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

M. Thomas Arnold**

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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 Eichenwald¹

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 1:9⁴

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 acts⁵ in this theater include:

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).
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 Stores10 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 1,043 institutions 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

8. See infra nn. 71 et seq.
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

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).


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 £127 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

general counsels of Converse Technology, Monster Worldwide, and McAfee. Id. 27.

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).


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.  

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, Bradford & Bingley plc, which was also taken over by the British Government, and Fortis NV, which was taken over by the Dutch Government at a cost of $23.2 billion. Enough already!

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

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, a corporation always has forty-nine options to avoid a particular state's


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.


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. 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. Consequently, they contend that there has been a race to the top rather than to the bottom. I cannot resolve this debate and, frankly, don’t want to; it makes for too good a discussion in my Corporate Law courses.

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, 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). Consequently, it found there is no private cause of action under § 10(b) for mere breach of fiduciary duty or internal corporate mismanagement. 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.”

Similarly, in CTS Corp. v. Dynamics Corp. of America, 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.”

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

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.”).


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).


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.


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. Consequently, when the SEC adopted Rule 19c-4 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. 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." The belief by some that state regulation had failed to hold large corporations accountable led to proposals for a federal law governing large corporations or for federal minimum standards that would apply to these corporations unless the applicable state standards were more demanding. 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

"[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

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. For example, there is a long history of federal government

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).
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.
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; Lockheed Aircraft Corporation, which received $250 million in loan guarantees in 1971; Chrysler, which received $1.5 billion in loans guaranteed by the federal government; 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; 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.”

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). 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. Among other reforms, ERISA imposed funding requirements for employer and multi-employer pension plans and established the Pension Benefit Guaranty Corporation (PBGC).

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) 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

64. Id. at 34–35.
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).
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.


\(^{78}\) "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/rs/0775.htm#3 (Apr. 1, 2006).


Insider Trading Sanctions Act of 1984\textsuperscript{82} and the Insider Trading and Securities Fraud Enforcement Act of 1988.\textsuperscript{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\textsuperscript{84} which regulates tender offers and the acquisition of significant stakes in public companies.\textsuperscript{85} In addition, a number of commentators have discussed how “securities regulation tends to follow crashes.”\textsuperscript{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.”\textsuperscript{87} I will return to this point below.

V. “CREEPING FEDERALISM”: ENRON AND WORLDCOM BEGET SARANES-OXLEY AND MORE

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

–Ronald Reagan\textsuperscript{88}

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

–Ronald Reagan\textsuperscript{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.\textsuperscript{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.\textsuperscript{91} The reforms include:

\textsuperscript{84.} Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), n(d)-(f)).
\textsuperscript{86.} See Larry E. Ribstein, Bubble Laws, 40 Hous. L. Rev. 77, 78 n. 3 (2003) (discussing this point and citing examples).
\textsuperscript{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).
\textsuperscript{89.} Id.
\textsuperscript{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 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; 10 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).
103. Id. at § 407.
104. Id. at § 307.
105. Id. at § 501.
106. Id. at § 702.
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—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

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).
117. The history of these filings is set out in the SEC release approving the changes to the standards. See SEC, NASD and NYSE Rulermaking: Relating to Corporate Governance, http://www.sec.gov/rules/sro/34-48745.htm#PS2_17027 (Nov. 4, 2003).
118. See id. This release gives a good, concise description of the NYSE and NASD requirements.
Sarbanes-Oxley has received mixed reviews. Some believe it was at least a step in the right direction. 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." Others have expressed concern that Congress did not adequately consider the effect of Sarbanes-Oxley on small businesses. 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." Professor Romano points out that "[a] regulatory agenda . . . does not generate popular support in a booming market." 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 . . . ." Other authors have noted the "creeping" federalization of corporate law in Sarbanes-Oxley. Judge Easterbrook also noted that "[t]he Sarbanes-Oxley Act has specified many governance devices that all traded firms must employ." He points out that "[i]f the mandatory rules turn out to be bad ones, investors can lose." Consequently, he argues, "[t]he national government . . . can win a race to the bottom in a way that states cannot."

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." 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

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


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.

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.” 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.

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).


\(^{(134)}\) 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.

\(^{(135)}\) Robert Ajemian, Where is the Real George Bush, http://www.time.com/time/magazine/article/0,9171,963342,00.html (Jan. 26, 1987) (quoting 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).

\(^{(136)}\) Newton, supra n. 60, at 14.

\(^{(137)}\) Romano, supra n. 87, at 1591.


\(^{(139)}\) H.R. 3269, 111th Cong. (passed the House of Representatives on July 31, 2009).
Oxley reforms, would interject federal governmental standards into areas traditionally authority and remedies, or to enhance regulation of credit ratings agencies.

To overhaul the federal financial regulatory system, to provide the accessible to plaintiffs who may have suffered in the recent crises, to radically federal concerns; for example, there are bills proposing to make federal courts more

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, to radically overhaul the federal financial regulatory system, to provide the SEC with broad new authority and remedies, or to enhance regulation of credit ratings agencies. 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; an independent chairman of the board; all members of a

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152. H.R. 3890, 111th Cong. (Oct. 21, 2009) (introduced by Rep Kanjorski.).
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;\(^1\) 159 a risk management committee and a chief risk officer while also defining their duties;\(^1\) 160 a supermajority shareholder vote to approve “excessive” executive pay;\(^1\) 161 a non-binding shareholder vote on golden parachute compensation;\(^1\) 162 the SEC to promulgate rules relating to shareholder use of issuer proxy solicitation materials to nominate individuals for board membership;\(^1\) 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.\(^1\) 164

A number of legislative proposals are, essentially, old or “recycled” ideas.\(^1\) 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.\(^1\) 166 Additionally, executive compensation has been a talking point of various unions for years\(^1\) 167 and Congress at least twice has passed provisions dealing with improper/excessive executive compensation.\(^1\) 168 And, of course, President Obama has appointed a “Pay Czar”\(^1\) 169 for a number of firms receiving federal governmental assistance. These firms are subject to special rules regarding executive compensation.\(^1\) 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).
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).
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

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.
176. Id. at 51–54.
177. Id. at 61 (“The case for fundamental reform is thus not yet made out.”).
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." Some courts have upheld convictions of corporate executives under the rubric of honest services fraud. The Supreme Court is currently considering the matter of the application of the honest services fraud concept to corporate executives. 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.

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

"Risk free capitalism is an oxymoron."

-The Hon. Leo Strine

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. "At its end, the firm had 115 legal actions against it, seeking a total of $362 million." 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, 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, would find a shareholder access rule desirable.

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).
2002.\textsuperscript{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.\textsuperscript{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."\textsuperscript{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.\textsuperscript{193}

B. Concerns about the Value and Validity of Ratings Awarded by Credit Rating Agencies\textsuperscript{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.\textsuperscript{195} Subsequent review of the actions of these agencies suggests significant shortcomings in their assignment of credit ratings to Enron.\textsuperscript{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."\textsuperscript{197} The SEC was also required to prepare a report and submit copies to various parties.\textsuperscript{198}

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

\begin{footnotesize}
\begin{enumerate}
\item[191.] Pub. L. No. 107-204 at § 701.
\item[193.] See Alex Spence, \textit{Audit Firms Left Unprotected Against Claims of Negligence}, http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article6851623.ece (Sept. 28, 2009).
\item[194.] Credit ratings agencies that are registered by the SEC are referred to as nationally recognized statistical rating organizations. \textit{See Securities Exchange Act of 1934}, 15 U.S.C. § 78c(62).
\item[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. \textit{See generally} Claire A. Hill, \textit{Ratings Agencies Behaving Badly: The Case of Enron}, 35 Conn. L. Rev. 1145 (2003).
\item[197.] Pub. L. No. 107-204 at § 701(a)(1).
\item[198.] Id. at § 701(b).
\end{enumerate}
\end{footnotesize}
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

202. See e.g. Andrew M. Kulpa, Minimal Deterrence: The Market Impact, Legal Fallout, and Impeding 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

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 Steams. 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. at 310.
206. Id. at 310.
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.
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.\textsuperscript{212}

Madoff himself was surprised that his scheme wasn’t discovered sooner.\textsuperscript{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 . . . .”\textsuperscript{214}

The reasons for the SEC falling short most certainly include a lack of education, training, and experience in the area of finance.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.

\textsuperscript{215} Id.
\textsuperscript{218} Id.
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. 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. George Bush’s various campaigns received over $555,000 from Enron and Ken Lay, the former chairman of Enron, who Bush called “Kenny boy” until the collapse of Enron. 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. 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.

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.

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


223. Storelli, supra n. 33, at 799–800. At that time “‘Kenny Boy’ suddenly became ‘Mr. Lay.’” Id. (citation omitted).

224. Robert O’Harro 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.


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.

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

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. In addition, Parmalat, Europe’s Enron, used SPE’s to hide losses through fictitious transactions.

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.”

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.

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. Similarly, while Continental Illinois was bailed out, many banks and savings & loans went out of business without any governmental support.

Of course, receiving substantial taxpayer financed assistance is really no guarantee. 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

228. *Id.* at 1306–1309.
229. *Id.* at 1316–1318.
231. Storelli, *supra* n. 33, 781–785 (the author refers to these SPE’s as “accounting dumps”).
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.
of about $20 trillion in 2006.”

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. Lincon Savings and Loan increased its assets from $1.1 billion in 1984 to $5.5 billion in 1988. Global Crossing was founded in 1997 and went into bankruptcy in 2002, unable to pay its $12 billion in debt. Parmalat, Europe’s Enron, grew from reported revenues of €500 million in 1990 to €7.7 billion in 2002. At Enron itself, reported revenues grew from $40 billion to $101 billion from 1999 to 2000. WorldCom also engaged in aggressive growth, doing 70 merger and acquisition deals in less than five years.

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

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


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.


243. Steve Rosenbush, Five Lessons of the WorldCom Debacle, http://www.businessweek.com/technology/content/mar2005/cb20050316_9160_te024.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.


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.


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. Enron Corporation was selected as the most innovative company by Fortune Magazine six years in a row (from 1996 to 2001). Ironically, Enron’s Andrew Fastow received CFO Magazine’s Excellence Award for Capital Structure Management. Satyam Computer Services was named the 2008 winner of the Golden Peacock Award for Corporate Governance by the World Council for Corporate Governance. It was stripped of this award about four months later.

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. 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.

Similarly, questions have been raised about the role of the federal government’s affordable housing policy in creating the recent global financial crisis. 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.

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

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).
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.\textsuperscript{255} Others have argued that the federal and state governments are largely responsible for encouraging reliance on credit rating agencies\textsuperscript{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,”\textsuperscript{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.”\textsuperscript{258}

\section*{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{261} There are many other examples. These include Brooksley Born’s warnings about over-the-counter derivatives.\textsuperscript{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,\textsuperscript{263} her concerns foreshadowed the collapse of

\begin{footnotesize}
\begin{enumerate}
\item 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.
\item Mendales, supra n. 237, at 1373–1376.
\item Id. at 1392.
\item Id. at 1392–1393; see also Brian Blackstone, Economists Warn of Asset-Price Bubbles, \url{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.”).
\item 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.
\item Manuel Roig-Franzia, Credit Crisis Cassandra, \url{http://www.washingtonpost.com/wp-dyn/content/article/2009/05/25/AR2009052502108.html} (May 26, 2009).
\item These include such household names as Greenspan, Levitt, Rubin, and Summers. Id.
\end{enumerate}
\end{footnotesize}
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 Corporation271 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

264. See generally Roger Lowenstein, When Genius Failed: The Rise and Fall of Long-Term Capital Management (Random House 2000).
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.
272. Steve Eder & Rachelle Younglai, Countrywide Exec Warned About Mortgage Risks, http://www.reuters.com/article/idUSTRE546JT20090605?feedType=RSS&feedName=businessNews&rpc=23&sp=true (June 5, 2009). Mr. McMurray was the Chief Risk Officer. Id.
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, 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; Enron founder Kenneth Lay, who was convicted but died prior to sentencing; former Enron CFO Andrew Fastow, sentenced to 10 years, later reduced to 6 years for his cooperation with the government in the case; founder and former WorldCom CEO Bernard Ebbers, sentenced to 25 years; former WorldCom CFO Scott Sullivan, sentenced to 5 years; former Tyco International CEO L. Dennis Kozlowski and former Tyco International CFO Mark Swartz, sentenced to 8 1/3 and 25 years; founder of Adelphia Communications, John Rigas, sentenced to 12 years and former CFO of Adelphia Timothy Rigas sentenced to 17 years; ex-Refco, Inc. CEO Phillip Bennet, sentenced to 16 years; ex-HealthSouth vice-president Hannibal “Sonny” Crumpler, sentenced to 8 years; and ex-HealthSouth CFO William Owens, sentenced to 5 years. I could go on.

I have not mentioned all the “small fish” convicted in the various corporate scandals of the last ten years 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. United States v. Lay, 456 F. Supp. 2d 869 (S.D. Tex. 2006), mandamus denied, No. 06-20848 (5th Cir. Nov. 1, 2006).
283. Bray, supra n. 25.
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

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 Hatter297

“All animals are equal, but some animals are more equal than others.”

–George Orwell298

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 . . . [to] 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 overreaction 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).

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

304. Id.
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 liable 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 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.

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. 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. The Supreme Court has held that there is an
implied cause of action for violation of Rule 14a-9.

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.

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."
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." 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.

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. 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. 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." 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.” “Covered person” is defined as “a defendant in any private action arising under [title 15].”

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

315. Id. at § 78c(c).
318. Id. at § 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).
323. See id. at § 78c(a)(9) (discussing definition of "person" applicable to the Act).
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.\(^{335}\)
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 above336 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


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

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upon the SEC’s handling of the Madoff situation and at least seven more have filed administrative claims with the SEC, a prerequisite to bringing a tort claim under the Federal Torts Claims Act. 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.

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.”

IX. “FOR A FEW DOLLARS MORE”:

“And now for something completely different.” “Not!”

—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

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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).


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, whistleblowers 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 violation352 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


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 B.U. L. Rev. 91, 118–126 (2007). Presumably, an effective incentive must overcome these disincentives.


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(3). (b)(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(b)(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." 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," 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;" 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." 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. The company must inform the SEC within one business day, providing a copy of the notice to the auditor. 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 or resign from the audit engagement and provide the SEC with a copy of its report.

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. Sarbanes-Oxley now provides a civil cause of action to whistle-blowers within reporting companies. 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. 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."

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

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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).
364. See text accompanying supra nn. 267-269.
366. Id.
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


\(^{371}\) 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).


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.


\(^{376}\) 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

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

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).
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.
386. Id. at 48.
almost 8 percent during the 1997-2001 period." 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.

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. 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. 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.

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; the right of a plaintiff in a class action to recover reasonable expenses and attorney fees where the suit benefits members of the class, 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.

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

388. Id. at 6.
391. 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).
392. 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.").
393. 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).
394. 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 statements of a public company should be compensated. They have conferred a substantial benefit on those companies, sometimes at significant personal expense. 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 statutes 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; (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; (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, 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.

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. 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.

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 and does not owe any fiduciary duties to the company. 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.

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

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).
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 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. 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, certainly it is a factor the auditor considers when choosing a course of action. 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 (whose members have their own liability concerns) and the PCAOB (which

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 USC § 78j-1).
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inspects and can investigate and discipline 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. 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.

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

In addition, the proposed Investor Protection Act of 2009 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.

However, my proposal has several potential advantages over both of these proposals. First, my proposal is “closer to the ground.” 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, and has a large number of investigations. If the auditor takes its duties seriously, the auditor is much more likely to actually investigate the report in a

413. Id. at § 104.
414. Id. at § 105.
415. Rapp, supra n. 350.
416. Id. at 147–148.
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).
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

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.
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.
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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 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.


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).