settlements of employment cases. *See* Evan Perez & Kara Scannell, *Top Stanford Official is Arrested in Probe*, 253 Wall St. J. C2 (Mar. 1, 2009); Nathan Koppel, *Rothstein Charged in Ponzi Scheme*, 254 Wall St. J. B3 (Dec. 2, 2009).

3. Twenty-two persons were arrested in connection with this alleged insider trading ring. So far, ten have pled guilty. Associated Press, *10th Guilty Plea in Galleon Insider Trading Case*, http://abcnews.go.com/Business/wireStory?id=9999577 (March 3, 2010).

4. Ecclesiastes 1:9 (New Intl.).

5. Professor Lawrence Cunningham, in looking at the Enron situation, also notes the existence of many other large corporate and financial scandals. *See* Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 Bus. Law. 1421, 1423–1428 (2002).

- The bankruptcy of Penn Central in 1970. At the time, this was the largest bankruptcy in United States history;[6]
- The closing of the Studebaker auto production facilities in South Bend, Indiana;[7]
- The improper payments by American corporations in the 1970s;[8]
- The excesses of the leveraged buyout era of the 1980s,[9] including a number of bankruptcies of companies that took on too much debt (for example, Federated Department Stores[10] and Revco Drug Stores);[11]
- Drexel Burnham Lambert, which at one time was the fifth largest investment bank in the country. However, the company ended up in Chapter 11 bankruptcy proceedings in 1990, not too long after pleading no contest to six felonies and agreeing to pay a $650 million fine under the federal securities laws;[12]
- The many insider-trading cases that have emerged over the years, including Ivan Boesky,[13] Michael Milken,[14] and Sam Waksal;[15]
- The savings and loan crisis of the late 1980s and early 1990s, which involved the failure (closing or resolution) of 1,043institutions holding $519 billion in assets,[16] including some spectacular failures such as Lincoln Savings and Loan in 1989;
- Salomon Brothers, which was fined $290 million in 1992 because one of its

6. Daniel J. Schwartz, *Penn Central: A Case Study of Outside Director Responsibility Under the Federal Securities Laws*, 45 UMKC. L. Rev. 394, 395 (1977); *see generally* Joseph R. Daughen & Peter Binzen, *The Wreck of the Penn Central* (Beard Books 1999).

7. *See* James A. Wooten, *"The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA*, 49 Buff. L. Rev. 683 (2001) (an account of the shutdown of the South Bend plant and its role in the passage of ERISA a number of years later).

8. *See infra* nn. 71 et seq.

9. *See generally* Daniel J. Morrissey, *Safeguarding the Public Interest in Leveraged Buyouts*, 69 Or. L. Rev. 47 (1990) (discussing the LBO phenomenon and issue of whether LBO's serve the public interest).

10. Stuart Silverstein, *Two Campeau Chains File for Bankruptcy*, http://articles.latimes.com/1990-01-16/news/mn-254_1_robert-campeau (Jan. 16, 1990). Campeau Corporation bought Federated Department Stores for $6.6 billion in a leveraged buyout in 1988 using junk bonds. Federated filed for bankruptcy in 1990. *Id.*

11. Janice Castro, Thomas McCarroll & Frederick Ungeheuer, *Special Report: Big-Time Buyouts*, http://www.time.com/time/magazine/article/0,9171,968871-5,00.html (Nov. 7, 1988). Revco "defaulted on $700 million worth of bonds and went into bankruptcy proceedings just 19 months after going private in a leveraged buyout." *Id.*

12. Mary Cronin, Thomas McCarroll & William McWhirter, *Predator's Fall: Drexel Burnham Lambert*, 135 TIME 46, 46–52 (Feb. 26 1990) (available at http://www.time.com/time/magazine/article/0,9171,969468-1,00.html).

13. Boesky agreed to pay $100 million to settle an SEC enforcement action against him. *See SEC v. Boesky*, 1986 WL 15283 (S.D.N.Y. Nov. 14, 1986).

14. Kurt Eichenwald, *Milken Set to Pay a $600 Million fine in Wall St. Fraud*, http://www.nytimes.com/1990/04/21/business/milken-set-to-pay-a-600-million-fine-in-wall-st-fraud.html (Apr. 21, 1990). Milken pled guilty to six criminal charges and agreed to pay $600 million in fines. *Id.*

15. Waksal tried to trade on non-public information that an application for approval of his company's cancer drug would be rejected. Matthew Herper, *Sam Waksal Sentenced*, http://www.forbes.com/2003/06/10/cx_mh_0610waksal.html (June 10, 2003). His case is probably best known because of his connection with Martha Stewart. *See* Brooke A. Masters & William Branigin, *Stewart Guilty on All Charges*, 127 Wash. Post A1 (Mar. 6, 2004).

16. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, FDIC Banking Rev. 26 (Dec. 2000) (available at http://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf).

traders submitted false bids for Treasury bonds in an effort to purchase more than the amount that was permissible for one buyer;[17]

- Pfizer Inc. and its subsidiary, Tenet Healthcare Corporation,[18] and numerous other companies that have paid billions of dollars as a result of False Claims Act proceedings;[19]
- Cendant, formed through the merger of CUC International and HFS, Inc., which discovered in 1997 that former executives of CUC had created $500 million in fake revenue;[20]
- Waste Management, which paid $457 million to settle a shareholder suit after an accounting scandal involving $1.7 billion in inflated profits, came to light in 1998;[21]
- Adelphia Communications, whose founder and his son allegedly looted the company of $100 million and hid $2.3 billion in debt;[22]
- Tyco, whose CEO L. Dennis Kozlowski and CFO Mark Swartz were indicted (in 2002) and convicted in 2005 of stealing more than $150 million from the company;[23]
- The bursting of the Dot-Com bubble around the year 2000, which took down a number of corporations including WorldCom, surpassing Enron as the largest corporate bankruptcy in 2003;[24]
- Refco, Inc., which went into bankruptcy in 2005 after it was discovered that it owed $430 million to an entity owned by its CEO Phillip Bennet;[25] and
- The revelations of stock option backdating by over 140 U.S. companies, resulting in the firings or resignations of over 70 corporate officials.[26]

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17. *Salomon's Fine*, 139 Time 26 (June 1, 1992) (available at http://www.time.com/time/magazine/article/0,9171,975631,00.html); *see generally* Martin Mayer, *Nightmare on Wall Street: Salomon Brothers and the Corruption of Wall Street* (Simon & Schuster 1993).

18. U.S. Dept. of Justice, *Tenet Healthcare Corporation to Pay U.S. More Than $900 Million to Resolve False Claims Act Allegations*, http://www.justice.gov/opa/pr/2006/ June/06_civ_406.html (June 29, 2006).

19. U.S. Dept. of Health & Human Services, *Justice Department Announces Largest Health Care Fraud Settlement in its History*, http://www.hhs.gov/news/press/ 2009pres/09/20090902a.html (Sept. 2, 2009) (announcing $2.3 billion settlement to settle criminal and civil liability).

20. CNNMoney, *Cendant Closes Fraud Case*, http://money.cnn.com/1998/08/27/companies/cendant_folo/ (Aug. 27, 1998).

21. CNNMoney, *Waste Management Settles*, http://money.cnn.com/2001/11/07/news/waste_mgt/index.htm (Nov. 7, 2001); SEC, *Waste Management Founder, Five Other Former Top Officers Sued for Massive Fraud*, http://www.sec.gov/news/headlines/wastemgmt6.htm (Mar. 26, 2002) (SEC announcement that it was filing suit against the founder and five other top officers of Waste Management for allegedly perpetrating a massive financial fraud).

22. Brooke A. Masters & Ben White, *Adelphia Founder, Son Convicted of Fraud*, 127 Wash. Post E1 (July 9, 2004).

23. *See Timeline of the Tyco International Scandal*, http://www.usatoday.com/money/industries/manufacturing/2005-06-17-tyco-timeline_x.htm (June 17, 2005).

24. Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overiew; WorldCom Files for Bankruptcy; Largest U.S. Case*, http://www.nytimes.com/2002/ 07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html (July 22, 2002).

25. Chad Bray, *Refco Ex-Ceo Gets 16-Year Sentence*, 252 Wall St. J. B3 (July 5, 2008).

26. Mark Maremont, Charles Forelle & James Bandler, *Companies Say Backdating Used in Days After 9/11*, 249 Wall St. J. A1 (Mar. 7, 2007); *see generally* SEC, *Spotlight on Stock Options Backdating*, http://www.sec.gov/spotlight/optionsbackdating.htm (last updated Mar. 29, 2010) (providing links to SEC Litigation Releases relating to options backdating). Unfortunately, a number of ex-corporate general counsels have been the subject of enforcement action based upon alleged options backdating. These include the ex-

In addition, this drama is not solely an American phenomenon. A large number of foreign companies suffered their own scandals or failures. These include, among many others:

- Barings PLC, the oldest British merchant bank, which was sold to AIG in 1985 for £1[27] after losing more than £827 million as a result of speculative trading by a "rogue trader";[28]
- Bank of Credit & Commerce International,[29] founded by a Pakistani financier and registered in Luxembourg. At one time, it was the seventh largest private bank in the world.[30] This extremely corrupt organization was involuntarily liquidated in 1991;[31]
- Royal Ahold NV, a Dutch company, which paid $1.1 billion to settle a securities fraud class action alleging accounting fraud at its U.S. Foodservice, Inc. subsidiary;[32]
- Parmalat, often thought of as Europe's Enron;[33]
- Austrian bank Bawag P.S.K., which lost about €1.7 billion in risky deals and a number of whose officers were convicted in Austria of helping Phillip Bennett conceal the true financial condition of Refco, Inc.;[34]
- Société Générale, a French bank that lost €4.9 billion in 2008 as a result of €50 billion worth of unauthorized trades and future positions by a rogue trader;[35]
- Satyam Computer Services, an Indian corporation whose former chairman confessed in November of 2009 to participation in a fraudulent accounting and embezzlement scheme in which possibly $2.5 billion was skimmed from the company;[36] and

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general counsels of Comverse Technology, Monster Worldwide, and McAfee. *Id.*

27. Jon Ashworth, *Going, Going, Gone: How We Sold Barings For £1*, The Times (London) 48 (Feb. 21, 2005).

28. *See* Erik Ipsen, *Barings Managers Share Blame for Collapse, Britain Says*, 144 N.Y. Times D2 (July 19, 1995).

29. Some referred to the bank as the "Bank of Crooks and Criminals International." James Bates, *BCCI: Behind the Bank Scandal*, http://articles.latimes.com/1991-07-30/news/wr-177_1_independence-bank (July 30, 1991).

30. Janice Castro & Elaine Shannon, *The Cash Cleaners*, http://www.time.com/time/magazine/article/0,9171,968767-1,00.html (Oct. 24, 1988).

31. Sara Fritz & James Bates, *BCCI Case May Be History's Biggest Bank Fraud Scandal Finance: Losses from seized institution may reach $15 billion. Some Third World central banks could collapse*, http://articles.latimes.com/1991-07-11/news/mn-2869_1_independence-bank (July 11, 1991); *see also* Jonathan Beaty, S.C. Gwynne, Cathy Booth, Jay Branegan & Helen Gibson, *B.B.C.I.: The Dirtiest Bank of All*, 138 Time 42, 42–47 (July 29, 1991) (available at http://www.time.com/time/ magazine/article/0,9171,973481-1,00.html).

32. Dean Starkman, *Ahold Settles Lawsuit for $1.1 Billion*, 128 Wash. Post D3 (Nov. 29, 2005). A number of former suppliers and executives of U.S. Food Service pled guilty to criminal charges related to a scheme to inflate corporate earnings. *Id.*; *see also* Ian Bickertonin, *Ahold Settles U.S. Lawsuit for $1.1 Billion*, http://www.ft.com/cms/s/0/f696082a-607c-11da-a3a6-0000779e2340.html?nclick_check=1 (Nov. 29, 2005). Some suggested that Royal Ahold might be Europe's Enron. Karen Lowry Miller & Frisco Endt, *The Enron of Europe?* 141 Newsweek 41 (Atl. Ed., Mar. 10, 2003).

33. *See generally* Claudio Storelli, *Corporate Governance Failures—Is Parmalat Europe's Enron?* 2005 Colum. Bus. L. Rev. 765 (2005).

34. Boris Groendahl, *Austria Court Convicts Bankers Over Heavy BAWAG Losses*, http://uk.reuters.com/article/idUKL0452523200807047?feedType=RSS&feedName=worldNews (July 4, 2008).

35. David Gauthier-Villars, Carrick Mollenkamp & Alistair MacDonald, *French Bank Rocked by Rogue Trader*, 251 Wall St. J. A1 (Jan. 28, 2008).

36. Nandini Lakshman, *Satyam Computer Fraud Grows to $2.5 Billion*, http://www.time.com/time/

- Siemens AG, a German company, which paid over $1 billion in bribes to obtain contracts.[37]

The current subprime mortgage crisis and credit crunch have not been solely American problems. It has, for example, affected a number of foreign financial institutions. These include Northern Rock Bank, which was effectively taken over by the British government in 2008,[38] Bradford & Bingley plc, which was also taken over by the British Government,[39] and Fortis NV, which was taken over by the Dutch Government at a cost of $23.2 billion.[40]

*Enough already!*[41]

## III. CORPORATE LAW: PRODUCED IN FIFTY LABORATORIES

*"Each state retains its sovereignty, freedom, and independence, and every power, jurisdiction, and right, which is not by this Confederation expressly delegated to the United States, in Congress assembled."*

–Articles of Confederation[42]

Corporation law historically has been a matter of state law. Most corporations are formed under state law and are, for the most part, governed by state law. For several decades there have been vigorous differences of opinion and debate over the desirability of state primacy in matters of corporate law. Some have argued that this has led to a "race to the bottom" in which no state is able to impose meaningful limits on corporate (mis)behavior;[43] a corporation always has forty-nine options to avoid a particular state's

business/article/0,8599,1943185,00.html (Nov. 27, 2009).

37. David Crawford & Mike Esterl, *Siemens Pays Record Fine in Probe*, 252 Wall St. J. B2 (Dec. 16, 2008). Siemens paid $800 million in penalties to settle Foreign Corrupt Practices Act claims by the U.S. Justice Department and the SEC, $528 million to settle criminal claims in Germany, and a €201 million fine imposed by a court in Munich. *Id.* In addition, Siemens agreed to pay over $100 million to the World Bank to settle bribery claims. Vanessa Fuhrmans, *Siemens Settles With World Bank on Bribes*, 253 Wall St. J. B1 (July 3, 2009). The SEC alleged that Siemens made at least 4,282 payments of approximately $1.4 billion to bribe government officials. SEC, *SEC Files Settled Foreign Corrupt Practices Act Charges Against Siemens AG for Engaging in Worldwide Bribery With Total Disgorgement and Criminal Fines of Over $1.6 Billion*, http://www.sec.gov/ litigation/litreleases/2008/lr20829.htm (Dec. 15, 2008).

38. Francis Elliott, *Northern Rock Takeover Brings Back Nationalisation*, The Times (London) 1 (Feb. 18, 2008) (available at http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/ article3386895.ece). At the time of its takeover, Northern Rock owed the British government £25 billion. The takeover added "a £90 billion liability to the Government's balance sheet." *Id.*

39. Emily Flynn Vencat, *UK Government Nationalizes Bradford & Bingley*, http://www.usatoday.com/ money/economy/2008-09-28-2318700586_x.htm (Sept. 29, 2008).

40. Toby Sterling, *Dutch to Bail Out Fortis Operations*, http://www.washingtontimes.com/news/2008/oct/ 04/dutch-to-bail-out-fortis-operations/ (Oct. 4, 2008).

41. Title of a book by Peter Walsh (Free Press 2009) on de-cluttering one's life. I hope not to have cluttered up the reader's mind with trivia.

42. Arts. of Confederation art. II (available at http://avalon.law.yale.edu/18th_century/artconf.asp#art1). Okay, I know: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X. Isn't the thought the same?

43. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L. J. 663 (1974). This leading article decries "the present predicament in which a pygmy [Delaware] among the 50 states prescribes, interprets, and indeed denigrates corporate policy . . . ." *Id.* at 701. Cary's solution was to propose a Federal Corporate Uniformity Act, which would allow corporations to incorporate "in the jurisdiction of their choosing but to remove much of the incentive to organize in Delaware or its rival states" by imposing specified federal standards on larger corporations. *Id.* at 701–703.

attempted regulation.[44] Others have argued that it has allowed for fifty little corporate law laboratories and that the good corporate law generated in some of the labs has won out over the bad corporate law produced in other labs.[45] Consequently, they contend that there has been a race to the top rather than to the bottom.[46] I cannot resolve this debate and, frankly, don't want to; it makes for too good a discussion in my Corporate Law courses.[47]

Over the years, the Supreme Court has recognized that there are areas traditionally regulated by state corporate law and it has shown some reluctance to federalize the law in these areas. For example, in *Santa Fe Industries, Inc. v. Green*,[48] the Court considered whether § 10(b) of the Securities Exchange Act of 1934 extended to transactions that are neither deceptive nor manipulative. The Court held some element of deception or manipulation is required by § 10(b).[49] Consequently, it found there is no private cause of action under § 10(b) for mere breach of fiduciary duty or internal corporate mismanagement.[50] The Court noted that these types of claims were "traditionally left to state regulation" and that it was "reluctant to federalize a substantial portion of the law of corporations."[51]

Similarly, in *CTS Corp. v. Dynamics Corp. of America*,[52] the Court allowed significant state regulation of takeovers of corporations incorporated in that state. The Court noted that "the Williams Act would pre-empt a variety of state corporate laws of hitherto unquestioned validity if it were construed to preempt any state statute that may limit or delay the free exercise of power after a successful tender offer."[53]

Federal securities law has focused mainly on disclosure. As the Supreme Court has stated, if full disclosure is made, the fairness of the terms of the transaction is, at most, a

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44. "What drives this engine is ease of movement within the large United States market plus the internal-affairs doctrine, a choice-of-law principle under which each state respects the governance structures of firms incorporated elsewhere." Frank Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 Va. L. Rev. 685, 688 (2009). The Model Business Corporation Act recognizes this rule. *See* Model Bus. Corp. Act § 15.05(c) (ABA 2002) ("This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state.").

Only California has seriously attempted to impose selected provisions of its corporate law to the internal affairs of foreign corporations, although only those with significant connections to California or "pseudo-foreign corporations." *See* Cal. Corp. Code § 2115 (2009).

45. *See* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 Yale J. on Reg. 209 (2006) (providing an excellent exposition of this view).

46. *See* Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Studies 251 (1977). Frank Easterbrook has described this article as "the most important contribution to the economic analysis of corporate law since Ronald Coase's *The Nature of the Firm* in 1937." Easterbrook, *supra* n. 44, at 686.

47. It is possible that there is in fact no competition between states for corporate charters. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679 (2002).

48. 430 U.S. 462 (1977).

49. *Id.* at 473–474. The Court relied heavily upon the wording of the statute in reaching its conclusion. *Id.* at 471–474.

50. *Id.* at 479–480.

51. *Id.* at 478–479.

52. 481 U.S. 69 (1987).

53. *Id.* at 85; *cf. Burks v. Lasker*, 441 U.S. 471, 477–478 (1979) ("This case involves the question whether directors are authorized to determine that certain claims not be pursued on the corporation's behalf. As we have said in the past, the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law.").

tangential concern.[54] Consequently, when the SEC adopted Rule 19c-4[55] in 1988 prohibiting national securities exchanges and national securities associations from listing shares of a corporation that takes any corporate action that nullified, restricted, or disparately reduced the per share voting rights of existing common shareholders, the rule was struck down by the United States Court of Appeals for the District of Columbia Circuit.[56] The court found that the Securities Exchange Act of 1934 "cannot be understood to include regulation of an issue that is so far beyond matters of disclosure. . . and that is concededly a part of corporate governance traditionally left to the states."[57]

The belief by some that state regulation had failed to hold large corporations accountable led to proposals for a federal law governing large corporations[58] or for federal minimum standards that would apply to these corporations unless the applicable state standards were more demanding.[59] These proposals, for better or for worse, did not generate much traction in the 1970s and 1980s.

## IV. THE BIG WAVE: CORPORATE AND FINANCIAL FAILURES AND SCANDALS INEVITABLY PRECIPITATE RESPONSES

*"Every body perseveres in its state of rest, or of uniform motion in a right line, unless it is compelled to change that state by forces impressed thereon."*

–Sir Isaac Newton[60]

*"[P]eople who are trying to advocate change are like surfers waiting for the big wave. You get out there, you have to be ready to go, you have to be ready to paddle. If you're not ready to paddle when the big wave comes along, you're not going to ride it in."*

–John W. Kingdon[61]

Previous corporate and financial failures and scandals have resulted in executive, legislative, and regulatory actions to alleviate the consequences and prevent the recurrence of similar events.[62] For example, there is a long history of federal government

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54. *Santa Fe Indus., Inc.*, 430 U.S. at 477–478. Some scholars argue that this should be changed and a system of federal merit review should be adopted. *See e.g.* Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. Rich. L. Rev. 647 (2010).

55. SEC, *Voting Rights Listing Standards; Disenfranchisement Rule, Release No. 34-25891*, 53 Fed. Reg. 26,376, 1988 WL 260045 (July 12, 1988).

56. *The Business Roundtable v. SEC*, 905 F.2d 406, 417 (D.C. Cir. 1990).

57. *Id.* at 408.

58. *See e.g.* Ralph Nader, Mark Green & Joel Seligman, *Taming the Giant Corporation* (Norton 1976). The Corporate Democracy Act of 1980, H.R. 7010, 96th Cong. (1980). The Corporate Democracy Act was a 36-page bill that would have federalized and significantly changed the law applicable to large corporations.

59. *See e.g.* The Protection of Shareholders' Rights Act of 1980, S. 2567, 96th Cong. (1980) (introduced by Sen. Metzenbaum). Among other things, this bill would have imposed minimum federal standards on "affected corporations," defined in § 3(a), including standards related to the duties of directors, board independence, audit and nominating committees, and cumulative voting. *Id.* at §§ 4–9.

60. Sir Isaac Newton, *Mathematical Principles of Natural Philosophy* Bk. I, 14 (Andrew Motte trans., Daniel Adee 1846) (available at http://rack1.ul.cs.cmu.edu/is/newton/) (first law of motion).

61. John W. Kingdon, *Agendas, Alternatives, and Public Policies* 165 (2d ed., Pearson Education 1995) (quoted in Wooten, *supra* n. 7, at 736).

62. Professor Bainbridge has commented: "For proponents of bigger federal government, corporate

bailouts through loans to, or governmental "investment" in or assistance to, troubled enterprises. These bailouts include, but are not limited to: the Penn Central Railroad, which received loan guarantees of $125 million;[63] Lockheed Aircraft Corporation, which received $250 million in loan guarantees in 1971;[64] Chrysler, which received $1.5 billion in loans guaranteed by the federal government;[65] Continental Illinois National Bank and Trust Company, the then-seventh largest bank in the United States, which received a $4.5 billion infusion from the Federal Deposit Insurance Corporation in 1984;[66] and the airline industry bailout bill in 2001, which "authorized $5 billion in direct grants and up to $10 billion in loan guarantees for airlines."[67]

In addition, prior failures and scandals resulted in some very significant federal legislation over the years. The closing of the Studebaker plant in South Bend, Indiana in December of 1963 is widely thought of as a pivotal event in the road to adoption of the Employee Retirement Income Security Act of 1974 (ERISA).[68] Many Studebaker employees lost all or a substantial portion of the pension they expected to receive under the defined benefit plan negotiated by the United Autoworkers and their employer.[69] Among other reforms, ERISA imposed funding requirements for employer and multi-employer pension plans and established the Pension Benefit Guaranty Corporation (PBGC).[70]

The widespread problem of improper payments by United States corporations and their affiliates to foreign officials in the 1970s led to the passage of the Foreign Corrupt Practices Act (FCPA)[71] in 1977. At that time, over 400 United States companies, including 117 of the *Fortune 500*, admitted making questionable payments of more than $300 million to foreign officials. The FCPA attempted to curb corporate bribery abroad

scandals are always a bullish signal." Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26 Regulation 32, 28 (2003) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=389403).

63. Barry Ritholtz, *Bailout Nation* 37 (Wiley 2009).

64. *Id.* at 34–35.

65. Peter Cohan, *Why the 1979 Chrysler Bailout Worked—Temporarily*, http://www.bloggingstocks.com/2008/11/15/why-the-1979-chrysler-bailout-worked-temporarily/ (Nov. 15, 2008). The Chrysler bailout required $2 billion in commitments or concessions from a variety of other parties. Ritholtz, *supra* n. 63, at 39. As a result, one can argue that the Chrysler bailout was a *de facto* Chapter 11-like reorganization. *See* James K. Hickel, *The Chrysler Bailout Bust*, http://www.heritage.org/Research/Reports/1983/07/The-Chrysler-Bail-Out-Bust (July 13, 1983).

66. FDIC, *Managing the Crisis: The FDIC and the RTC Experience* ch. 4, http://www.fdic.gov/bank/historical/managing/history2-04.pdf (Aug. 1998). As a result of the bailout, the federal government became the majority shareholder in the bank. *See id.* at 556–558.

67. Jon Birger, *The Airline Bailout Bounty*, http://money.cnn.com/magazines/fortune/fortune_archive/2007/03/05/8401274/index.htm (Feb. 21, 2007). This bill authorized the Treasury Department to negotiate warrants from airlines getting guarantees. By 2007, this had "netted $119 million for the Treasury . . . ." *Id.*

68. Pub. L. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001–1461).

69. Wooten, *supra* n. 7, at 735–736 (footnotes omitted).

> Studebaker quickly emerged as a "battle cry" for pension reformers. In 1970 a House Labor Committee staffer compared the shutdown to the mine explosion in Farmington, West Virginia that led Congress to pass the Federal Coal Mine Health and Safety Act of 1969, while AFL-CIO lobbyist Andy Biemiller likened it to "the Triangle fire episode that led to the drive on sweatshops in the garment industry many years ago."

*Id.*

70. The PBGC "currently protects the pensions of more than 44 million American workers and retirees in more than 29,000 private single-employer and multiemployer defined benefit pension plans." PBGC, *Welcome to PBGC*, http://www.pbgc.gov/ (last accessed May 10, 2010).

71. Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified as amended at 15 U.S.C. §§ 78dd-1 et. seq. (2009)).

in several ways, including: (1) making it illegal to bribe foreign officials, foreign political parties or their officials, or candidates for foreign political office to obtain or retain business;[72] (2) requiring companies subject to SEC reporting requirements to keep detailed books and records that accurately reflect corporate payments and transactions;[73] and (3) requiring companies subject to SEC reporting requirements to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" of management control over the companies' assets, the proper recording of transactions, and the periodic comparison of recorded transactions with existing assets.[74]

While the FCPA, particularly early on, was criticized as handicapping U.S. companies competing for business, over the years the international community has come to accept the American view regarding the corrosive effect of corrupt payments. Numerous countries have adopted their own laws regarding such payments; additionally, a number of international and regional provisions now target such payments. These include: the Organization for Economic Co-operation and Development's *Convention on Combating Bribery of Foreign Public Officials* (1997);[75] the *U.N. Convention Against Corruption* (2004);[76] the *Inter-American Convention Against Corruption* (1996),[77] negotiated by the Organization of American States;[78] the nonbinding *Anti-Corruption Action Plan for Asia and the Pacific* (2001);[79] the *African Union Convention on Preventing and Combating Corruption* (2003);[80] and the South African Development Community's *Protocol Against Corruption* (2001).[81]

Other scandals have resulted in legislation that is, frankly, not as significant. For example, the insider trading scandals of the 1980s helped lead to the passage of the

72. Securities Exchange Act of 1934, 15 U.S.C. § 78dd-1. There is an exception for facilitating or expediting payments for routine governmental actions. *Id.* at § 78dd-1(b).

73. *Id.* at § 78m(b)(2)(A).

74. *Id.* at § 78m(b)(2)(B).

75. OECD, *OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, http://www.oecd.org/dataoecd/4/18/38028044.pdf (Nov. 21, 1997). The Convention has been adopted by the 30 OECD countries and eight non-member countries. *Id.*

76. U.N. Office on Drugs and Crime, *U.N. Convention against Corruption*, http://www.unodc.org/documents/treaties/UNCAC/Publications/Convention/08-50026_E.pdf (Oct. 31, 2003). There are 140 signatories and 143 parties to this convention. The United States signed the convention on Dec. 9, 2003 and ratified it on Oct. 30, 2006. U.N. Office on Drugs and Crime, *U.N. Convention against Corruption: Signatories*, http://www.unodc.org/unodc/en/ treaties/CAC/signatories.html (last accessed May 10, 2010).

77. Dept. of International Law, *Inter-American Convention Against Corruption*, http://www.oas.org/juridico/english/Treaties/b-58.html (Mar. 29, 1996).

78. "As of December 31, 2005, 33 of the 34 participating OAS Member States were States Parties to the IACAC." Dept. of State, *Sixth Annual Report to Congress on the Inter-American Convention Against Corruption*, http://www.state.gov/p/inl/rls/rpt/67758.htm#3 (Apr. 1, 2006).

79. OECD, *Anti-Corruption Action Plan for Asia and the Pacific*, http://www.oecd.org/dataoecd/38/24/35021642.pdf (Nov. 30, 2001). "Today, 28 countries and jurisdictions of the Asia-Pacific region have formally endorsed the Action Plan and committed to its goals . . . ." OECD, *The Initiative's Member Countries and Economies*, http://www.oecd.org/document/23/0,3343,en_34982156_35315367 _35030743_1_1_1_1,00.html (last accessed May 10, 2010).

80. African Union, *African Union Convention on Preventing and Combating Corruption*, http://www.africa-union.org/Official_documents/Treaties_%20Conventions_%20Protocols/Convention%20on%20Combating%20Corruption.pdf (July 11, 2003). Thirty-one countries have ratified this convention. African Union, *List of Countries which have Signed, Ratified/Acceded to the African Union Convention on Preventing and Combating Corruption*, http://www.africa-union.org/root/au/Documents/Treaties/List/African%20Convention%20on%20Combating%20Corruption.pdf (Mar. 2, 2010).

81. S. African Dev. Community, *Protocol Against Corruption*, http://www.sadc.int/index/browse/page/122 (Aug. 14, 2001).

Insider Trading Sanctions Act of 1984[82] and the Insider Trading and Securities Fraud Enforcement Act of 1988.[83]

Although one might argue that the conglomerate movement of the 60s and 70s was really not a scandal, some certainly thought it was scandalous. It resulted in the passage of the Williams Act in 1968[84] which regulates tender offers and the acquisition of significant stakes in public companies.[85] In addition, a number of commentators have discussed how "securities regulation tends to follow crashes."[86]

While some crises or scandals result in genuinely innovative legislation, Professor Roberta Romano has argued that "congressional initiatives rarely are constructed from whole cloth; rather, successful law reform in the national arena typically involves the recombination of old elements that have been advanced in policy circles for a number of years prior to adoption."[87] I will return to this point below.

## V. "CREEPING FEDERALISM": ENRON AND WORLDCOM BEGET SARBANES-OXLEY AND MORE

*"The best minds are not in government. If any were, business would hire them away."*

–Ronald Reagan[88]

*"The nine most terrifying words in the English language are, 'I'm from the government and I'm here to help.'"*

–Ronald Reagan[89]

After the Enron debacle in 2001 and amidst the WorldCom collapse in 2002, Congress passed, and President Bush signed, the Sarbanes-Oxley Act of 2002. This Act was the most significant federal incursion into the area of corporate law since the passage of the federal securities laws in the 1930s.[90] It changed the landscape in a number of ways. Many of these changes were in direct response to particular perceived problems arising in Enron.[91] The reforms include:

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82. Pub. L. 98-376, 98 Stat. 1264 (1984).

83. Pub. L. 100-704, 102 Stat. 4677 (1988).

84. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f)).

85. Gregory A. Mark, *The Legal History of Corporate Scandal: Some Observations on the Ancestry and Significance of the Enron Era*, 35 Conn. L. Rev. 1073, 1089–1090 (2003).

86. *See* Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77, 78 n. 3 (2003) (discussing this point and citing examples).

87. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L. J. 1521, 1524 (2005) (citing Kingdon, *supra* n. 61, at 192, 209–211).

88. The Quotations Page, *Quotations By Author: Ronald Reagan (1911-2004)*, http://www.quotationspage.com/quotes/Ronald_Reagan (last accessed May 10, 2010).

89. *Id.*

90. President Bush, when signing the Sarbanes-Oxley Act, stated it was "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Elisabeth Bumiller, *Corporate Conduct: The President Bush Signs Bill Aimed at Fraud in Corporations*, http://www.nytimes.com/2002/07/31/business/corporate-conduct-the-president-bush-signs-bill-aimed-at-fraud-in-corporations.html (July 31, 2002).

91. A number of foreign countries also passed reform legislation after the scandals of this period. *See generally* Manish Gupta, *Elan, Enron, and the Aftermath of Scandal: A Comparative Analysis of Recent Irish*

- The establishment of the Public Company Oversight Board;[92]
- The imposition of significant new rules to promote auditor independence;[93]
- Enhanced financial disclosure requirements;[94]
- The requirement that rules be developed by the SEC, a registered securities association, or national securities exchange that are "reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information;"[95] and
- The adoption of a myriad of provisions to deal with corporate and white-collar fraud;[96]

Perhaps more interesting to the student of corporate law are the Sarbanes-Oxley reforms that could be viewed as incursions into areas traditionally regulated primarily by states (and, contractually, by stock exchange listing requirements). These include provisions dealing with executive duties, executive compensation and loans to executives, and committee duties and membership. For example, Sarbanes-Oxley:

- Requires the CEO and the CFO to certify the financial statements included in periodic reports filed with the SEC;[97]
- Requires forfeiture of certain bonuses and profits when accounting statements are restated due to material non-compliance with securities laws;[98]
- Prohibits loans to directors and executive officers;[99]
- Lowers the bar for the SEC to seek a court order barring a person from serving as an officer or director of a public company from substantial unfitness to mere unfitness;[100]and
- Requires the audit committees of listed public corporations to consist of independent directors, to fulfill certain statutorily specified duties, to have the authority to engage independent counsel and other advisers where necessary,

*and American Corporate Governance Legislation*, 39 Cal. W. Inter. L.J. 1, 22–26 (2008) (discussing Irish reforms); Luca Enriques, *Bad Apples, Bad Oranges: A Comment From Old Europe on Post-Enron Corporate Governance Reforms*, 38 Wake Forest L. Rev. 911 (2003) (discussing post-Enron reform in Europe).

92. Pub. L. No. 107-204, §§ 101–109 (July 30, 2002).

93. *Id.* at §§ 201–209.

94. *Id.* at §§ 401–409.

95. *Id.* at § 501.

96. *See e.g. id.* at § 802 (making it a felony to alter documents to impede a federal investigation); Pub. L. No. 107-204 at § 803 (making debts incurred in violation of federal securities law non-dischargeable); *Id.* at § 804 (lengthening statute of limitations for securities fraud); *Id.* at § 806 (providing protection to whistle-blowers at public companies); *Id.* at § 807 (creating new crime for defrauding shareholders of publicly traded companies); *Id.* at § 903 (increasing criminal penalties for mail and wire fraud); Pub. L. No. 107-204 at § 906 (requires the CEO and CFO of publicly traded companies to certify the financial statements of the company and creates criminal penalties for knowing or willful violations); *Id.* at § 904 (increasing criminal penalties for violating Employee Retirement Income Security Act of 1974); *Id.* at § 1102 (making it a crime to "corruptly" tamper with a record or otherwise impede an official proceeding); and *Id.* at § 1103 (giving the SEC authority to seek temporary freeze orders where it appears that a company is likely to make an extraordinary payment during an SEC investigation).

97. *Id.* at § 302.

98. Pub. L. No. 107-204 at § 304.

99. *Id.* at § 402.

100. *Id.* at § 1105.

and to be adequately funded.[101]

Although Sarbanes-Oxley is a fairly lengthy act (sixty-six single-spaced pages), the full impact of the Act and the activity it has generated cannot be appreciated unless one takes into account the fact that it required the SEC to issue rules on a number of topics and directed that a number of studies be made. These include requirements that:

- The SEC promulgate certain rules prohibiting the listing of securities of issuers who do not meet specified requirements pertaining to an audit committee;[102]
- The SEC issue rules relating to the disclosure of whether the audit committee of a company has a financial expert and, if not, disclosure of the reason;[103]
- The SEC adopt new rules of professional responsibility for attorneys practicing before the SEC so that it is now a duty "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" up-the-ladder;[104]
- The SEC or a registered securities association or national securities exchange (with SEC oversight) issue rules to deal with independence of analysts and disclosure of conflicts of interest;[105]
- The SEC conduct a study of and prepare a report about the role of credit rating agencies in the securities market,[106] a study of and report about securities law violators for the period from January 1, 1998 to December 31, 2001,[107] and a study of and report on SEC enforcement actions of specified types for a five-year period preceding the adoption of Sarbanes-Oxley;[108]
- The Comptroller General conduct a study of and prepare a report on consolidation of and competition between public accounting firms,[109] and a study of and report on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition;[110] and
- The SEC promulgate rules requiring earlier, new or better disclosures on a number of matters, such as material off-balance sheet transactions.[111]

Speaking in April of 2003, then SEC Commissioner Cynthia Glassman commented on the workload of the agency in responding to Sarbanes-Oxley:

> In the process of implementing Sarbanes-Oxley and other recent rules, the Commission received over 9,000 comment letters, each of which was read, carefully considered, and

101. *Id.* at § 301; *see also id.* at § 202 (requiring audit committee pre-approval of certain non-audit services performed by a public company's auditor).
102. Pub. L. No. 107-204 at § 301.
103. *Id.* at § 407.
104. *Id.* at § 307.
105. *Id.* at § 501.
106. *Id.* at § 702.
107. Pub. L. No. 107-204 at § 703.
108. *Id.* at § 704.
109. *Id.* at § 701.
110. *Id.* at § 705.
111. *Id.* at § 401(a). The Act also requires the SEC to issue rules regarding *pro forma* financial statements, improved disclosure of insider transactions, internal control reports, disclosures regarding codes of ethics for senior financial officers, and disclosure regarding financial expert members, if any, of the audit committee. Pub. L. No. 107-204 at §§ 401(b), 403, 404, 406, 407, 408(a).

included in a comment summary that you can find on the Commission's website. The following statistics are unofficial, but I'm told our adopting releases for the 11 rules adopted in January totaled over 1,000 pages (double-spaced, 10-point font) (only lawyers could take over 1,000 pages to write 11 releases), and they contained over a quarter-million words. I'm also told—off the record—that we reviewed over 113 different drafts, held over 2,700 man-hours worth of meetings, ate over 1,100 meals at our desks, and drank more than 4,800 cups of coffee![112]

The SEC was not the only rulemaking body to respond to Enron and other meltdowns. In February of 2002, then SEC chairman Harvey Pitt asked the New York Stock Exchange (NYSE) and NASDQ to review their corporate governance and listing standards.[113] The NYSE appointed a Corporate Accountability and Listing Standards Committee to review their listing standards.[114] On August 1, 2002 the NYSE Board of Directors approved changes to the listing standards and submitted the proposed changes to the SEC on August 16, 2002.[115] Subsequently the NYSE filed three amendments to its corporate governance proposals and the National Association of Securities Dealers (NASD),[116] through its subsidiary, The Nasdaq Stock Market, Inc., filed a number of proposed requirements relating to corporate governance.[117] The SEC approved these proposals in November of 2003.[118]

In addition, the American Bar Association amended Rules 1.6 and 1.13 of its Model Rules of Professional Conduct in 2003 to expand the situations in which a lawyer may reveal information relating to the lawyer's representation of a client and to make "up-the-ladder" reporting the usual requirement, subject to exceptional circumstances, in the case of illegality or threatened illegal behavior.[119] Like Sarbanes-Oxley, these rule changes, in large part, "were reactions to the perceived inadequacies in the performance of Enron's lawyers."[120]

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112. SEC Commissioner Cynthia A. Glassman, Speech, *SEC Implementation of Sarbanes-Oxley: The New Corporate Governance* (D.C. Apr. 7, 2003) (available at http://www.sec.gov/news/speech/spch040703cag.htm).

113. See SEC, *Pitt Seeks Review of Corporate Governance, Conduct Codes*, http://www.sec.gov/news/press/2002-23.txt (Feb. 13, 2002).

114. The report of this Committee was presented to the board of the NYSE in June of 2002. It is available at NYSE Corporate Accountability and Listing Standards Committee, *Report*, http://www.nyse.com/pdfs/corp_govreport.pdf (June 6, 2002).

115. NYSE, *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors*, http://www.nyse.com/pdfs/corp_gov_pro_b.pdf (Aug. 1, 2002).

116. NASD is now the Financial Industry Regulatory Authority (FINRA). *See generally* FINRA, *About the Financial Industry Regulatory Authority*, http://www.finra.org/AboutFINRA/index.htm (last accessed May 10, 2010).

117. The history of these filings is set out in the SEC release approving the changes to the standards. *See* SEC, *NASD and NYSE Rulemaking: Relating to Corporate Governance*, http://www.sec.gov/rules/ sro/34-48745.htm#P52_17027 (Nov. 4, 2003).

118. *See id.* This release gives a good, concise description of the NYSE and NASD requirements.

119. *See* Catharine E. Stark, *Regulating Corporate Governance: Amended Rules of Professional Conduct Allow Lawyers to Make the World a More Ethical Place*, 53 Cath. U. L. Rev. 1195, 1213–1223 (2004) (discussing amendments to Model Rules 1.6 & 1.13); Jenny E. Cieplak & Michael K. Hibey, *The Sarbanes-Oxley Regulations and Model Rule 1.13: Redundant or Complementary?* 17 Geo. J. Legal Ethics 715, 717–718 (2004) (concise comparison of Sarbanes-Oxley up-the-ladder reporting requirement and revised Model Rule 1.13).

120. Thomas Bost, *Corporate Lawyers after the Big Quake: The Conceptual Fault Line in the Professional Duty of Confidentiality*, 19 Geo. J. Legal Ethics 1089, 1093 (2006). See *id.* at 1096–1102 for a discussion of the

Sarbanes-Oxley has received mixed reviews. Some believe it was at least a step in the right direction.[121] One writer states: "Sarbanes-Oxley in many respects imposes what responsible corporate executives have urged in the past—honesty in financial disclosures, management accountability for the financial affairs of the corporation, and avoidance of personal financial interest or conflict in decision-making by corporate executives."[122]

Others have expressed concern that Congress did not adequately consider the effect of Sarbanes-Oxley on small businesses.[123] Professor Romano is particularly hard on Congress and Sarbanes-Oxley. She writes: "The dismal saga of the SOX governance mandates demonstrates that congressional lawmaking in times of perceived emergency offers windows of opportunity to well-positioned policy entrepreneurs to market their preferred, ready-made solutions when there is little time for reflective deliberation."[124] Professor Romano points out that "[a] regulatory agenda . . . does not generate popular support in a booming market."[125] She argues that making the mandates of the Act optional, preferably at the state level, would be a superior approach that would have "a greater likelihood of producing the default rules preferred by a majority of investors and issuers . . . ."[126]

Other authors have noted the "creeping" federalization of corporate law in Sarbanes-Oxley.[127] Judge Easterbrook also noted that "[t]he Sarbanes-Oxley Act has specified many governance devices that all traded firms must employ."[128] He points out that "[i]f the mandatory rules turn out to be bad ones, investors can lose."[129] Consequently, he argues, "[t]he national government . . . can win a race to the bottom in a way that states cannot."[130]

One commentator goes so far as to state that, with the exception of takeover defenses, "state law is nearly irrelevant in affecting the corporate governance of publicly-held corporations."[131] Noting the lack of reforms of state corporate law after Enron and the other corporate scandals, he concludes: "Ironically, and somewhat unfortunately, one key player in the development of corporate law, the state legislature, was remarkably

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role of Enron's primary outside counsel in the Enron debacle.

121. *See e.g.* Neil H. Aronson, *Preventing Future Enrons: Implementing the Sarbanes-Oxley Act of 2002*, 8 Stan. J.L., Bus. & Fin. 127, 153 (2002) ("The SOA, although insufficient on its own, is a step in the right direction . . . ." The author proposes additional steps for reform).

122. William S. Duffey, Jr., *Corporate Fraud and Accountability: A Primer on Sarbanes-Oxley Act of 2002*, 54 S.C. L. Rev. 405, 406 (2002).

123. *See e.g.* Nathan Wilda, *David Pays for Goliath's Mistakes: The Costly Effect Sarbanes-Oxley Has on Small Companies*, 38 John Marshall L. Rev. 671, 680–687 (2004); Andrew Skouvakis, *Exiting the Public Markets: A Difficult Choice for Small Public Companies Struggling with Sarbanes-Oxley*, 109 Penn. St. L. Rev. 1279 (2005).

124. Romano, *supra* n. 87, at 1591.

125. *Id.* at 1593.

126. *Id.* at 1595. As an alternative, Professor Romano suggests that the Act could have included a sunset provision to require revisiting the mandates it imposes at a time "when more considered deliberation would be possible." *Id.* at 1595.

127. Easterbrook, *supra* n. 44, at 692 ("we are moving toward national regulation of corporate governance").

128. *Id.*

129. *Id.*

130. *Id.*

131. Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 S.M.U. L. Rev. 353, 363 (2004) (referring to the combined effect of Sarbanes-Oxley, SEC actions, and stock exchange rules).

absent in enacting reforms. The states seem to have abdicated their traditional role of defining the internal affairs of corporations, at least insofar as publicly-held corporations are concerned."[132] In evaluating his conclusion, one should consider whether, to the extent to which Enron and the other scandals of the time were part of a classic bubble, the problems of the time should have been at least partially self-correcting, i.e., through market discipline.[133]

## VI. "OH, THE VISION THING":[134] INCREASING FORCE TOWARDS FEDERALIZATION?

*"If any force generates a motion, a double force will generate double the motion, a triple force triple the motion, whether that force be impressed altogether and at once, or gradually and successively."*

–Sir Isaac Newton[135]

*"Never let a serious crisis go to waste."*

–White House Chief of Staff Rahm Emanuel[136]

While Rahm Emanuel's words gathered much attention, the thought that crises are useful for pushing pre-existing agendas is hardly novel. As noted above, in 2005 Professor Romano wrote: "congressional lawmaking in times of perceived emergency offers windows of opportunity to well-positioned policy entrepreneurs to market their preferred, ready-made solutions . . . ."[137]

The current crises have produced a frenzy of legislation, legislative proposals, and other governmental activity.[138] These include:

- The Wall Street Reform and Consumer Protection Act of 2009;[139]
- The Corporate and Financial Institution Compensation Fairness Act of 2009;[140]
- The Shareholder Empowerment Act of 2009;[141]

132. *Id.* at 385. In 2005, former SEC Commissioner Roberta Karmel mused that Sarbanes-Oxley could either motivate states to "try to be stricter policemen than the SEC" and to adopt legislation in response to it, or it may result in "a hollowing out of state law protections for shareholders as the result of a comprehensive federal regulatory scheme. This can result in a kind of de facto . . . preemption." Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 Del. J. Corp. L. 79, 135, 138 (2005).

133. *See* John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 Bus. Law. 1403, 1416–1417 (2002) (discussing this point).

134. Robert Ajemian, *Where is the Real George Bush*, http://www.time.com/time/magazine/article/0,9171,963342,00.html (Jan. 26, 1987) (referring to then-Vice President George Bush's exasperated reply when a friend suggested he take a few days to determine the direction in which he wanted to take the county).

135. Newton, *supra* n. 60, at 14.

136. The Wall St. J., *A 40-Year Wish List*, http://online.wsj.com/article/SB123310466514522309.html (Jan. 28, 2009) (quoting White House Chief of Staff Rahm Emanuel).

137. Romano, *supra* n. 87, at 1591.

138. After Enron, Professor Ribstein noted: "A boom encourages unwarranted trust in markets, leading to the speculative frenzy of a bubble and then to the inevitable bust. The bust, in turn, leads first to the disclosure of fraud and then to the mirror image of the bubble—a kind of speculative frenzy in regulation." Ribstein, *supra* n. 86, at 78.

139. H.R. 4173, 111th Cong. (Dec. 2, 2009) (introduced by Rep. Frank).

140. H.R. 3269, 111th Cong. (passed the House of Representatives on July 31, 2009).

- The Corporate Governance Reform Act of 2009;[142]
- The Proxy Voting Transparency Act of 2009;[143]
- The Restoring American Financial Stability Act of 2009;[144]
- The Excessive Pay Shareholder Approval Act;[145]
- The Excessive Pay Capped Deduction Act of 2009;[146]
- The Income Equity Act of 2009;[147]
- The Shareholder Bill of Rights Act of 2009;[148]
- The Corporate Executive Accountability Act of 2010;[149]
- The Investor Protection Act of 2009;[150]
- The Ending Excessive Corporate Deductions for Stock Options Act;[151] and
- The Accountability and Transparency in Ratings Agencies Act.[152]

A number of these bills deal with matters that fit within the area of more traditional federal concerns; for example, there are bills proposing to make federal courts more accessible to plaintiffs who may have suffered in the recent crises,[153] to radically overhaul the federal financial regulatory system,[154] to provide the SEC with broad new authority and remedies,[155] or to enhance regulation of credit ratings agencies.[156] However, a number of them contain provisions which, as with a number of Sarbanes-Oxley reforms, would interject federal governmental standards into areas traditionally governed by state corporation law.

For example, one or more of the bills require: non-binding shareholder votes on executive compensation;[157] an independent chairman of the board;[158] all members of a

141. H.R. 2861, 111th Cong. (June 12, 2009) (introduced by Rep. Peters).

142. H.R. 3272, 111th Cong. (July 21, 2009) (introduced by Rep. Ellison).

143. H.R. 3351, 111th Cong. (July 27, 2009) (introduced by Rep. Kilroy).

144. Sen. 3217, 111th Cong. (introduced by Sen. Dodd) (available at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf).

145. Sen. 1006, 111th Cong. (May 7, 2009) (introduced by Sen. Durbin).

146. Sen. 1007, 111th Cong. (May 7, 2009) (introduced by Sen. Durbin).

147. H.R. 1594, 111th Cong. (March 18, 2009) (introduced by Rep. Lee).

148. Sen. 1074, 111th Cong. (May 19, 2009) (introduced by Sen. Schumer).

149. Sen. 3049, 111th Cong. (Feb. 26, 2010) (introduced by Sen. Menendez).

150. H.R. 3817, 111th Cong. (Oct. 15, 2009) (introduced by Rep. Kanjorski).

151. Sen. 1491, 111th Cong. (July 22, 2009) (introduced by Sen. Levin and McCain).

152. H.R. 3890, 111th Cong. (Oct. 21, 2009) (introduced by Rep Kanjorski.).

153. *See e.g.* Notice Pleading Restoration Act of 2009, Sen. 1504, 111th Cong. (July 22, 2009) (introduced by Sen. Specter) (aiming to restore the standards set forth in *Conley v. Gibson*, 355 U.S. 41 (1957) and, presumably, override the Supreme Court's decision in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007)); Liability for Aiding and Abetting Securities Violations Act of 2009, Sen. 1551, 111th Cong. (July 30, 2009) (introduced by Sen. Specter) (which would provide a private cause of action under the Securities Exchange Act of 1934 and, consequently, override the Supreme Court's decision in *C. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)).

154. *See e.g.* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (passed by the House and referred to the Senate Committee on Banking, Housing, and Urban Affairs on Jan. 20, 2010); The Restoring American Financial Stability Act of 2009, Sen. 3217, 111th Cong.

155. *See* The Investor Protection Act of 2009, H.R. 3817, 111th Cong. This Act would also create an Investor Advisory Committee to advise and consult with the SEC. *Id.* at § 101.

156. *See* The Accountability and Transparency in Ratings Agencies Act, H.R. 3890, 111th Cong. This Act would also establish standards for private causes of action against credit rating agencies. *Id.* at § 3.

157. H.R. 2861, 111th Cong. at § 3; H.R. 3269, 111th Cong. at § 2; H.R. 3272, 111th Cong. at § 5; H.R. 3351, 111th Cong. at § 2; Sen. 1074, 111th Cong. at § 3.

158. H.R. 3272, 111th Cong. at § 2.

corporation's compensation committee to be independent;[159] a risk management committee and a chief risk officer while also defining their duties;[160] a supermajority shareholder vote to approve "excessive" executive pay;[161] a non-binding shareholder vote on golden parachute compensation;[162] the SEC to promulgate rules relating to shareholder use of issuer proxy solicitation materials to nominate individuals for board membership;[163] or the SEC to adopt rules to direct national securities exchanges and national securities associations to prohibit the listing of securities of issuers that do not meet specified corporate governance standards, such as an independent chairman of the board, annual election of directors, rules regarding elections of directors, the creation of a risk committee, and rules regarding the independence and powers of the compensation committee.[164]

A number of legislative proposals are, essentially, old or "recycled" ideas.[165] The prime example is the attention given to executive compensation. This issue is a perennial talking point for many corporate governance activists and has resulted in numerous prior bills in Congress.[166] Additionally, executive compensation has been a talking point of various unions for years[167] and Congress at least twice has passed provisions dealing with improper/excessive executive compensation.[168] And, of course, President Obama has appointed a "Pay Czar"[169] for a number of firms receiving federal governmental assistance. These firms are subject to special rules regarding executive compensation.[170]

Similarly, the continuing push for more and more board independence exhibits itself in the proposed legislation. Roberta Karmel has noted: "The keystone of the SEC's

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159. *Id.* at § 4; H.R. 3269, 111th Cong. at § 2.

160. H.R. 3272, 111th Cong. at § 3.

161. Sen. 1007, 111th Cong. at § 2(a). At least 60% of the shareholders must vote to approve excessive pay which, under the Act, would be compensation in any taxable year that exceeds an amount equal to "100 times the amount of the average compensation for services performed by all employees" of the issuer. *Id.*

162. H.R. 3269, 111th Cong. at § 2; Sen. 1074, 111th Cong. at § 3(a); Sen. 3049, 111th Cong. at § 2(a).

163. Sen. 1074, 111th Cong. at § 4.

164. H.R. 2861, 111th Cong. at § 2; H.R. 3269, 111th Cong. at § 3; Sen. 1074, 111th Cong. at § 5.

165. *See e.g.* H.R. 1594, 111th Cong. (would deny income tax deduction for compensation exceeding greater of "an amount equal to 25 times the lowest compensation" of any other full-time employee or $500,000); Sen. 1007, 111th Cong. (would deny deduction for compensation that "exceeds that amount which is equal to 100 times the amount of the average compensation for services performed by all employees of the taxpayer").

166. *See e.g.* the Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. (as passed by House on Apr. 20, 2007); The Income Equity Act of 2005, H.R. 3260, 109th Cong. (July 12, 2005) (which would deny a tax deduction for executive pay more than 25 times more than that of lowest-paid employees); The Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (Nov. 10, 2005) (introduced by Rep. Frank).

167. *See e.g.* AFL-CIO, *2009 Executive PayWatch*, http://www.aflcio.org/corporatewatch/paywatch/ (last accessed Apr. 12, 2010).

168. *See* I.R.C. § 162(m) (2006) (denying publicly held corporations a deduction for compensation of specified high level executives in excess of $1 million per year unless compensation is performance based, with goals set by compensation committee comprised solely of two or more outside directors and materials terms disclose to and approved by shareholders); I.R.C. § 280G (2006) (disallowing a deduction for "excess" golden parachute payments).

169. Deborah Solomon, *White House Set to Appoint a Pay Czar*, http://online.wsj.com/article/SB124416737421887739.html (June 5, 2009).

170. *See e.g.* American Recovery and Reinvestment Act of 2009, Pub. L. 111-5, § 7001, 123 Stat 115, 516 (2009) (imposing certain compensation limits on TARP recipients and requiring non-binding shareholder "say on pay" votes); *see generally* Michael diFilipo, *Regulating Executive Compensation in the Wake of the Financial Crisis*, 2 Drexel L. Rev. 258, 286–303 (2009).

corporate governance policy is the independent director. The author has long felt that this model is flawed. Independent directors are part-time participants in a corporation's affairs. By definition they are outsiders."[171] She points out that they do not have the time "to challenge management's judgments, except as to a discrete number of issues . . . . If they become essentially full-time directors, then they will no longer be independent."[172]

Ms. Karmel is not opposed to outside directors–"This does not mean that independent directors are a bad idea, but corporations should have greater freedom to experiment with board structures than Sarbanes-Oxley permits."[173] This is another issue that makes for a good debate in a corporate law class. One can understand that "more is not always better" and there can be "too much of a good thing," if I may draw from my sack of clichés. Even too much water, a necessity of life, can lead to water intoxication and death.[174]

It has been argued that corporate governance did not fail during the 2008 stock market collapse and that most of the major problems were at financial firms.[175] If so, this may justify a close look at that sector,[176] but certainly does not make the case for fundamental reforms to the U.S. corporate governance system.[177]

Two recent developments that also involve the issue of the "federalization creep" in the area of corporation law merit at least mention. The first is the SEC shareholder access proposal, which "would require, under certain circumstances, a company to include in the company's proxy materials a shareholder's, or group of shareholders' nominees for director."[178] This is not a new idea,[179] but in light of current events it seems inevitable that the SEC will adopt shareholder access rules. Much has been written regarding this issue. I am not going to add to it other than to note that it is ironic that business persons behaving badly may be creating more momentum toward the federalization of corporate law than William Cary, Ralph Nader, and Howard Metzenbaum ever could.[180]

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171. Karmel, *supra* n. 132, at 134.

172. *Id.*

173. *Id.* She fears that an independent director board "is bound to disappoint and cause investor and public dissatisfaction as well as a loss of confidence [in the SEC]." *Id.* at 135.

174. *See* Scott Conroy, *Woman Dies After Water Drinking Contest*, http://www.cbsnews.com/stories/2007/01/14/national/main2358958.shtml (Jan. 13, 2007).

175. Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 Bus. Law. 1 (2009). The author does point to AIG and Citigroup as "potentially noteworthy corporate governance lapses that came to light during the stock market meltdown . . . ." *Id.* at 21.

176. *Id.* at 51–54.

177. *Id.* at 61 ("The case for fundamental reform is thus not yet made out.").

178. SEC, *Facilitating Shareholder Director Nominations*, http://www.sec.gov/rules/proposed/2009/33-9046.pdf (June 10, 2009).

179. The SEC proposed a shareholder access rule in 2003. *See* SEC, *Proposed rule: Security Holder Director Nominations*, http://www.sec.gov/rules/proposed/34-48626.htm (Oct. 14, 2003). This proposal was never adopted.

180. Under existing Delaware law, shareholders can adopt bylaws providing for shareholder access to a corporation's proxy solicitation materials and reimbursement of proxy expenses incurred by a shareholder in soliciting proxies in connection with the election of directors. Del. Gen. Corp. L. §§ 109(a), 112, 113 (2009). In addition, amendments have been proposed to the Model Business Corporation Act to permit shareholder proxy access. Comm. on Corp. Laws, ABA Section of Bus. L., *Changes in the Model Business Corporation Act—Proposed Shareholder Proxy Access Amendments to Chapters 2 and 10*, 64 Bus. Law. 1157 (2009). If the shareholders of a Delaware corporation as a group desire shareholder access, it is available under existing law. Unlike the proposed SEC rule, the Delaware statute does not assume that the shareholders in every corporation

The other and perhaps more interesting issue involves the question of "honest services" fraud. The federal wire and mail fraud statutes include schemes to "deprive another of the intangible right of honest services" with the definition of "a scheme or artifice to defraud."[181] Some courts have upheld convictions of corporate executives under the rubric of honest services fraud.[182] The Supreme Court is currently considering the matter of the application of the honest services fraud concept to corporate executives.[183] Depending upon how the Court decides these cases, the honest services concept could become a tool federal prosecutors use to criminally prosecute executives who it was previously thought had at most committed breaches of fiduciary duty.[184]

## VII. "SAME STORY, SAME OLD SONG AND DANCE":[185] WE'VE SEEN IT ALL BEFORE REDUX

*"Risk free capitalism is an oxymoron."*

–The Hon. Leo Strine[186]

It seems that with every new corporate or financial crisis/scandal/failure, we end up discussing many of the same issues and concerns as with prior ones. There are so many examples that I could not possibly exhaust them in a reasonably brief article. They include:

### A. *Concerns about the Failure or Disappearance of Major Accounting Firms*

During the savings and loan crisis, Laventhol & Horwath, the then seventh largest accounting firm in the country, sought Chapter 11 bankruptcy protection.[187] "At its end, the firm had 115 legal actions against it, seeking a total of $362 million."[188]

In the aftermath of the Enron scandal, Arthur Anderson, the auditor for both Enron and WorldCom, was convicted of obstruction of justice for shredding documents related to its audit of Enron. Although the Supreme Court unanimously overturned this conviction in 2005,[189] this was a pyrrhic victory for Arthur Andersen. Pursuant to an agreement with the SEC, the firm had surrendered its state licenses on August 31,

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would find a shareholder access rule desirable.

181. 18 U.S.C. § 1346 (2006).

182. *See U.S. v. Skilling*, 554 F.3d 529 (5th Cir. 2009), *cert. granted*, 130 S. Ct. 393 (2009) (upholding conviction of former Enron CEO of conspiracy to commit honest services fraud); *U.S. v. Black*, 530 F.3d 596 (7th Cir. 2008), *cert. granted*, 129 S. Ct. 2379 (2009) (holding that conviction of CEO of Hollinger International could be based upon honest services fraud).

183. *Id.*

184. *See* Lisa L. Casey, *Twenty-Eight Words: Enforcing Corporate Fiduciary Duties Through Criminal Prosecutions of Honest Services Fraud*, 35 Del. J. Corp. L. 1 (extensive discussion of honest services fraud and the cases currently before the Supreme Court).

185. Aerosmith, *Same Old Song and Dance*, in *Get Your Wings* (Columbia 1974) (CD).

186. Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 Bus. Law. 1371, 1374 (2002).

187. Time, *Bankruptcy: Laventhol's Number is Up*, http://www.time.com/time/magazine/article/0,9171,971825,00.html (Dec. 3, 1990).

188. Gregory Richards, *1990: The Other Big Accounting Firm Meltdown*, http://philadelphia.bizjournals.com/philadelphia/stories/2002/08/05/focus9.html?page=2 (August 2, 2002).

189. *Arthur Andersen LLP v. U.S.*, 544 U.S. 696 (2005) (finding serious flaws in jury instructions).

2002.[190] The demise of Andersen resulted in the Big 5 becoming the Big 4, and raised concerns about concentration in the market for auditing services. In fact, as part of Sarbanes-Oxley, Congress required the General Accounting Office (GAO) to conduct a study and prepare a report on the consolidation of accounting firms.[191] Congress expressed an interest in, among other things, "the problems, if any, faced by business organizations that have resulted from limited competition among public accounting firms."[192]

The recent crises and scandals have caused people to question which Big 4 auditing firm will be the next to fail. These firms are currently faced with lawsuits claiming damages in amounts that could conceivably bankrupt them, if successful.[193]

### B. *Concerns about the Value and Validity of Ratings Awarded by Credit Rating Agencies*[194]

In the Enron situation, the three major credit rating agencies did not lower their ratings of Enron to below investment grade until four days before Enron filed for bankruptcy.[195] Subsequent review of the actions of these agencies suggests significant shortcomings in their assignment of credit ratings to Enron.[196] As part of Sarbanes-Oxley, Congress required the SEC to "conduct a study of the role and function of credit rating agencies in the operation of the securities market."[197] The SEC was also required to prepare a report and submit copies to various parties.[198]

After submission of this report and numerous Congressional hearings, Congress adopted the Credit Rating Agency Reform Act in 2006.[199] Despite the attention to credit rating agencies after Enron and the 2006 Act, credit rating agencies have again come

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190. Rosemary Schlank, *Andersen Surrenders Its Licenses- Its Legacy Lives On*, http://www.accountingweb.com/print/node/131647 (Sept. 2, 2002).

191. Pub. L. No. 107-204 at § 701.

192. Id. The GAO issued its report in July of 2003. *See* GAO, *Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, Accounting Firms: Mandated Study on Consolidation and Competition, GAO-03-864*, http://www.gao.gov/new.items/d03864.pdf (July, 2003).

193. *See* Alex Spence, *Audit Firms Left Unprotected Against Claims of Negligence*, http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article6851623.ece (Sept. 28, 2009).

194. Credit ratings agencies that are registered by the SEC are referred to as nationally recognized statistical rating organizations. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78c(62).

195. Staff to the Sen. Comm. on Gov. Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs* 76, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_senate_committee_prints&docid=f:82147.pdf (Oct. 7, 2002).

196. *See id.* 109–124. The short of it is that the credit rating agencies did not gather adequate information, did not understand the information they had, and relied too heavily on the statements of Enron's management. *See generally* Claire A. Hill, *Ratings Agencies Behaving Badly: The Case of Enron*, 35 Conn. L. Rev. 1145 (2003).

197. Pub. L. No. 107-204 at § 701(a)(1).

198. *Id.* at § 701(b).

199. Pub. L. No. 109-291, 120 Stat. 1327 (2006); *see generally* James Hamilton, *Congress Ends Duopoly by Reforming Process for Designating Credit Ratings Agencies*, http://business.cch.com/securitieslaw/news/Rating%20Agency%20Reform%20Act%20White%20Paper.pdf (a concise discussion of Credit Rating Agency Reform Act). The SEC has engaged in rule-making relating to credit rating agencies, as required by the Act. *See* Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What Can Be Done to Protect Investors*, 50 B. C. L. Rev. 1275, 1286–1288, 1291–1295 (2009) (a concise discussion of recent SEC rulemaking).

under fire as a result of the recent crises. "[I]t now appears that the rating agencies were far too willing to grant high ratings . . . . [A] number of scholars allege that credit-rating agencies were systematically underestimating the risk of mortgage-backed securities to attract business."[200] Since the meltdown, several states have filed suit against credit rating agencies for losses incurred by various state funds.[201]

The concern about credit rating agencies is made more acute because, depending upon the nature of the business, a downgrade by credit rating agencies can be a "death sentence."[202]

### C. *The Shortcomings of the SEC and Other Governmental Agencies*

The shortcomings and failures of the SEC are not new. In the Equity Funding Corporation of America scandal in the early 1970s,[203] the SEC failed to act until after the California insurance authorities impounded Equity Funding's records and the NYSE halted trading in Equity Funding shares. In a case reviewing a censure imposed by the SEC against a securities analyst who brought his evidence of the fraud to the SEC, the court of appeals observed:

> The SEC had a history of failing to act promptly in the Equity Funding case. In 1971, the SEC was approached by William Mercado, an Equity Funding employee, with reports of questionable accounting practices at Equity Funding. The SEC performed a cursory investigation and took no further action . . . . On March 9, 1973, an official of the California [Insurance] Department had a conference with one of the staff attorneys in the SEC's Los Angeles office at which he repeated Secrist's charges as relayed by the New York authorities. The California official stated that he thought his department might want to do a full inspection of Equity Funding, and he asked for help from the SEC. The SEC staff attorney stated that similar allegations had been made about Equity Funding before by disgruntled employees. He recommended "delaying any type of inspection of the Equity

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200. Richard M. Hynes, *Securitization, Agency Costs, and the Subprime Crisis*, 4 Va. L. & Bus. Rev. 231, 270 (2009).

201. David Segal, *Ohio Sues Rating Firms for Losses in Funds*, http://www.nytimes.com/2009/11/21/business/21ratings.html?_r=1&dbk=&pagewanted=all (Nov. 20, 2009) (Ohio claims losses of $457 million to state retirement and pension funds); Martha Graybow, *Connecticut Sues Top Credit Rating Agencies*, http://www.reuters.com/article/idUSN3048374820080730 (July 30, 2008); *see also* Joseph A. Giannone, *Calpers Sues Rating Agencies Over Losses*, http://www.reuters.com/article/idUSTRE56E4D420090715 (July 15, 2009) (California Public Employees' Retirement System alleges that it may lose more than $1 billion from structured investment vehicles). These suits face a number of obstacles, including preemption and First Amendment defenses. *See* Larry P. Ellsworth & Keith V. Porapaiboon, *Credit Agencies in the Spotlight: A New Casualty of the Mortgage Meltdown*, 18(4) Bus. L. Today (March/April 2009) (available at http://www.abanet.org/buslaw/blt/2009-03-04/ellsworth.shtml).

202. *See e.g.* Andrew M. Kulpa, *Minimal Deterrence: The Market Impact, Legal Fallout, and Impending Regulation of Credit Default Swaps*, 5 J. L. Econ. & Policy 291, 299 (2009) (credit rating downgrade triggered estimated $100 billion in exposure for AIG under credit default swaps to which it was a party); James C. DuPont, *A Second Chance at Legal Certainty: AIG Collapse Provides Impetus to Regulate Credit Default Swaps*, 61 Admin. L. Rev. 843, 843–844 (2009) (noting impact of collateral calls on AIG's collapse after credit rating agencies lowered it credit rating); Mulligan, *supra* n. 199, at 1275–1276 (discussing how credit rating downgrade quickly lead to demise of Bear Stearns).

203. Equity Funding created fictitious life insurance policies, which it sold to re-insurers for a price equal to 80% of the first-year premiums. Secrist, a former Equity Funding employee, estimated that by 1972 at least 40,000 phony policies were created, representing at least one-third of Equity Funding's outstanding life insurance business. *In the Matter of Raymond L. Dirks, Release No. 34-17480*, 21 SEC Docket 1401, 1981 WL 36329 (Jan. 22, 1981), *rev'd*, *Dirks v. SEC*, 463 U.S. 646 (1983).

Funding operations until next year when more personnel are available.[204]

In a recent article, Professor Poser discusses what he perceives as the SEC's enforcement failures with regards to abuses in initial public offerings, research analyst recommendations, late trading and market timing, and auction rate securities, in addition to the Madoff scandal.[205] He states: "Ironically, in its own enforcement activities, the SEC has not met the standard of conduct that it requires of the broker-dealer firms it regulates."[206]

In the Enron situation, the SEC staff did not review the Forms 10-K filed by Enron in 1998, 1999, and 2000.[207] This occurred even though there were factors that

> should have at least triggered the SEC's interest in these reports, including Enron's astonishing growth, among the fastest of U.S. companies, and the significant change in the nature of its business (from energy to trading)–facts available from both press reports and the filings themselves. The sheer number of Enron-related entities–Enron's 2000 Form 10-K lists over 50 pages of affiliates, many of which were not consolidated onto Enron's balance sheets–perhaps also should have raised suspicions.[208]

After Enron, Congress increased the funds to be appropriated to the SEC for the fiscal year 2003 to $776 million.[209] The SEC budget has increased from $377 million in 2000 to $906 million in 2008.[210] The funds allotted for fiscal year 2010 are an estimated $1.11 billion, and on February 1, 2010 President Obama recommended fiscal year 2011 funding of $1.58 billion for the SEC, a 12 percent increase.[211]

Even though the SEC budget is substantially larger than it was pre-Enron, the failure of the SEC to uncover or put a halt to Bernard Madoff's Ponzi scheme is already legendary. The SEC Office of Investigation's massive report on its investigation into the failure of the SEC to uncover Madoff's scheme states:

> The OIG investigation did find, however, that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed. The OIG found that between June 1992 and December 2008 when Madoff confessed, the SEC received six substantive complaints that raised significant red

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204. *Dirks v. SEC*, 681 F.2d 824, 832 n. 6 (1982) (citation omitted), *rev'd*, 464 U.S. 646 (1983).

205. Norman S. Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 Brook. J. Corp. Fin. & Com. L. 289, 309–317 (2009). He also discusses briefly the "failed SEC investigation of possible insider trading by Pequot Capital Management" and the failure of the SEC to act after it became aware of numerous red flags prior to the collapse of Bear Stearns. *Id.* at 320, 299. An interesting sidelight to the SEC failures that Professor Poser notes is that state officials and agencies stepped into the void in several of these situations. *Id.*

206. *Id.* at 310.

207. Staff of the Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs* 26, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_senate_committee_prints&docid=f:82147.pdf (Oct. 7, 2002).

208. *Id.* at 27 (citations omitted). These comments were based on Senate Committee staff interviews with Professor James D. Cox of Duke University School of Law and Dean and Professor Joel Seligman of Washington University School of Law. *Id.* at 27 n. 123.

209. Pub. L. No. 107-204 at § 601 (amending Securities Exchange Act of 1934, 15 U.S.C. § 78kk).

210. Poser, *supra* n. 205, at 321.

211. Yin Wilczek, *Administration Requests 12 Percent Increase in SEC Funding to Boost Staffing, Technology*, 42 Sec. Reg. & L. Rep. 214 (Feb. 8, 2010).

flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading. Finally, the SEC was also aware of two articles regarding Madoff's investment operations that appeared in reputable publications in 2001 and questioned Madoff's unusually consistent returns.[212]

Madoff himself was surprised that his scheme wasn't discovered sooner.[213] In commenting on the SEC's failures in the Madoff matter, one commentator states that "the SEC and its lawyers were presented with the proverbial 'videotape' of the crime, and yet they were unable to comprehend what had occurred . . . ."[214]

The reasons for the SEC falling short most certainly include a lack of education, training, and experience in the area of finance.[215] The SEC itself understands this and, as a result of the Madoff Ponzi scheme, has announced a number of "reforms." These include, among quite a number of others: improving fraud detection procedures for SEC examiners; recruiting staff with specialized experience "in areas such as trading, operations, portfolio management, options, compliance, valuation, new instruments and portfolio strategies, and forensic accounting" and also "with expertise in modern financial products and techniques—such as derivatives and hedge fund activities;" and expanding and targeting training relating to such things as "hedge funds and specialized products; derivatives and options."[216]

With respect to the SEC's culpability in the subprime crisis, the FBI warned of the possibility of a mortgage fraud "epidemic" in 2004.[217] At that time, an FBI official stated: "We think we can prevent a problem that could have as much impact as the S&L crisis."[218] Attorney General Eric Holder, in response to questioning before a congressional panel, said that the diversion of Justice Department and FBI officers to post-September 11 anti-terrorism duties may have negatively impacted the investigation of white-collar crime.[219]

### D. *Concerns that Politicians (or Family Members) Are Too Close to Problem Companies and Their Managers.*

There is a long history of politicians getting too close with problem companies and their managers. These companies are often also political contributors to the politicians or their parties. Examples include the Keating Five senators who accepted $1.3 million in campaign contributions from Charles Keating, the head of Lincoln Savings and Loan.

212. SEC Office of Investigations, *Investigation of Failure of The SEC To Uncover Bernard Madoff's Ponzi Scheme–Public Version*, http://www.sec.gov/news/studies/2009/oig-509.pdf (Aug. 31, 2009) (footnote omitted).

213. *See* Jonathan Dienst, *Madoff: "Amazing to Me" I Wasn't Caught Sooner*, http://www.nbcnewyork.com/news/local-beat/Madoff-Amazing-To-Me-I-Wasnt-Caught-Sooner-67781537.html (Oct. 30, 2009).

214. Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. Corp. L. 363, 377 (2009).

215. *Id.*

216. SEC, *Post-Madoff Reforms*, http://www.sec.gov/spotlight/secpostmadoffreforms.htm (last updated Dec. 7, 2009).

217. Terry Frieden, *FBI Warns of Mortgage Fraud "Epidemic"*, http://www.cnn.com/2004/LAW/09/17/mortgage.fraud (Sept. 17, 2004).

218. *Id.*

219. Daniel Wagner, *Holder to Look Into FBI Report of Mortgage Fraud*, http://www.philly.com/inquirer/business/20100115_Holder_to_look_into_FBI_report_of_mortgage_fraud.html (Jan. 15, 2010).

These senators met twice with federal banking regulators on behalf of Charles H. Keating, Jr., whose bank later collapsed at a cost to taxpayers of $3 billion.[220] In addition, Neil Bush, son of then Vice President George Walker Bush, was a director of Silverado Savings and Loan at the time of its collapse.[221] George Bush's various campaigns received over $555,000 from Enron and Ken Lay, the former chairman of Enron,[222] who Bush called "Kenny boy" until the collapse of Enron.[223] Dick Cheney's service as CEO of Halliburton and various dealings of the company were an issue in his vice-presidential debate with John Edwards in 2004.[224] Then-Senate Majority Leader Bill Frist's sale of shares in HCA, Inc., founded by this father and brother, brought on two federal investigations and accusations of ethical violations.[225]

During the recent financial crisis it became public that Angelo Mozilo, former CEO of Countrywide Financial, had a "Friends of Angelo" program that appears to have given sweetheart mortgage loans to a number of prominent politicians, including Senators Chris Dodd and Kent Conrad.[226]

### E. *Concerns that Off-Balance Sheet Entities Skewed the Picture of Companies' Performances and Financial Health*

It is common knowledge that a major problem with the picture that Enron presented was created through the large scale and improper use of Special Purpose Entities (SPE's). Enron did this to: transfer appreciated assets to SPE's, treat the transfers

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220. N.Y. Times, *Keating Five*, http://topics.nytimes.com/top/reference/timestopics/subjects/k/keating_five/index.html?inline=nyt-classifier (last accessed May 10, 2010). The actions of the five senators "later became the subject of a lengthy ethics investigation into what became known as the case of the Keating Five. In 1991, the Senate censured Mr. Cranston and reprimanded the others for 'poor judgment.' " *Id.*

221. *See* Martin Tolchin, *Legal Scholars Clash Over Neil Bush Actions*, http://www.nytimes.com/1990/09/27/business/legal-scholars-clash-over-neil-bush-actions.html (Sept. 27, 1990). (summarizing arguments before an administrative law judge regarding alleged conflicts of interest violations by Neil Bush).

222. Richard A. Oppel, Jr. & Don Van Natta, Jr., *Bush and Democrats Disputing Ties to Enron*, http://www.nytimes.com/2002/01/12/business/12TIES.html (Jan. 12, 2002).

223. Storelli, *supra* n. 33, at 799–800. At that time " 'Kenny Boy' suddenly became 'Mr. Lay.' " *Id.* (citation omitted).

224. Robert O'Harrow Jr., *Halliburton Charges Jumbled by Edwards and Denied by Cheney*, Wash. Post A08 (Oct. 7, 2004). Edwards raised several matters including a no-bid contract Halliburton received from the federal government and a $7.5 million settlement of accounting related charges by Halliburton with the SEC. *Id.*

225. Charles Babington & Jeffrey H. Birnbaum, *Frist Issue Adds to GOP's Ethics Troubles*, http://www.washingtonpost.com/wp-dyn/content/article/2005/09/24/AR2005092401379.html (Sept. 25, 2005).

> Frist, a wealthy surgeon, "had no information about the company or its performance that was not available to the public when he directed the trustees to sell the HCA stock," his office said.
>
> The senator's spokesmen say he sold the HCA stock to avoid possible conflicts of interest as Congress deals with health care legislation. For years, however, Frist had rejected arguments that his stock holdings could cause a possible conflict.

*Id.*

226. Wall St. J., *The Secret 'Friends of Angelo'*, http://online.wsj.com/article/SB124588865553750813.html (June 25, 2009); "These borrowers, known internally as "friends of Angelo" or FoA, include two former CEOs of Fannie Mae, the biggest buyer of Countrywide's mortgages, say people familiar with the matter . . . . One was James Johnson, a longtime Democratic Party power and an adviser to Sen. Barack Obama's campaign . . . ." Glenn R. Simpson & James R. Hagerty, *Countrywide Friends Got Good Loans*, http://wsj.com/public/ article_print/SB121279970984353933.html (June 7, 2008). Countrywide, the nation's largest mortgage lender, was purchased by Bank of American in an all stock deal in 2008. Ieva M. Augstums, *Bank of America to Buy Countrywide*, http://www.usatoday.com/money/topstories/2008-01-11-2280383570_x.htm?csp=34 (Jan. 11, 2008).

as sales, and book the differences between the cost and the "value" of the assets as profits;[227] raise capital without showing debt on Enron's books and maintain its investment grade credit rating;[228] and allow it to take the position that it had hedged its position on various investments and avoid booking losses.[229]

SPE's have played a big role in a number of corporate scandals or failures. These include Elan Corporation, an Irish corporation. It sold shares of its subsidiaries to SPE's, recorded $40 million in profits, but never received any cash.[230] In addition, Parmalat, Europe's Enron, used SPE's to hide losses through fictitious transactions.[231]

SPE's have played a big role in the recent corporate and financial crises, as well. For example, Citigroup has numerous SPE's. It "lost over 45% of its shareholder value as investors in Citigroup learned Citigroup's capital base had been comprised of massive holdings in off-balance sheet investment entities."[232]

### F. *Concerns that Some (but Certainly Not All) Companies Were Considered "Too Big to Fail"*

The history of some companies being considered too big to fail did not begin with the recent financial/corporate crises. I mentioned a number of corporate bailouts above. Long before AIG, GM, Chrysler, and many others who were bailed out during our recent financial and corporate crises, Long Term Capital Management and a host of other companies were bailed out by the federal government in one manner or another.[233]

However, while GM and Chrysler were bailed out, a large number of auto company suppliers were allowed to go bankrupt with no federal government support given.[234] Similarly, while Continental Illinois was bailed out, many banks and savings & loans went out of business without any governmental support.[235]

Of course, receiving substantial taxpayer financed assistance is really no guarantee.[236] And, the recent meltdown raises the prospect that we may soon get to the point that "a market may become too large for even a central bank to rescue. The market for credit derivatives grew in less than a decade from insignificance to a global volume

227. William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 Tulane L. Rev. 1275, 1306–1307 (2002).

228. *Id.* at 1306–1309.

229. *Id.* at 1316–1318.

230. Gupta, *supra* n. 91, at 12–13.

231. Storelli, *supra* n. 33, 781–785 (the author refers to these SPE's as "accounting dumps").

232. Tyson Taylor, *Detrimental Legal Implications of Off-Balance Sheet Special Purpose Vehicles in Light of Implicit Guarantees*, 11 U. Pa. J. Bus. L. 1007, 1009 (2009). Citigroup ultimately took $45 billion of assets of these entities back onto its own balance sheet. *Id.*

233. See the discussion accompanying *supra* nn. 63-67.

234. *See* Carl Gutierrez, *Auto Parts Suppliers Tap TARP*, http://www.forbes.com/2009/03/19/auto-parts-obama-markets-equity-suppliers.html (March 19, 2009) (reporting that "more than 40 major U.S. suppliers have filed for Chapter 11 bankruptcy protection"). The articles also notes that the federal government had committed to lend "$5.0 billion via its Troubled Assets Relief Program to compensate them for merchandise that they have shipped to carmakers and that have not yet been paid for," citing congressional aides. *Id.*

235. *See supra* n. 16 and accompanying text. Of course, depositors were protected to the extent of the applicable federal deposit insurance program.

236. N.Y. Times, *CIT Group Inc*, http://topics.nytimes.com/top/news/business/companies/cit_group_inc/index.html (Nov. 2, 2009) ("the bankruptcy filing means taxpayers will lose the $2.3 billion investment they made in CIT as part of the government's sweeping financial rescue in 2008 . . . .").

of about $20 trillion in 2006."[237]

*G. Concerns that Many of the Companies Engaged in Almost Meteoric Growth.*

The assets of Penn Square Bank, which failed in 1982, increased more than 15 times between 1974 and 1982.[238] Lincoln Savings and Loan increased its assets from $1.1 billion in 1984 to $5.5 billion in 1988.[239] Global Crossing was founded in 1997 and went into bankruptcy in 2002, unable to pay its $12 billion in debt.[240] Parmalat, Europe's Enron, grew from reported revenues of €500 million in 1990 to €7.7 billion in 2002.[241] At Enron itself, reported revenues grew from $40 billion to $101 billion from 1999 to 2000.[242] WorldCom also engaged in aggressive growth, doing 70 merger and acquisition deals in less than five years.[243]

As to the current crises, Washington Mutual, which in 2008 became the largest bank failure in United States history, had an aggressive growth strategy[244] and the possibility of reckless growth has been raised with respect to a number of other institutions.[245]

*H. Concerns that Being an "Award Winning" or Model Company is No Assurance that the Company is Getting It Right*

"In 1978, Dunn's Review described Continental [Illinois National Bank Trust

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237. Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. Ill. L. Rev. 1359, 1401. "The top four banks have combined assets of $7.4 billion or 56% of the U.S. banking sector's total." Peter Eavis, *Finance Fixers Still Living in Denial*, http://online.wsj.com/article/SB20001424052748704398304574598284287945294.html (Dec. 16, 2009).

238. Susan Lee, *Mickey Mouse in Oklahoma*, http://www.nytimes.com/1985/06/23/books/ mickey-mouse-in-oklahoma.html (June 23, 1985) (reviewing Mark Singer, *Funny Money*).

239. N.Y. Times, *The Lincoln Savings and Loan Investigation: Who is Involved*, http://www.nytimes.com/ 1989/11/22/business/the-lincoln-savings-and-loan-investigation-who-is-involved.html (Nov. 22, 1989).

240. Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 Ind L.J. 723, 777 (2003).

241. Storelli, *supra* n. 33, at 772–773. The author notes that Parmalat's actual revenue in 2002 was only €6.2 billion. *Id.* at 773.

242. Dan Ackman, *Enron's Mysterious, Troubled Core*, http://www.forbes.com/2001/12/14/ 1214topnews_print.html (Dec. 14, 2001).

243. Steve Rosenbush, *Five Lessons of the WorldCom Debacle*, http://www.businessweek.com/technology/ content/mar2005/tc20050316_9160_tc024.htm (Mar. 16, 2005). The author states that when a company "bases its business plan on acquiring even more companies, that's a flashing yellow light. It's a strong signal that the other engines of growth, such as product development, sales, and marketing, aren't very strong." *Id.*

244. Robin Sidel, David Enrich, & Dan Fitzpatrick, *WaMU is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, http://online.wsj.com/article/SB122238415586576687.html (Sept. 26, 2008).

> WaMu, founded in 1889, became a national mortgage- and consumer-lending giant via a string of mergers in the 1990s led by Chief Executive Officer Kerry Killinger. But Mr. Killinger made several missteps. He pursued an aggressive retail expansion marred by poor locations in too many markets. He steered WaMu into subprime mortgages, only to discover too late that the thrift was lending to many unqualified borrowers.

*Id.*; *see also* Drew DeSilver, *Part One: Reckless Strategies Doomed WaMu*, http://seattletimes.nwsource.com/ html/businesstechnology/2010131911_wamu25.html (Oct. 25, 2009).

245. Catherine Clifford & Chris Isidore, *The Fall of IndyMac*, http://money.cnn.com/2008/07/12/news/ companies/indymac_fdic/index.htm?source=yahoo_quote (July 13, 2008) (discussing the demise of IndyMac Bancorp, Inc.). "IndyMac grew rapidly during the real estate and home building boom. Its specialty was so-called Alt-A loans, those for which home buyers were asked to produce little or no evidence of income or assets other than the house they were buying." *Id.*

Company] as one of the five best managed companies in America."[246] Enron Corporation was selected as the most innovative company by Fortune Magazine six years in a row (from 1996 to 2001).[247] Ironically, Enron's Andrew Fastow received CFO Magazine's Excellence Award for Capital Structure Management.[248] Satyam Computer Services was named the 2008 winner of the Golden Peacock Award for Corporate Governance by the World Council for Corporate Governance.[249] It was stripped of this award about four months later.[250]

### *I. Concerns that Government Policies May Have Contributed to the Problem*

In a number of corporate or financial crises or scandals, it is likely that federal policies at least contributed to the problem. Much ink has been spilled over the possible role of governmental policies in creating or contributing to the savings and loan crisis.[251] Even the FDIC and Congress came to the conclusion that brokered deposits, encouraged by deposit insurance, contributed significantly to the collapse of the savings and loan industry, and Congress subsequently imposed restrictions on such deposits.[252]

Similarly, questions have been raised about the role of the federal government's affordable housing policy in creating the recent global financial crisis.[253]Some place much of the blame on lax monetary policy, or blame government policies designed to increase homeownership by encouraging the extension of credit to lower-income households. These policies may have had a direct impact on the securitization of subprime mortgages. "Between 2005 and 2007 Fannie Mae and Freddie Mac were the largest buyers of the AAA tranches from private-label subprime securitizations, and some scholars believe that these entities bought these securities to appease members of Congress."[254]

In addition, Professor Poser argues that the SEC's action in allowing the five

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246. Wharton Fin. Insts. Ctr., *The Collapse of Continental Illinois National Bank and Trust Company: The Implications for Risk Management and Regulation* 8, http://fic.wharton.upenn.edu/fic/case%20studies/continental%20full.pdf (last accessed May 11, 2010).

247. Peter C. Fusaro & Ross M. Miller, *What Went Wrong at Enron: Everyone's Guide to the Largest Bankruptcy in History* 75 (J. Wiley & Sons 2002).

248. *See* Russ Banham, *Andrew S. Fastow–Enron Corp.*, http://www.cfo.com/article.cfm/ 2989389 (Oct. 1, 1999).

249. The Fin. Express, *Satyam Receives Golden Peacock Global Award for Excellence in Corporate Governance*, http://www.financialexpress.com/news/satyam-receives-golden-peacock-global-award-for-excellence-in-corporate-governance/364843/ (Sept. 23, 2008). Satyam Computer also was rated "as the company with [the] Best Corporate Governance Practices for 2006 and 2007." *Id.*

250. The Econ. Times, *Satyam Stripped off* [sic] *Golden Peacock Award 2008*, http://economictimes.indiatimes.com/articleshow/3948408.cms (Jan. 7, 2009).

251. *See e.g.* Bert Ely, *Savings and Loan Crisis*, http://www.econlib.org/library/Enc/SavingsandLoanCrisis.html (last accessed Apr. 24, 2010) (summarizing fifteen public policies that the author believes contributed to the savings and loan crisis); Catherine England, *Lessons from the Savings and Loan Debacle: The Case for Further Financial Deregulation*, 15 Reg. 36 (Summer 1992) (arguing that regulation was the initial cause and exacerbating factor in the crisis).

252. Christine M. Bradley & Lynn Shibut, *The Liability Structure of FDIC-Insured Institutions: Changes and Implications*, 18(2) FDIC Banking Rev. 1, 4 (2006).

253. *See e.g.* U.S. H.R. Comm. on Oversight & Govt. Reform, 111th Cong., *The Role of Government Affordable Housing Policy in Creating the Global Financial Crisis of 2008*, http://republicans.oversight.house.gov/images/stories/Reports/20090707HousingCrisisReport.pdf (July 7, 2009).

254. Hynes, *supra* n. 200, at 259.

largest broker-dealers to become consolidated supervised agencies with the investment bank holding company with which they were affiliated (and thus exempt from the SEC net capital rule) contributed to the multi-billion dollar losses at Bear Stearns, Lehman Brothers, and Merrill Lynch.[255] Others have argued that the federal and state governments are largely responsible for encouraging reliance on credit rating agencies[256] whose ratings have turned out to be (and I'm being charitable here) unreliable.

Interestingly, one author has suggested that the Federal Reserve's response to the bursting of the Dot-Com bubble, namely, "flooding the financial markets with easy credit in an effort to forestall a major recession,"[257] may have contributed "to a housing bubble accompanied by a new and enormous generation of CDOs based on mortgage-backed securities, leading eventually to the great meltdown that began in 2006."[258]

### J. *Concerns that Some Saw or Suspected the Problems that Ultimately Surfaced, While Most Did Not*

In Enron, numerous parties questioned the Enron success story. A March 2001 Fortune Magazine article asked "Is Enron Over Priced?" and raised concerns that no one really understood Enron's business or how it made its money.[259] In addition, while credit rating agencies and major stock analysts hung with Enron almost until the bitter end, and Arthur Andersen gave Enron a clean audit report shortly before its meltdown, by November 1, 2001, six of eight independent investment newsletters were recommending selling Enron shares. Similarly, a number of analysts were able to discern the problems at Parmalat, Europe's Enron.[260]

The Madoff situation and the numerous warnings given to the SEC are common knowledge. Then SEC Chairman Christopher Cox was grilled by Congress about these failures.[261] There are many other examples. These include Brooksley Born's warnings about over-the-counter derivatives.[262] While numerous federal officials lined up against the then chairperson of the Commodity Futures Trading Commission's concept release proposing regulation of these derivatives,[263] her concerns foreshadowed the collapse of

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255. Poser, *supra* n. 205, at 297–299. "Virtually free of SEC regulation, the . . . firms took on enormous risks, using extreme leverage to invest in mortgage-backed securities and other exotic financial instruments." *Id.* at 299.

256. Mendales, *supra* n. 237, at 1373–1376.

257. *Id.* at 1392.

258. *Id.* at 1392–1393; *see also* Brian Blackstone, *Economists Warn of Asset-Price Bubbles*, http://online.wsj.com/article/SB126074172673289729.html (Dec. 14, 2009) ("The financial crisis of the past two years is blamed partly on decisions by policy makers, especially the U.S. Federal Reserve, to keep interest rates very low after the 2001 downturn, despite a recovering economy . . . . Such a policy is a'breeding ground' for asset bubbles, Stephen Roach, chairman of Morgan Stanley Asia, said at a conference in Berlin organized by Columbia University.").

259. Bethany McLean, *Is Enron Overpriced?* http://money.cnn.com/2006/01/13/news/companies/enronoriginal_fortune/index.htm (Jan. 19, 2006).

260. Storelli, *supra* n. 33, at 821–822. The author asks "if the publicly available data was sufficient to lead one analyst to question Parmalat's statements, why did more analysts not voice their concerns?" *Id.* at 822.

261. Associated Press, *SEC Ignored Madoff Fraud Warnings, Faces Grilling*, http://www.foxnews.com/politics/2008/12/16/sec-ignored-madoff-fraud-warnings-faces-grilling/ (last updated Dec. 16, 2008).

262. Manuel Roig-Franzia, *Credit Crisis Cassandra*, http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html (May 26, 2009).

263. These include such household names as Greenspan, Levitt, Rubin, and Summers. *Id.*

Long Term Capital Management (LTCM) in 1998.[264] "Reportedly, LTCM managed to borrow approximately 100 times its capital and to hold derivatives positions with a notional value of approximately $1.25 trillion or 1000 times its capital."[265]

In addition, one can argue that Ms. Born's concerns also presaged the massive problems at AIG, which "had sold $440 billion in credit-default swaps tied to mortgage securities that began to falter. When its losses mounted, the credit-rating agencies downgraded AIG's standing, triggering a clause in its credit-default swap contracts to post billions in collateral that it didn't have."[266]

People who saw problems and raised them, at least internally, include Sherrin Watkins at Enron,[267] Cynthia Cooper, Gene Morse, and Glyn Smith at WorldCom,[268] and Roy L. Olofson at Global Crossing.[269] Recognizing the significance of these whistleblowers, Time magazine named three whistleblowers, including Ms. Cooper and Ms. Watkins, as their Persons of the Year in 2002.[270] In the recent crises, the names of persons who saw and raised problems include Matthew Lee, a senior vice-president at Lehman Brothers Holding Corporation[271] and John P. McMurray at Countrywide Financial Corporation.[272]

In sum, there are usually people who are not involved in corporate or financial chicanery who are aware of it.[273] I will return to the topic of whistle-blowers below.[274]

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264. *See generally* Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long-Term Capital Management* (Random House 2000).

265. Brooksley Born, Speech, *The Lessons of Long-Term Capital Management L.P.* (Chi. Kent-IIT Commodities L. Inst., Chic., Ill., Oct. 15, 1998) (available at http://www.cftc.gov/opa/speeches/opaborn-37.htm).

266. Anthony Faiola, Ellen Nakashima & Jill Drew, *What Went Wrong*, http://www.washingtonpost.com/wp-dyn/content/article/2008/10/14/AR2008101403343.html?sid= ST2008101403344 (Oct. 15, 2008).

267. Bost, *supra* n. 120, at 1097–1099. An argument has been made that Ms. Watkins was, in fact, not a whistle blower at all, but rather simply provided cover for Ken Lay and the Enron board of directors. *See* Dan Ackman, *Sherron Watkins Had Whistle, But Blew It*, http://www.forbes.com/2002/02/14/0214watkins.html (Feb. 14, 2002). "A whistle-blower, literally speaking, is someone who spots a criminal robbing a bank and blows a whistle, alerting the police. That's not *Sherron Watkins*." *Id.* (emphasis in original). Professor Macey concludes she was a "self-interested whistleblower" whose objective was to "retain her employment and to protect her pension savings." Jonathan Macey, *Getting the Word Out about Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 Mich. L. Rev. 1899, 1907–1908 (2007). He also concludes, "Watkins clearly identified herself with the management team that created the scandal . . . ." *Id.* at 1908.

268. Susan Pulliam & Deborah Solomon, *How Three Unlikely Sleuths Exposed Fraud at WorldCom*, http://online.wsj.com/article/SB1035929943494003751.html (Oct. 30, 2002).

269. Barbara Whitaker, *An Accountant Who Raised Enronian Issues*, http://www.nytimes.com/2002/02/17/business/an-accountant-who-raised-enronian-issues.html (Feb. 17, 2002).

270. *See* Richard Lacayo & Amanda Ripley, *Persons of the Year 2002: Cynthia Cooper, Coleen Rowley and Sherron Watkins*, http://www.time.com/time/subscriber/personoftheyear/2002/poyintro.html (Dec. 22, 2002).

271. Michael Corkery, *Insider Warned About Lehman Accounting*, http://online.wsj.com/article/SB10001424052748703447104575118122594094284.html (Mar. 13, 2010). Mr. Lee was ousted shortly after raising his concerns. Sakthi Prasad, *Lehman Brothers' Whistle Blower was Ousted: Report*, http://www.reuters.com/article/idUSTRE62F0XP20100316 (Mar. 16, 2010).

272. Steve Eder & Rachelle Younglai, *Countrywide Exec Warned About Mortgage Risks*, http://www.reuters.com/article/idUSTRE5546JT20090605?feedType=RSS&feedName=businessNews&rpc=23&sp=true (June 5, 2009). Mr. McMurray was the Chief Risk Officer. *Id.*

273. *See* Jonathan D. Glater, *Survey Finds Fraud's Reach in Big Business*, http://www.nytimes.com/2003/07/08/business/survey-finds-fraud-s-reach-in-big-business.html (July 8, 2003) (reporting on survey finding that whistleblowers reported 36% of corporate frauds).

274. *See infra* pt. IX.

### K. Concerns that All the Crooks Would Escape Punishment

These concerns may well be unwarranted. People go to jail for long periods of time under existing laws. Although scandals and failures often generate calls for the legislative recognition of new crimes or increased penalties for existing crimes, existing laws are often more than adequate to send miscreants to prison for extended periods of time. For example, while Sarbanes-Oxley created new crimes and enhanced the penalties for a number of existing crimes,[275] numerous corporate executives were sentenced to prison for long periods of time under pre-Sarbanes-Oxley state and federal laws. These include: former Enron CEO Jeffrey Skilling, sentenced to 24 years and 4 months;[276] Enron founder Kenneth Lay, who was convicted but died prior to sentencing;[277] former Enron CFO Andrew Fastow, sentenced to 10 years, later reduced to 6 years for his cooperation with the government in the case;[278] founder and former WorldCom CEO Bernard Ebbers, sentenced to 25 years;[279] former WorldCom CFO Scott Sullivan, sentenced to 5 years;[280] former Tyco International CEO L. Dennis Kozlowski and former Tyco International CFO Mark Swartz, sentenced to 8 1/3 and 25 years;[281] founder of Adelphia Communications, John Rigas, sentenced to 12 years and former CFO of Adelphia Timothy Rigas sentenced to 17 years;[282] ex-Refco, Inc. CEO Phillip Bennet, sentenced to 16 years;[283] ex-HealthSouth vice-president Hannibal "Sonny" Crumpler, sentenced to 8 years;[284] and ex-HealthSouth CFO William Owens, sentenced to 5 years.[285] I could go on.

I have not mentioned all the "small fish" convicted in the various corporate scandals of the last ten years[286] or all the successful SEC enforcement actions based upon pre-Sarbanes-Oxley laws. The Corporate Fraud Task Force established by President Bush in July of 2002 reported in July of 2007 more than 1,200 convictions,

275. *See supra* n. 96.

276. Carrie Johnson, *Skilling Gets 24 Years for Fraud at Enron*, http://www.washingtonpost.com/wp-dyn/content/article/2006/10/23/AR2006102300287.html (Oct. 24, 2006). Skilling's conviction was affirmed on appeal, but his sentence was vacated and the case remanded for resentencing. The Supreme Court granted certiorari in the case. *Skilling*, 554 F.3d 529, *cert. granted*, 130 S. Ct. 393.

277. As a consequence of his death, Lay's sentence was vacated under the doctrine of abatement. *U.S. v. Lay*, 456 F. Supp. 2d 869 (S.D. Tex. 2006), *mandamus denied*, No. 06-20848 (5th Cir. Nov. 1, 2006).

278. Carrie Johnson, *Feeling 'Slap in the Face' After Fastow's Sentence*, http://www.washingtonpost.com/wp-dyn/content/article/2006/10/02/AR2006100201280.html?nav=emailpage (Oct. 3, 2006).

279. Jennifer Bayot, *Ebbers Sentenced to 25 Years in Prison for $11 Billion Fraud*, http://www.nytimes.com/2005/07/13/business/13WIRE-EBBERS.html?ei=5090&en=157897ba56c425a7&ex=1278907200&pagewanted=print (July 13, 2005).

280. Sullivan received a relatively light sentence as a result of his cooperation with the government. Associated Press, *Sullivan Gets Five Years for WorldCom Fraud*, http://www.msnbc.msn.com/ id/8907976/ (Aug. 11, 2005).

281. Reuters, *Ex-Tyco Executives' Appeal Rejected*, http://www.nytimes.com/2008/10/17/business/17tyco.html?_r=1&fta=y&pagewanted=print (Oct. 17, 2008). Kozlowski and Swartz were convicted on state law charges and these convictions were upheld upon appeal. *People v. Kozlowski*, 898 N.E.2d 891 (N.Y. 2008).

282. *See U.S. v. Rigas*, 583 F.3d 108 (2d Cir. 2009) (affirming sentences imposed after resentencing).

283. Bray, *supra* n. 25.

284. Associated Press, *HealthSouth Executive Sentenced to Eight Years*, http://articles.latimes.com/2006/jun/16/business/fi-healthsouth16 (June 16, 2006).

285. Kyle Whitmire, *Executive Gets 5-Year Term in Fraud Case*, http://www.nytimes.com/2005/12/10/business/10health.html?pagewanted=print (Dec. 10, 2005).

286. For example, nineteen former Enron executives either pled or were found guilty. CBC News Online, *From Collapse to Convictions: A Timeline*, http://www.cbc.ca/news/background/enron/ (Oct. 23, 2006).

including 200 chief executives and presidents, 53 CFOs, and 23 corporate lawyers.[287]

Perhaps not to be outdone, President Obama created a new Financial Fraud Enforcement Task Force in November of 2009 to replace the Bush Task Force.[288] This Task Force will focus on mortgage fraud, securities fraud, Recovery Act and rescue fraud, and discrimination in the financial markets.[289]

### L. *Concerns that Government Support of or Assistance to Some Companies Place Others at a Competitive Disadvantage*

There is a continuing debate regarding whether government assistant to some but not all companies, or on different terms to some companies than others, gives some companies a competitive advantage. Some AIG competitors have claimed that AIG has been able to price commercial insurance at a price that is out of line with the risks it is assuming.[290] In addition, the fact that a company is not only viewed as too big to fail but has also received federal governmental support may give it an advantage in raising capital.[291]

### M. *Where does This Discussion Lead?*

Professor Geoffrey Miller wrote an excellent article in 2004 in which he looked at six corporate "catastrophes" and points out a number of the "apparent common features."[292] Some the items mentioned are the same or similar to those I discuss. However, he identifies additional things, including poor underlying performance, domination by a single person or a small group, lavish expenditures and disproportionate management compensation, image management, and drastic changes in the nature of the business. He concludes: "The multiple overlaps among the six firms examined suggests that regulators, analysts, and providers of financing may usefully study firms with an eye toward detecting undue accumulation of these warning signs."[293] Recent events suggest the continuing wisdom of his suggestion.

In addition, this discussion suggests that a whole heap of new law may not be the answer, at least on the corporate governance side of the equation. Because the wrongdoers in the Enron era scandals were "prosecuted by criminal laws long on the

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287. Carrie Johnson, *U.S. Promotes Its Record on Corporate Crime*, http://www.washingtonpost.com/wp-dyn/content/article/2007/07/17/AR2007071701767.html (July 18, 2007).

288. Jim Puzzanghera, *Financial Crime Targeted*, http://www.post-gazette.com/pg/09322/1014319-84.stm (Nov. 18, 2009).

289. Eric Holder, U.S. Atty. Gen., Speech, *Financial Fraud Enforcement Task Force Press Conference* (D.C., Nov. 17, 2009) (available at http://www.justice.gov/ag/speeches/2009/ag-speech-091117.html).

290. *See* U.S. Govt. Accountability Off., *Test. Before the Subcomm. on Capital Mkts., Ins. & Govt. Sponsored Enter.: Federal Financial Assistance: Preliminary Observations on Assistance Provided by AIG*, 12–13, http://www.gao.gov/new.items/d09490t.pdf (Mar. 18, 2009) (statement of Orice M. Williams, Dir. Fin. Mkts. And Community Inv.).

291. Michael R. Crittenden & Matthias Rieker, *Clash Over "Too Big to Fail,"* http://online.wsj.com/article/SB10001424052748704187204575101511215418730.html (March 5, 2010) (noting a ratings-company report referring to federal backing of Citigroup, Elizabeth Warren, member of Congressional Oversight Panel, stated: "That gives Citi an advantage in raising capital.").

292. Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 Cornell L. Rev. 423, 423–425 (2004) (the companies are WorldCom, Enron, Lincoln Savings, HIH Insurance Group, EIEI International, and Bank of Credit and Commerce International).

293. *Id.* at 454.

books, a legislator might view the problem as one already adequately addressed by law."[294] In addition, more law may simply be, as one author described it, insisting "on a redundancy of corrective devices that are more bureaucratic than effective."[295] Any new laws should be laser-focused to improve existing compliance and law enforcement efforts.

Finally, the discussion suggests the need, going forward, to focus more closely on the potential unintended consequences of laws and regulations.

## VIII. "CURIOUSER AND CURIOUSER!"[296] HOLDING THE SEC, OTHER FEDERAL AGENCIES, AND FEDERAL OFFICIALS AND EMPLOYEES RESPONSIBLE

*"If I had a world of my own, everything would be nonsense. Nothing would be what it is, because everything would be what it isn't. And contrary wise, what is, it wouldn't be. And what it wouldn't be, it would. You see?"*

–The Mad Hatter[297]

*"All animals are equal, but some animals are more equal than others."*

–George Orwell[298]

Federal government executive agencies and departments, officials, employees, and agents are generally not covered by the securities fraud provisions of the Securities Exchange Act of 1934. In addition, the liability of the federal government for negligence under the Federal Torts Claims Act is limited, and federal employees acting within the scope of their employments are immune from liability for negligence. This may lead to an unwise exculpation of federal entities and representatives for culpable behavior and an unfair allocation of responsibility for damages to investors.

Section 10(b) of the Securities Exchange Act of 1934 includes a broad provision making it

> unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or

294. Loewenstein, *supra* n. 131, at 383 (focusing on possible causes of failure of state legislatures to respond to the Enron era corporate scandals). After Enron, Professor Cunningham wrote: "Regulations are all in place. There are also criminal laws relating to accounting, auditing, and disclosure that landed in jail top executives at companies rocked by recent accounting scandals, along with hefty civil penalties for associated professionals." Cunningham, *supra* n.5, at 1428.

295. Mark, supra n. 85, at 1076. According to Chancellor Strine, "Enron and corporations like it are dangerous not only for the obvious harm they cause . . . but also because they generate the potential for over-reaction by policymakers, to the overall detriment of our economic well-being." Strine, *supra* note 186, at 1401.

296. Lewis Carroll, *Alice's Adventures in Wonderland* 21 (Rand, McNally & Co. 1902). "[S]he was so much surprised that for the moment she quite forgot how to speak good English." *Id.*

297. *Alice in Wonderland* (Disney 1951) (motion picture).

298. George Orwell, *Animal Farm* 88 (Alfred A. Knopf 1993).

appropriate in the public interest or for the protection of investors.[299]

Pursuant to this provision, the SEC promulgated its Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[300]

This provision has been found to prohibit, among other things, a person from trading on confidential information that she misappropriates in violation of a fiduciary duty.[301] Thus, § 10(b) is not limited in coverage to the deception of a purchaser or seller. It reaches any deceptive device in connection with the purchase or sale of a security. While *Chiarella v. United States*[302] requires a breach of duty, a breach of duty owed to the source of information is enough for criminal liability.[303] It need not be a breach of duty to a trading party. The person deceived is the person who entrusted the information to the fiduciary.[304]

In addition, § 10(b) and Rule 10b-5 prohibits a party from making a false statement or omitting to state a fact necessary to make those statements that were made not misleading in connection with the purchase or sale of a security. While Congress[305] and the Supreme Court[306] have narrowed down somewhat the scope of civil liability under

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299. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

300. 17 C.F.R. § 240.10b-5 (2009).

301. *U.S. v. O'Hagan*, 521 U.S. 642 (1997) (upholding the criminal conviction of a law firm partner who purchased call options for and shares of Pillsbury after learning that a client of the firm planned to make a tender offer for the company).

302. 445 U.S. 222 (1980).

303. *O'Hagan*, 521 U.S. at 652–653.

304. *Id.*

305. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995).

306. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (holding that only actual purchasers or sellers of securities have standing to bring a private cause of action for damages under § 10(b)); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 201 (1976) (holding that scienter, for purposes of a private cause of action under § 10(b), requires intent to deceive, manipulate, or defraud and does not include negligence); *Santa Fe Indus., Inc*, 430 U.S. 462 (holding that some element of deception, manipulation, or nondisclosure is required; there is no cause of action under § 10(b) for mere breach of fiduciary duty or corporate mismanagement); *C. Bank of Denver, N.A.*, 511 U.S. at 191 (holding that there is no civil liability for aiding and abetting a § 10(b) violation); *Basic Inc. v. Levinson*, 485 U.S. 224, 231–232 (1988) (holding that the standard for materiality under § 10(b) is whether there is a substantial likelihood a reasonable shareholder would consider it to be important and rejecting a "might" think it important standard); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 346–347 (2005) (deciding that a complaint that merely alleges the purchase of a security at an inflated price does not adequately plead loss causation); *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 159, 166, (2008) (holding that investors in corporation could not invoke rebuttable presumption of reliance against vendors and suppliers of corporation who had no duty to disclose corporation's fraud; investors did not rely upon any actions of these parties; in addition, vendors and suppliers could not be held liability under "scheme liability" theory because the alleged conduct "took place in the marketplace for goods and services, not in the investment sphere"). In one respect, *Basic Inc.* took an expansive view of liability under § 10(b). A plurality of the Court accepted the fraud-on-the-market presumption of reliance with

§ 10(b) and Rule 10b-5, numerous § 10(b) cases were brought as a result of the Enron debacle[307] and other contemporaneous corporate failures. In addition, a number of cases have been brought as a result of events occurring during the recent series of financial crises and scandals.[308]

Similarly, § 14(a) of the Securities Exchange Act of 1934 makes it unlawful to solicit proxies in respect of the securities of publicly held corporations in contravention of SEC rules.[309] One of the rules that the SEC has promulgated pursuant to this statutory authorization is Rule 14a-9, which prohibits the making of false or misleading statements in the solicitation of such proxies.[310] The Supreme Court has held that there is an implied cause of action for violation of Rule 14a-9.[311]

The Securities Exchange Act of 1934 also imposes joint and several liability on a controlling person, subject to a good faith defense. It provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.[312]

There are a number of cases that confront the question of what is necessary to be a controlling person under this provision. Generally, "control" means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[313]

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respect to public material misrepresentations relating to securities traded in open and developed markets. *Basic, Inc.*, U.S. at 241–249.

307. *See In re Enron Corp. Sec., Derivative & "ERISA" Litigation*, 196 F.Supp.2d 1375 (M.D.L. 2002) (consolidating 54 Enron related lawsuits in the Southern District of Texas for pretrial proceedings).

308. *See* Advisen Productivity & Insight for Ins. Profs., *Securities Suits Abound in a Harsh 2009*, https://www.advisen.com/downloads/sec_lit_Q42009.pdf (last accessed May 27, 2009). Advisen reports:

> Lawsuits filed in response to the credit crisis started growing in number beginning in February 2007. Subprime mortgage suits, which hail back to 2005 fall within the larger credit-crisis umbrella. Through the end of 2009, 1,005 total credit crisis suits have been filed. Of this total, 342 were securities suits.
>
> . . .
>
> Madoff-related cases filed since the fraud was disclosed on December 11, 2008 comprise 251 lawsuits in total through the end of 2009 . . . .

*Id.* at 15.

309. Securities Exchange Act of 1934, 15 U.S.C. § 78n(a).

310. 17 C.F.R. § 240.14a-9.

311. *J.I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964). The approach the Court used in *Borak* to find an implied case of action is no longer followed by the Court. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102–1104 (1991). However, the Court has never repudiated the implication of a cause of action under § 14(a). *Id.* at 1104 n. 11 (noting that the Court, in refusing to expand the cause of action under § 14(a), was not questioning the holding of *Borak*); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 577 (1979) (stating, "[w]e do not now question the actual holding of that case, but we decline to read the opinion so broadly that virtually every provision of the securities Acts gives rise to an implied private cause of action").

312. Securities Exchange Act of 1934, 15 U.S.C. § 78t(a); *see generally* Erin L. Massey, *Control Person Liability Under Section 20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 Hous. Bus. & Tax L.J. 109 (2005) (discussing, among other things, the differences among federal courts on the control person question).

313. 17 C.F.R. § 240.12b-2(iv)(2).

The definition of "person," for purposes of liability under § 10(b), is very broad. It means "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."[314] However, the Act also provides:

> No provision of this chapter shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.[315]

Consequently, federal government agencies and employees are generally not subject to civil damage liability for primary violations of § 10(b), subject to enforcement action for aiding and abetting primary violations, or subject to control person liability[316] In contrast, state and local governmental officials and employees, as well as state and local governments and any agency or instrumentality of these governments, would be included within the broad definition of "person" under the Securities Exchange Act and are not included within the exclusion discussed above.

Prior to the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), liability under § 10(b) and Rule 10b-5 was joint and several. As a result, a defendant whose role in causing injuries was relatively minor could be held liable for all of a plaintiff's damages. The PSLRA amended the Securities Exchange Act of 1934 to substitute a system of proportionate liability in securities fraud cases in which liability is based upon unknowing conduct.[317] However, it permits joint and several liability to be imposed upon a "covered person" if the trier of fact determines that the covered person "knowingly committed a violation of the securities laws."[318] Consequently, a covered person who did not knowingly commit a violation of the securities laws is "liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person."[319] "Covered person" is defined as "a defendant in any private action arising under [title 15]."[320]

The PSLRA requires that the jury answer special interrogatories or the court make findings of fact regarding several matters including "the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or

314. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(9).

315. *Id.* at § 78c(c).

316. While the Supreme Court held in *C. Bank of Denver, N.A.* that there is no cause of action for aiding and abetting a violation of § 10(b) and Rule 1b-5, Congress has overridden this with regards to SEC enforcement action. *C. Bank of Denver, N.A.*, 511 U.S. at 191; Securities Exchange Act of 1934, 15 U.S.C. § 78t(e) (added by the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737, 757 (1995)).

317. Pub. L. No. 104-67, § 201, 109 Stat. 737, 758-762 (adding new subsection (g), now (f), to 15 U.S.C. § 78u-4 of the Securities Exchange Act of 1934). After Enron, bills were introduced in Congress that would expand or restore joint and several liability in securities fraud cases. These bills did not make it into law. *See* Accountability for Accountants Act of 2002, H.R. 3617, 107th Cong. § 2 (Jan 23, 2002); Comprehensive Investor Protection Act of 2002, H.R. 3818, 107th Cong. § 12 (Feb. 28, 2002); Investor Protection Act of 2002, Sen. 1933, 107th Cong. § 2 (Feb. 12, 2002).

318. Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(f)(2)(A).

319. *Id.* at § 78u-4(f)(2)(B)(i).

320. *Id.* at § 78u-4(f)(10)(C)(i). The definition also includes outside directors who are defendants in actions under § 11 of the Securities Act of 1933. *Id.* at § 78u-4(f)(10)(C)(ii).

contributed to the loss incurred by the plaintiff."[321] In determining each person's percentage of responsibility, the trier of fact is to consider: "(i) the nature of the conduct of each covered person found to have caused or contributed to the loss incurred by the plaintiff or plaintiffs; and (ii) the nature and extent of the causal relationship between the conduct of each such person and the damages incurred by the plaintiff or plaintiffs."[322]

Since the word "person" does not include federal governmental executive departments, establishments, or lending agencies, or officials, employees, or agents acting within the course of official duty,[323] presumably such an entity or individual cannot be a "covered person" for purposes of proportional liability. Consequently, a person who is held liable for a primary violation of § 10(b) and Rule 10b-5 or for a violation of § 14(a) and Rule 14a-9, may not have the fault of any of these parties considered for proportional liability purposes.

This makes the recent furor over Bank of America's (BOA's) apparent failure to disclose huge losses at Merrill Lynch prior to shareholder approval of the merger even more interesting. Kenneth Lewis, the then president of BOA, testified under oath that BOA was pressured by Federal Reserve Chairman Ben Bernanke and then Treasury Department chief Henry Paulson not to discuss the troubles at Merrill Lynch and that he believed they were telling him not to disclose Merrill's difficulties.[324] BOA's and Lewis' failure to disclose this material information may have violated both § 14(a) and § 10(b), since the proxy process was necessary to garner BOA shareholder approval of the merger and BOA issued over a billion shares of stock in exchange for Merrill Lynch shares.[325] Presumably, this would constitute a "sale" of shares for § 10(b) purposes.[326] In addition, the failure of Lewis and others to disclose that Merrill Lynch was expecting to report a $15 billion loss before the deal went through on December 31, 2008, means that everyone who purchased BOA shares between that date (or possibly even earlier) and expected disclosure of the true facts may have a securities fraud claim against various parties. These parties will not, however, include Bernanke and Paulson, even should it turn out that they were complicit in the non-disclosure of this information. This hardly seems fair or appropriate.

The exclusion of federal government entities and officials, employees, and agents may be more significant than ever given the significantly increased role of the federal government in private business. The federal government recently took large equity stakes in Chrysler, GM, AIG, Citibank, and other financial institutions. For example, "Treasury owns 9.85 percent of the common equity in the restructured Chrysler and 60.8 percent of

321. *Id.* at § 78u-4(f)(3)(A)(ii).

322. Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(f)(3)(C).

323. *See id.* at § 78c(a)(9) (discussing definition of "person" applicable to the Act).

324. Liz Rappaport, *Lewis Testifies U.S. Urged Silence on Deal, The* http://online.wsj.com/article/SB124045610029046349.html (Apr. 23, 2009); *see also* Robert Lenzer, *Lies, Threats, Deal: Paulson, Bernanke, Lewis,* http://www.forbes.com/2009/04/23/lewis-bernanke-paulson-personal-finance-investing-ideas-merrill-lynch.html (Apr. 23, 2009).

325. *See Bank of America Definitive Proxy Statement, Information Required in Proxy Statement Schedule 14A Information* 115 (Oct. 31, 2008) (available at http://www.sec.gov/Archives/edgar/data/70858/000095012308014243/g15211badefm14a.htm).

326. "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(14).

the common equity, plus $2.1 billion in preferred stock in the restructured GM."[327] In addition, a trust with the U.S. Treasury as beneficiary, managed by three trustees, holds "convertible preferred shares representing approximately 77.9 percent of the current voting power of the AIG common shares,"[328] and, in exchange for its assistance to Citigroup, the Treasury Department held an equity position of almost 34 percent in July of 2009.[329] It also holds 56 percent of the shares in auto lender GMAC.[330] The specific numbers are not important. What is significant is that the federal government has become a major player in a number of large American businesses. It is the majority shareholder in GM, AIG, and GMAC.

President Obama has declared the federal government to be a "reluctant shareholder" in GM and vowed a "hands-off" approach.[331] It is notable, however, that the White House exercised its influence as a lender to oust GM CEO Wagner prior to the federal government becoming a GM shareholder.[332] In addition, the government has imposed conditions on both Chrysler and GM that, one could argue, are more political than business in nature.

> Chrysler must either manufacture 40 percent of its U.S. sales volume in the United States or its U.S. production volume must be at least 90 percent of its 2008 U.S. production volume . . . . GM must use its commercially reasonable best efforts to ensure that the volume of manufacturing conducted in the U.S. is consistent with at least 90 percent of the level envisioned in GM's business plan.[333]

The President's "hands-off" approach also did not stop him from telephoning Detroit Mayor David Bing to assure him that GM headquarters would stay in Detroit and not move to Warren, Michigan.[334] A number of members of Congress also appear quite willing to interject themselves into decisions at GM.[335]

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327. U.S. Govt. Accountability Off., *Test. Before the Subcomm. on Dom. Policy, Comm. on Oversight and Govt. Reform*: *Trouble Asset Relief Program: The U.S. Govt. Role as Shareholder in AIG, Citigroup, Chrysler and General Motors and Preliminary Views on its Investment Management Activities* 11, http://www.gao.gov/new.items/d10325t.pdf (Dec. 16, 2009) (statements of Orice Williams Brown, Dir. Fin. Mkts. And Community Inv., and A. Nicole Clowers, Acting Dir. Physical Infrastructure) [hereinafter *TARP Testimony*].

328. *Id.* at 10.

329. *Id.* at 11.

330. Binyamin Appelbaum, *U.S. Takes Majority Stake in GMAC, Giving Lender $3.8 Billion More in Aid*, http://www.washingtonpost.com/wp-dyn/content/article/2009/12/30/AR2009123002049.html (Dec. 31, 2009).

331. David Jackson, *Obama Vows 'Hands-off' Approach in GM Stake*, http://www.usatoday.com/news/washington/2009-06-01-gmobama_N.htm (June 2, 2009).

332. Associated Press, *Obama Fires GM's CEO*, http://www.suntimes.com/business/1501561%2Cw-obama-gm-wagoner032909.article (Mar. 29, 2009).

333. *TARP Testimony*, *supra* n. 327, at 14.

334. Wall St. J., *Busy Not Running GM*, http://online.wsj.com/ article/SB124389952143874411.html (June 3, 2009); *see also* Joann S. Lublin, *U.S.'s Role Expands in the Boardroom*, http://online.wsj.com/article/SB125971955152172159.html (Dec. 2, 2009) (noting that Representative Barney Frank demanded GM keep a Massachusetts facility open).

335 Neil King, Jr., *Politicians Butt In at Bailed-Out GM*, http://online.wsj.com/article/SB125677552001414699.html (Oct. 30, 2009).

> Federal support for companies such as GM, Chrysler Group LLC and Bank of America Corp. has come with baggage: Companies in hock to Washington now have the equivalent of 535 new board members–100 U.S. senators and 435 House members.
>
> Since the financial crisis broke, Congress has been acting like the board of USA Inc., invoking the infusion of taxpayer money to get banks to modify loans to constituents and to give more help to those in danger of foreclosure. Members have berated CEOs for their business practices and pushed

In sum, if the federal government's departments and agencies and their officials, employees, and agents are going to be actively involved in the market as shareholders, selectors of corporate CEO's and directors, and determiners of corporate policy (which may be heavily influenced by political considerations), shouldn't the Securities Exchange Act of 1934 apply to them? It would be very simple. All that would be required is to delete § 3(c) of the Act set out above[336] and amend the definition of "person" in § 3(a)(9) to make absolutely clear that Congress intends to waive the federal government's sovereign immunity as to civil actions under the Act. Presumably adding the language "including any agency, department or instrumentality of the United States and any officer, agent, or employee thereof" at the end of the current definition would be sufficient.

If this were done, the federal government's departments and agencies, officials, employees, and agents could be liable as primary violators of the Act, as aiders or abettors of primary violations (in SEC enforcement actions), or as control persons in appropriate cases. In addition, the fault of these parties could be taken into account in establishing the appropriate proportional liability for defendants in securities fraud cases.

In the BOA-Merrill Lynch matter, Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke offered BOA CEO Kenneth Lewis a large package of taxpayer funded incentives to go through with the deal. This offer was made on December 17, 2008, but not disclosed by any of the principals involved prior to the closing of the BOA-Merrill Lynch merger on December 31.[337] As one commentator noted, the irony is that ". . . the U.S. federal government, which has for upward of 70 years urged ever more transparency for publicly traded companies, didn't feel the urge to tell of a mid-December financing agreement that affected the future and value of two of the U.S's biggest financial institutions."[338] Yes, it is ironic.

Beyond the type of issue suggested by the BOA-Merrill Lynch situation, the possibility also exists that the federal government could trade on non-public information. One commentator has stated that "[t]he Treasury would . . . cause tremendous damage to the financial markets if it were to trade its TARP preferred shares using the voluminous inside information is [sic] possesses through its regulatory and market interactions with the banks participating in TARP."[339]

*A Few Comments on the Federal Torts Claims Act.*

Two investors have brought a negligence claim against the United States based

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> for caps on executive pay. They have also pushed GM and Chrysler to reverse core decisions designed to cut costs, such as closing facilities and shuttering dealerships.

*Id.*

336. Securities Exchange Act of 1934, 15 U.S.C. § 78c(c).

337. Dennis K. Berman, *BofA's Merrill Deal Exposes Myth of Transparency*, http://online.wsj.com/article/SB123241223885296179.html?mod=article-outset-box (Jan. 20, 2009).

338. Heidi N. Moore, *Bank of America: How to Lose $20 Billion of Value in 2 Trading Days*, http://blogs.wsj.com/deals/2009/01/20/bank-of-america-how-to-lose-20-billion-of-value-in-2-trading-days/ (Jan, 20, 2009).

339. J.W. Verret, *The U.S. Government as Control Shareholder of the Financial and Automotive Sector: Implications and Analysis*, http://mercatus.org/uploadedFiles/Mercatus/Events/CHC_-_2009_FMWG_II_-_Verret_Handout.pdf (last accessed Apr. 21, 2010).

upon the SEC's handling of the Madoff situation[340] and at least seven more have filed administrative claims with the SEC,[341] a prerequisite to bringing a tort claim under the Federal Torts Claims Act.[342] While one can understand the plaintiffs' discontent with the SEC's handling of the matter, they would seem to face a daunting challenge in the case. The United States has moved to dismiss the case on the grounds of the discretionary function exception to Federal Torts Claims Act liability.[343]

It will be interesting to see how the federal courts respond to the argument that the SEC's inexcusable failure to halt Madoff's massive Ponzi scheme did not involve discretionary functions and also breached a duty to these investors. The SEC employees who actually mishandled the Madoff matter are, of course, immune from liability. The Federal Torts Claims Act remedy against the government is the exclusive remedy of a person "for injury or loss of property, or personal injury or death arising or resulting from the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment."[344]

## IX. "FOR A FEW DOLLARS MORE":[345] BRING IN THE BOUNTY HUNTERS

*"And now for something completely different."*[346] *"Not!"*[347]

–*Monty Python* and *Wayne's World*

What is clear is that Sarbanes-Oxley and other federal laws and regulations did not prevent the recent crises that have emerged in the last few years. One reason is that Sarbanes-Oxley cannot prevent mismanagement of a company or cure a company's lack of competitiveness. But, beyond that, corporate fraud and accounting irregularities are

340. Pl.'s Resp. Mot. Dismiss, *Molchatsky v. U.S.*, 1:09-cv-08697 (S.D. N.Y. 2009); *see also* Kara Scannell, *Two Investors Sue SEC Over Madoff Probe*, http://online.wsj.com/article/SB125553847707385223.html ?mod=WSJ_hps_LEFTWhatsNews (Oct. 15, 2009). After the collapse of the Bank of Credit and Commerce International, creditors of BCCI brought suit against the Bank of England seeking to recover on the basis of the tort of misfeasance in public office. The suit was unsuccessful. *See* Noel Cox, *Challenging the State: The Tort of Misfeasance in Public Office and the Case of* Three Rivers District Council v. The Bank of England 9–21, http://works.bepress.com/cgi/viewcontent.cgi?article=1008&context=noel_cox (last accessed May 27, 2010) (good discussion of case).

341. Erik Larson, *SEC Seeks Dismissal of Madoff Victims Negligence Suit*, http://www.bloomberg.com/apps/news?pid=20601103&sid=aXSJgft70cJo (Dec. 15, 2009).

342. *See* 28 U.S.C. § 2675 (2006).

343. Larson, *supra* n. 341; *see also* 28 U.S.C. § 2680(a) (stating the discretionary function exception).

344. 28 U.S.C. § 2679(b)(1). The exceptions are civil actions brought against a federal employee for a violation of the U.S. Constitution or for violation of a U.S. statute "under which such action against an individual is otherwise authorized." *Id.* at § 2679(b)(2)(B).

345. *For a Few Dollars More* (United Artists 1965) (motion picture) (a movie released in the United States in 1967, in which Lee Van Cleef played Colonel Douglas Mortimer and Clint Eastwood played Monco, two bounty hunters on the trail of a bad guy named Indio); *see also* Intl. Movie Database, *Per Qualche Dollaro in Più*, http://www.imdb.com/title/tt0059578/ (last accessed Apr. 23, 2010).

346. *Monty Python*, "And Now for Something Completely Different" (Columbia Aug. 22, 1972) (TV series). "And Now for Something Completely Different" is also the title of "[a]n anthology of Monty Python's best sketches from their 1st & 2nd seasons of their original TV show." Intl. Movie Database, *And Now for Something Completely Different*, http://www.imdb.com/title/tt0066765/ (last accessed Apr. 23, 2010).

347. *Wayne's World* (Paramount 1992) (motion picture). "Not!" is a catchphrase popularized in this movie. It is used "after apparently affirmative sentences in order to state the contrary." Wikipedia, *Wayne's World (film)*, http://en.wikipedia.org/wiki/Wayne%27s_World_(film) (last accessed Apr. 23, 2010).

simply impossible to totally root out.[348]

The question is, what should be done in response to the recent meltdowns. Are more laws and regulations the answer? If so, what shape should they take? Additional crimes, enhanced fines or penalties, more federal oversight, or federally imposed corporate governance standards? If so, are the benefits worth the price?[349] Or maybe something different?

There are already provisions in federal securities laws requiring auditors of public companies and attorneys appearing or practicing before the SEC to take specified actions when aware of information concerning designated wrongdoings. In addition, whistle-blowers within reporting companies now enjoy protections established by Sarbanes-Oxley.

One thing we need is a stronger incentive for private parties to come forward with information about corporate frauds and improper corporate accounting.[350] There is precedent in federal law for the use of bounties to reward informants in some types of cases. I propose that a system of bounties be established for informants with information about corporate frauds or materially faulty financial statements, as discussed below. My proposal leverages existing reforms with respect to gatekeepers and, consequently, should be comparatively inexpensive and effective.

As mandated by Sarbanes-Oxley,[351] the SEC adopted rules requiring attorneys who appear or practice before it to report any material violation of the securities laws, breach of fiduciary duty, or similar violation[352] by the corporation or any corporate agent "up-the-ladder" to the chief legal officer or to both the chief legal officer and CEO.[353] If that person does not respond appropriately to the evidence within a reasonable time, it must be reported to the audit committee of the board of directors, another board committee composed solely of independent directors not employed by the company, or to the board of directors itself.[354] If a corporation has established a "qualified legal compliance committee," an attorney can satisfy her reporting obligation by reporting the material violation to that committee.[355]

348. *See* Symposium Panel Discussion, *Enron: What Went Wrong?* 8 Fordham J. Corp. & Fin. L. S1 (2002). "Most of the people that complain about recent accounting meltdowns have very short memories." *Id.* at S12 (comments of Daniel Dooley, Partner, PricewaterhouseCoopers, LLP).

349. "In an economically rational world we would not want to prevent all fraud, because that would be too expensive. Instead, the goal should be to keep spending on fraud prevention until the returns on a dollar invested in prevention are no more than a dollar." William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private"*, 55 Emory L. J. 141, 141 (2006).

350. Professor Rapp identifies and discusses a number of the disincentives to whistle blowing, including loss of employment, ostracism, psychological strain, and blacklisting. Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Incentives for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 BU. L. Rev. 91, 118–126 (2007). Presumably, an effective incentive must overcome these disincentives.

351. Pub. L. No. 107-204 at § 307.

352. The SEC rule requires reporting of a "material violation," which is defined as "a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law." 17 C.F.R. § 205.2(h)(i).

353. *Id.* at § 205.3(b)(i). A subordinate attorney meets this reporting requirement if she reports evidence of a material violation to her supervising attorney. *Id.* at § 205.5(c). The supervising attorney then has the obligation to comply with the reporting requirement. *Id.* at § 205.4(c).

354. *Id.* at § 205.3(b)(3).

355. 17 C.F.R. § 205.3(c)(1). "An attorney who reports evidence of a material violation to such a qualified

Further, since 1995, a public accounting firm must include within the audit of a public company "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."[356] In addition, if the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred,"[357] it must take several steps including: determining whether an illegal act occurred and, if so, "determine and consider the possible effect of the illegal act on the financial statements of the issuer;"[358] and informing the management of the issuer and assuring that the audit committee, or board if there is none, "is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential."[359] If the company does not take appropriate remedial action with respect to the illegal act, the auditor must inform the board of directors directly of its conclusion if the illegal act has a material effect on the company's financial statements and the failure to remedy will prevent a standard report or require the resignation of the auditor.[360] The company must inform the SEC within one business day, providing a copy of the notice to the auditor.[361] If the company fails to provide a copy of the notice within the one business day period, the auditor must either provide the SEC with a copy of its report[362] or resign from the audit engagement and provide the SEC with a copy of its report.[363]

We know that there are generally people who know or have reasonable suspicions of corporate wrongdoing. In a number of corporate scandals, these individuals have raised their concerns internally.[364] Sarbanes-Oxley now provides a civil cause of action to whistle-blowers within reporting companies.[365] The Act protects against a broad range of actions that a company or an officer, employee, contractor, subcontractor, or agent of the company might take against the employee for a wide variety of whistle-blowing activities.[366] In addition, the Act criminalizes retaliation against a person "for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense."[367]

What is missing is a financial incentive for whistle-blowers or informants. There

legal compliance committee has satisfied his or her obligation to report such evidence and is not required to assess the issuer's response to the reported evidence of a material violation." *Id.* at § 205.3(c)(1). The requirements for a qualified legal compliance committee are defined by the SEC. *Id.* at § 205.2(k).

356. Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(a)(1) (2006).

357. *Id.* at § 78j-1(b)(1).

358. *Id.* at § 78j-1(b)(1)(A)(ii).

359. *Id.* at § 78j-1(b)(1)(B).

360. *Id.* at § 78j-1(b)(2).

361. Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(b)(3); *see also* 17 C.F.R. § 240.10A-1 (entitled "Notice to the Commission Pursuant to Section 10A of the Act").

362. Securities Exchange Act of 1934, 15 U.S.C. § 78j-1(b)(3)(B).

363. *Id.* at § 78j-1(3)(A), (4). The SEC received 29 letters from auditors under Section 10A between 1996 and 2003. SEC, *Securities Exchange Act: Review of Reporting Under Section 10A*, http://www.gao.gov/new.items/d03982r.pdf (Sept. 3, 2003).

364. See text accompanying *supra* nn. 267-269.

365. Pub. L. No. 107-204, at § 806 (codified as 18 U.S.C. § 1514A).

366. *Id.*

367. Pub. L. No. 107-204, at § 1107 (codified at 18 U.S.C. § 1513(e)).

are a number of statutory provisions permitting the payment of bounties to informants in other contexts. For example, the Securities Exchange Act of 1934 § 21A(e) permits the SEC to award a bounty to informants "not to exceed 10 percent" of any penalties recovered from insider traders by the SEC or Attorney General under the section.[368] This bounty is only available in insider trading cases; the SEC has sole discretion to determine "whether, to whom, or in what amount to make payments," and its decisions are "not subject to judicial review."[369]

Similarly, the Internal Revenue Code permits the IRS to make awards to informants of up to 15 percent of the amount of taxes, penalties, and interest collected.[370] The awards are discretionary.[371] Since 1996, the Internal Revenue Code generally requires the IRS to pay an award of 15 to 30 percent in the cases where the amount in dispute exceeds $2 million.[372] The amount of the award may be appealed to the U.S. Tax Court.[373]

The False Claims Act[374] goes a bit further and, in an appropriate case, permits a private party, the relator, to bring a cause of action against a person who submits a false claim to the U.S. government.[375] This is referred to as a *qui tam* action. Prior to bringing suit, the person must serve a "copy of the complaint and written disclosure of substantially all material evidence and information the person possesses" on the Government.[376] The Government may either decide to proceed with the suit or decline to proceed with the suit, in which case the private party has the right to conduct the action.[377] Most significantly, the private party, or *qui tam* plaintiff, is generally entitled to "receive at least 15 percent but not more than 25 percent of the proceeds of the action or settlement of the claim" and expenses (including reasonable attorney fees) if the Government proceeds with the action,[378] or "not less than 25 percent and not more than

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368. Securities Exchange Act of 1934, 15 U.S.C. § 78u-l(e).

369. *Id.*; *see generally* SEC, *Insider Trading: Information on Bounties*, http://www.sec.gov/divisions/enforce/insider.htm (last accessed Apr. 24, 2010).

370. 26 U.S.C. § 7623(a) (2006).

371. *Id.*

372. *Id.* at § 7623(b)(1), (5). The Internal Revenue Code provides that the award may be reduced or denied in certain circumstances. *Id.* at § 7623(b)(2)-(3).

373. *Id.* at § 7623(b)(4).

374. 31 U.S.C. §§ 3729–3733 (2006).

> The Federal False Claims Act ("FCA") was enacted in part because of bad mules. During the Civil War, unscrupulous early day defense contractors sold the Union Army decrepit horses and mules in ill health, faulty rifles and ammunition, and rancid rations and provisions .... These frauds caused President Abraham Lincoln to urge Congress to pass in March 1863 the original FCA commonly known as the "Informer's Law" or the "Lincoln Law" after President Lincoln.

Larry D. Lahman, *Bad Mules: A Primer on the Federal False Claims Act*, 76 Okla. B. J. 901, 901 (2005) (citations omitted).

375. 31 U.S.C. § 3730(b)(1).

376. *Id.* at § 3730(b)(2).

377. *Id.* at § 3730(b)(4). If the Government proceeds with the action, the private party has "the right to continue as a party to the action," although the Government "shall have the primary responsibility for prosecuting the action." *Id.* at § 3730(c)(1).

378. *Id.* at § 3730(d)(1) (2006). If the action is based primarily upon specific information not provided by the *qui tam* plaintiff

> relating to allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, the court may award such sums as it considers appropriate,

30 percent of the proceeds of the action or settlement" plus expenses (including reasonable attorney fees) if the Government does not proceed with the action.[379]

Although the SEC usually does not pay bounties,[380] the *qui tam* provisions of the False Claims Act have resulted in large recoveries for the government and large bounties to private parties. The Department of Justice reports that for fiscal year 2009, nearly $2 billion was recovered in *qui tam* actions, with payments of $255 million to relators.[381] The majority of the $2.4 billion recovered by the United States in fiscal year 2009 was recovered in *qui tam* actions.[382] In sum, the federal government's experience demonstrates that private parties can do well by doing good.[383]

One concern both pre- and post-Sarbanes-Oxley is the significant number of public companies that restate their financial statements due to material errors in them. A number of cases of faulty financial statements have, in fact, involved criminal behavior. Beyond that, the financial statements of corporations and financial institutions that "melt down" generally do not present fairly, in all material respects, the financial position of the company and the results of its operations in conformity with generally accepted accounting principles. Many companies melt down shortly after receiving a "clean" or unqualified audit report.[384] The GAO identified "919 financial statement restatements announced by 845 public companies from January 1, 1997, to June 30, 2002, that involved accounting irregularities resulting in material misstatements of financial results."[385] The GAO also found that accounting-related enforcement actions constituted almost 20 percent of all SEC enforcement actions from fiscal year 1999 through 2001.[386] A subsequent GAO study found that announcements of restatements of financial statements increased by about 67 percent from 2002 through September 2005.[387] According to the study, "the total number of restating companies (1,084) represents 16 percent of the average number of listed companies from 2002 to 2005, as compared to

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but in no case more than 10 percent of the proceeds . . . .

31 U.S.C. § 3730(d)(1) (footnote omitted).

379. *Id.* at § 3730(d)(2).

380. "Although the SEC has had a bounty program for more than 20 years, very few bounty awards have been issued." SEC Off. of Inspector Gen., *Assessment of the Commission's Bounty Program for Whistleblowers*, http://www.sec-oig.gov/AuditsInspections/Ongoing.html (last accessed Mar. 28, 2010).

381. DOJ Off. of Pub. Affairs, *Justice Department Recovers $2.4 Billion in False Claims Cases in Fiscal Year 2009; More than $24 Billion Since 1986*, http://www.justice.gov/opa/pr/2009/November/09-civ-1253.html (Nov. 19, 2009).

382. *Id.*

383. *See generally* Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 Vill. L. Rev. 273 (1992). The authors note: "Virtue may be its own reward, but for many, money is more gratifying." *Id.* at 336.

384. Elizabeth K. Venuti, *The Going-Concern Assumption Revisited: Assessing a Company's Future Viability*, http://www.nysscpa.org/cpajournal/2004/504/essentials/p40.htm (last accessed May 27, 2010) ("Twelve of the 20 largest bankruptcy filings in U.S. history took place in 2001 and 2002 . . . . All 12 companies received an unqualified opinion on their most recent financial statements filed prior to the bankruptcy filing.").

385. U.S. Govt. Accountability Off., *Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses, and Remaining Challenges* 2, http://www.gao.gov/new.items/d03138.pdf (Oct. 4, 2002) (footnote omitted).

386. *Id.* at 48.

387. U.S. Govt. Accountability Off., *Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities* 4, http://www.gao.gov/new.items/d06678.pdf (Mar. 5, 2007).

almost 8 percent during the 1997-2001 period."[388] In addition,

> The number of SEC enforcement cases involving financial fraud and issuer reporting issues increased from 79 in fiscal year 1998 to 185 in fiscal year 2005—a more than a 130 percent increase. Moreover, in fiscal year 2005, cases involving financial fraud and issuer reporting issues constituted the largest category of enforcement actions.[389]

Both federal and state laws recognize that, in an appropriate case, a corporation may be represented by an individual. At the federal level, § 16(b) of the Securities Exchange Act of 1934 permits a shareholder to bring a cause of action against a statutory insider to recover short swing profits where the corporation fails or refuses to do so upon demand.[390] At the state level, a shareholder may bring a derivative action on behalf of a corporation where the corporate board of directors wrongfully refuses to bring the action.[391] In recent years, Delaware has recognized a right of a corporate creditor to bring a derivative action on behalf of the corporation when the corporation is insolvent.[392]

Furthermore, the law has long recognized the right of a person who has conferred a benefit on another to recover compensation or expenses in an appropriate case. This includes the right of a plaintiff in a shareholder derivative suit to recover reasonable expenses and attorney fees where the suit has conferred a substantial benefit on the corporation,[393] the right of a plaintiff in a class action to recover reasonable expenses and attorney fees where the suit benefits members of the class,[394] as well as the right of a person who confers a benefit on another to recover on a restitutionary theory where it would be unjust for the other to retain that benefit without paying for it.[395]

Pulling these ideas together, I propose that informants who provide reliable, original[396] information that exposes or is a substantial factor in exposing significant

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388. *Id.*

389. *Id.* at 6.

390. Securities Exchange Act of 1934, 15 U.S.C. § 78p(b).

391. *See generally* Model Bus. Corp. Act §§ 7.40–7.47; Fed. R. Civ. P. 23.1.

392. *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101–102 (Del. 2007).

393. Model Bus. Corp. Act § 7.46(1); *see also Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 389–396, (1970) (holding that the expenses of a lawsuit to establish a violation of securities laws by a corporation and corporate officials was for the benefit of the corporation and other shareholders and that the corporation should reimburse litigation costs and reasonable attorney fees).

394. *Boeing Co. v. Van Gemert*, 444 U.S. 472, 478 (1980) ("[A] litigant or a lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole.").

395. *Restatement of Restitution* § 1 (1937) ("A person who has been unjustly enriched at the expense of another is required to make restitution to the other."); *Restatement (Third) of Restitution* § 1 (discussion dft. 2000).

396. The provision in the federal False Claims Act barring *qui tam* actions based upon certain public disclosures is instructive here.

> (A) No court shall have jurisdiction over an action under this section based upon the public disclosure of allegations or transactions in a criminal, civil, or administrative hearing, in a congressional, administrative, or Government Accounting Office report, hearing, audit, or investigation, or from the news media, unless the action is brought by the Attorney General or the person bringing the action is an original source of the information.
>
> (B) For purposes of this paragraph, "original source" means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government before filing an action under this

fraud or materially false financial statementsof a public company should be compensated. They have conferred a substantial benefit on those companies, sometimes at significant personal expense.[397] Designing the specific details of such a program presents some challenges.

I propose that an effective program would: (1) not apply in cases where other federal statues like the Internal Revenue Code, False Claims Act, or Securities Exchange Act already provide an incentive to disclose; (2) require disclosure by the informant in writing of the relevant information to the company's audit committee, which would be required to forward a copy to the company's auditor; (3) require the auditor to retain any written disclosures from informants as part of the audit work papers for the audit year during which it is received; (4) require the company's auditor to disclose to the company's chief legal officer (or equivalent) and the SEC the results of its investigation if it concludes it is likely that an illegal act has occurred, unless the illegal act is clearly inconsequential;[398] (5) not permit bounties to government officials or employees or to corporate employees or accountants who discover the information as part of employment or contractual duties that include seeking out or reporting such information to the company;[399] (6) be generous enough to incentivize a person to be a whistle-blower or informant; (7) provide for mandatory and not discretionary payment of bounties; and (8) require bounties to be paid only if the original information disclosed is a substantial factor leading to a restatement of the company's financial statements.

The auditor would be required to maintain a record of who made written disclosures to them and when such disclosures were received. Upon any restatement of a public company's financial statements, the auditor would be required to determine: (1) whether any of the written disclosures was a substantial factor leading to the restatement of the financial statements; (2) if so, whether the disclosure was original information; (3) if more than one original disclosure was a significant factor, the relative significance of each; and (4) the dollar value of the information provided by each informant who provided significant information.

The auditor would be required to file a written report with the SEC, presumably on a Form 8-K or Current Report,[400] and with the Public Company Accounting Oversight Board (PCAOB) setting forth: (1) how many written informant reports it received; (2) how many reports containing original information were a significant factor leading to the restatement; (3) a statement of the value it determined for each of the significant original reports; (4) an explanation of how that value was determined; and (5) a concise statement as to each of the non-significant or non-original reports addressing the basis for the auditor's determination. The names of the informants would not be included in these

section which is based on the information.

31 U.S.C. § 3730(e)(4) (footnote omitted).

397. Corkery, *supra* n. 271.

398. The illegal act could be the filing of false and misleading financial statements with the SEC.

399. For example, a person who is employed as an internal auditor or another similar position and is compensated for uncovering and communicating to the company information regarding fraud or improper accounting would not be eligible.

400. A reporting company is already required to file a Form 8-K in most cases when the company concludes that prior financial statements can no longer be relied upon. *See* SEC, *Form 8-K Item 4.02*, http://www.sec.gov/about/forms/form8-k.pdf (last accessed May 28, 2010).

reports. The reporting company would be required to pay the amounts determined as an expense of the audit.

The SEC or PCAOB would review the decisions of the auditor based solely upon the report submitted by the auditor using a standard of review similar to the abuse of discretion standard used by appellate courts to review many trial court decisions.[401] In a perfect world, informants and companies would have no right to appeal the auditor's determinations. I am not sure whether this would be constitutional, e.g., whether it would run afoul of due process requirements. In any event, I would propose that a minimalist approach be adopted with regard to any appeal or review process in order to minimize the costs associated with my proposal.

The key features of the bounty system I am suggesting are based upon various considerations. First, I propose that the informant make the written report to the company's Audit Committee to take advantage of pre-existing procedures (required by Sarbanes-Oxley and listing standards) for receiving complaints about accounting, internal controls, or auditing matters.[402]

Second, I suggest that the report be made to the auditors rather than to the chief legal officer (or equivalent) because an auditor is required to be independent[403] and does not owe any fiduciary duties to the company.[404] The Supreme Court has stated:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[405]

In contrast, an attorney for a company stands in a fiduciary relationship with the company[406] and owes her primary obligation to her client.[407]

If, however, the auditor believes it is likely that an illegal act has occurred, it will be required to report this to the company's chief legal officer, its audit committee, and the SEC. The purposes of this requirement are that it leverages the SEC Standards on the Professional Conduct of Lawyers, discussed above, which require "up-the-ladder" reporting of material violations, and it builds a paper trail regarding the SEC's awareness

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401. *See e.g. Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 141(1997) ("We have held that abuse of discretion is the proper standard of review of a district court's evidentiary rulings.").

402. *See* 17 C.F.R. § 240.10A-3.

403. *See generally*, 17 C.F.R. § 210.2–01 (Qualifications of Accountants).

404. *Resolution Trust Corp. v. KPMG Peat Marwick*, 844 F. Supp. 431, 436 (N.D. Ill. 1994) (granting motion to dismiss breach of fiduciary duty claim against auditor of bank); *FDIC v. Schoenberger*, 781 F. Supp. 1155, 1157–1158 (E.D. La. 1992). The independence required of an auditor is fundamentally inconsistent with status as a fiduciary. *Painters of Phila. Dist. Council No. 21 Welfare Fund v. Price Waterhouse*, 879 F.2d 1146, 1150 (3d Cir. 1989) (holding that the independent auditor of an employee welfare plan was not an ERISA fiduciary).

405. *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817–818, (1984).

406. *Rippey v. Wilson*, 273 N.W. 552, 555 (Mich. 1937) ("The relationship between client and attorney is a fiduciary one, not measured by the rule of dealing at arm's length.").

407. *Cf.* 17 C.F.R. § 205.3 ("An attorney appearing and practicing before the [Securities and Exchange] Commission] in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization.").

of likely illegal activity; this may assist injured parties to establish that the conduct did not fall within the discretionary function exception to liability under the Federal Torts Claims Act if the SEC fails to exercise reasonable care in the matter. In addition, building some redundancy into the system provides an incentive to all of these gatekeepers to act appropriately and professionally; if they do not, there are other gatekeepers[408] who may be aware of it.

Third, while my proposal would mandate bonuses and provide that the amount of such bonuses would be the reasonable value of the information disclosed, it also provides that the amount will be determined by the auditor subject to review by the PCAOB under an abuse of discretion standard of review. One concern might be that auditors have too much discretion under my proposal, or that the auditors may, in some cases, be part of the problem. Maybe so. On the other hand, requiring the auditor to maintain a report as "records relevant to the audit" would mean that the auditor would have to retain it for seven years.[409] If the auditor does not adequately investigate an informant report, it could come back to bite him later.

While there are differences of opinion regarding the extent to which auditor concern over reputation keeps auditors honest,[410] certainly it is a factor the auditor considers when choosing a course of action.[411] Furthermore, an auditor would have other incentives to take informant reports seriously and compensate informants fairly; not only would it be a potentially valuable means of reducing its litigation risk and that of its audit client, but also the extent to which these reports are taken seriously could be observed by other parties who have carrots and sticks, including, the company's audit committee[412](whose members have their own liability concerns) and the PCAOB (which

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408. "Although scholars disagree as to the precise definition of 'gatekeeper,' a gatekeeper is generally understood as one who looks over company management's shoulder." David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 28 Rev. Banking & Fin. L. 339, 370 (2008) (citations omitted). Professor Cunningham has a detailed discussion of this question in an extensive footnote. *See* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. Rev. 413, 417 n. 6 (2004). I use the term in a very broad sense and include the SEC where it has been given actual written notice of the likelihood of illegal behavior within the scope of its statutory mission.

409. 17 C.F.R. § 205.2; *see also* Pub. L. No. 107-204 at § 103(a)(2)(A)(i) (requiring PCAOB to promulgate rules requiring registered public accounting firms to maintain audit work papers and other information related to audit report for seven years).

410. *Compare DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) ("An accountant's greatest asset is its reputation for honesty, followed closely by its reputation for careful work. Fees for two years' audits could not approach the losses E & W would suffer from a perception that it would muffle a client's fraud.") *with* Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 Cornell L. Rev. 775, 786 (2005-2006) ("Thirty years of accounting research using the tenets of behavioral psychology and related fields demonstrates that auditors scarcely resemble the 'Chicago man,' the model of the law and economics literature who is thought to rationally protect his reputation by acting in an upstanding fashion." (citation omitted)).

411. Even before Arthur Andersen became ineligible to audit reporting companies, hundreds of its audit clients had switched to new auditors. John George, *Variety of Andersen Clients Switch Auditors*, http://philadelphia.bizjournals.com/philadelphia/stories/2002/05/20/focus2.html (May 17, 2002) (reporting that "more than 350 publicly traded companies have dropped Arthur Andersen as their independent auditor in the wake of the Enron debacle"). Other auditors must be aware of this and realize the importance of an auditor's reputation to client retention.

412. In theory, audit committees of listed companies were strengthened as a result of Sarbanes-Oxley and should be more effective gatekeepers. *See* Pub. L. No. 107-204, at § 301 (codified as Securities Exchange Act of 1934, 15 USCA § 78j-1).

inspects[413] and can investigate and discipline[414] a registered public accounting firm).

The idea of using bounties or incentives for private parties in order to reveal corporate frauds was also proposed by Professor Geoffrey Rapp in 2007.[415] He suggests several ways in which an incentive system could be structured and states:

> The more straightforward and effective way to provide bounties for SOX whistleblowers is through amendment to the Fair Funds provision of SOX discussed above. The amendment would provide that when a Fair Fund is created as a result of an SEC enforcement action against a security fraudster, the "original source" of the information against the fraudster is entitled to a 15-25% bounty. Such a scheme could be effected administratively; or, in the alternative, "original sources" could be required to file complaints (as under the FCA) which the SEC could subsequently "assume" in pursuing civil enforcement actions. The main advantage of the Fair Funds approach is that it would provide a bounty award to whistleblowers without imposing any additional administrative burdens on the SEC.[416]

This proposal is interesting, given the amount of money that the fair funds provision of Sarbanes-Oxley[417] is generating.[418]

In addition, the proposed Investor Protection Act of 2009[419] would authorize the SEC to pay an award or bounty not exceeding 30% of any monetary sanctions in any judicial or administrative action resulting in monetary sanctions exceeding $1 million. The determination of the amount of the award would be in the sole discretion of the SEC. The award would be payable only to a person who "voluntarily provided original information" and specified persons would not be eligible. Any determination by the SEC would be final and not subject to judicial review.[420]

However, my proposal has several potential advantages over both of these proposals. First, my proposal is "closer to the ground."[421] A company's auditor is inherently more familiar with a company's accounting methods and internal controls. It is far more efficient to have the auditor conduct the initial investigation of an informant's report.

Second, the SEC receives an enormous number of investor complaints and questions each year,[422] and has a large number of investigations.[423] If the auditor takes its duties seriously, the auditor is much more likely to actually investigate the report in a

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413. *Id.* at § 104.

414. *Id.* at § 105.

415. Rapp, *supra* n. 350.

416. *Id.* at 147–148.

417. Pub. L. No. 107-204 at § 308, 116 Stat. at 784–785.

418. The SEC distributed over $2 billion in Fair Funds to investors in calendar year 2009. SEC, *SEC Surpasses $2 Billion in Fair Fund Distributions in 2009*, http://www.sec.gov/news/press/2009/2009-254.htm (Nov. 25, 2009).

419. H.R. 3817, 111th Cong.

420. *Id.* at § 202.

421. *See* Glater, *supra* n. 273 (reporting on survey finding that half of reported economic crime was found by auditors).

422. The SEC Office of Investor Education and Advocacy received 77,174 complaints and questions in fiscal year 2007. SEC, *2007 Performance and Accountability Report* 37, http://www.sec.gov/about/secpar/secpar2007.pdf (last accessed Apr. 1, 2010).

423. The SEC had 4,088 investigations pending at the beginning of fiscal year 2009. During fiscal year 2009, it closed 716 investigations. SEC, *2009 Performance and Accountability Report* 36, http://www.sec.gov/about/secpar/secpar2009.pdf (accessed Mar. 27, 2010).

timely fashion than the SEC.

Finally, my proposal does not "cut out" the SEC. In fact, it should increase the efficiency and effectiveness of SEC investigations because the informant reports it receives will already have been pre-screened by the company's auditor; the auditor only forwards reports where it finds it likely that an illegal act has occurred.

My proposal is also preferable to those which would allow private parties who have not personally suffered any injury to bring suit to redress corporate fraud or wrongdoing. Expanding *qui tam* actions to cover corporate wrongdoing or permitting an action against the SEC for failure to enforce the federal securities laws or regulations, as proposed by Ralph Nader,[424] will result in a significant amount of new litigation and attorney fee awards, but is unlikely to result in the speedy resolution of cases of corporate fraud or materially false financial statements. Trying a simple, inexpensive proposal to deal with these problems seems preferable as an initial step.[425]

To be sure, there are potential difficulties. For example, how does the auditor decide the fair value of the information provided by an informant? Presumably, standards or practices would develop to simplify this. As an alternative, a schedule of fixed bounties, based upon the size of the accounting restatements, could be developed.

Ultimately whether this proposal, if implemented, is successful would be an empirical question. If financial incentives significantly increase the number of individuals willing to speak out against harmful activity, deter potential wrongdoers by the threat of whistle-blowing, facilitate the redress of wrongdoing that has occurred, and encourage organizations to police themselves, then self-interested law enforcement may be worth its costs. "A reduction in wrongdoing, not the individual benefit to snitches, is the final societal reward."[426]

Because of this, it might be sensible to subject my proposal, if adopted, to a sunset provision, forcing an examination of its effectiveness after ten years.[427]

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424. Nader et al., *supra* n. 58, at 245.

425. Although it may well be that permitting insiders to trade on information of corporate wrongdoing is a more effective way of exposing it than paying bounties to informants, politically it is only a "theoretical" possibility. *See generally* Macey, *supra* n. 267.

> I don't think the scandals would ever have erupted if we had allowed insider trading because there would be plenty of people in those companies who would know exactly what was going on, and who couldn't resist the temptation to get rich by trading on the information, and the stock market would have reflected those problems months and months earlier than they did under this cockamamie regulatory system we have.

Donald J. Boudreaux, *Learning to Love Insider Trading*, http://online.wsj.com/article/SB10001424052748704224004574489324091790350.html (Oct. 24, 2009) (quoting Henry Manne).

426. Callahan & Dworkin, *supra* n. 383, at 336.

427. *Cf.* Romano, *supra* n. 87, at 1600–1601 (discussing the possible use of sunset provisions for emergency legislation). Professor Romano also notes the possible use of "blue-ribbon outside advisory committee, consisting of academic experts and representatives from industry and the investor community, to be appointed by the President and the ranking party leaders in Congress within the statute's sunset time frame." *Id.* at 1601.

## X. CONCLUSION

*"History is little else than a picture of human crimes and misfortunes."*

–Voltaire[428]

Will my two proposals prevent future scandals and meltdowns? Absolutely not. But none of the proposals that have been or will be made will do that.

The salient question is whether they will have a positive impact on fairly assigning the responsibility for securities fraud and on uncovering corporate fraud and improper accounting. Sure, why not?[429]

The attraction of my proposals is that the they are relatively easy to implement, will make federal entities and representatives (now major players in business) liable under the Securities Exchange Act for culpable behavior, will not be very costly to public companies,[430] leverage existing provisions in our current laws and regulations, allow (if not encourage) various gatekeepers to look over each others' shoulders, and would be easy to undo if they in fact do not work or generate unwanted unintended consequences.

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428. Francois-Marie Arouet de Voltaire, *L'Ingénu* Chap. X (1767) (quoted in John Bartlett, *Familiar Quotations* 986 (10th ed., S.J. Parkhill & Co. 1914) (available at http://www.bartleby.com/100/744.html#744.note4)).

429. Socratic Method–"method of reasoning: a means developed by Socrates of arriving at the truth by continually questioning, obtaining answers, and criticizing the answers." MSN Encarta, *Dictionary*, http://encarta.msn.com/dictionary_1861709623/Socratic_method.html (last accessed Mar. 27, 2010). "Socrates's dialogues are dialectic–that is, the truth is not known to either of the participants, and the questioning is pursued in an attempt to figure out the truth." Jeffrey D. Jackson, *Socrates and Langdell in Legal Writing: Is the Socratic Method a Proper Tool for Legal Writing Courses?* 43 Cal. W. L. Rev. 267, 272 (2007).

430. Certainly the cost to companies generally will be pocket change compared to the costs that have been imposed by § 404 of Sarbanes-Oxley, and other Sarbanes-Oxley provisions and regulations promulgated in conformity with them. *Cf.* U.S. Govt. Accountability Off., *Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, http://www.gao.gov/new.items/d06361.pdf (April 2006) (addressing implementation in light of fact that smaller public companies incur disproportionately high costs in complying with Sarbanes-Oxley).