The Undercivilization of Corporate Law

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Abstract

This article restructures the current debate surrounding the “overcriminalization” of corporate law by comparing the powerful tools of federal prosecutors with the sometimes insurmountable procedural impediments their civil counterparts, private plaintiffs, must overcome in private litigation surrounding the same corporate misconduct. Although the past five years have seen prosecutors accumulating over 1000 indictments of corporate officers, the same years have seen a decline in the ability of shareholder plaintiffs to receive civil redress for the same wrongs. I frame my analysis in the lexicon of statistical error. Which system, the criminal system or the civil system, is erring in creating more false positives or false negatives? If a court is to determine whether a corporate defendant is guilty, then a false positive finding by the court is a “Type I” error. However, if the defendant actually is culpable, but a court finds the defendant not culpable, a false negative, we say that the system has created a “Type II” error. No system, either a criminal law system or a civil system, can eliminate both Type I and Type II errors. Traditionally, the public has found Type I errors in criminal law fairly intolerable, and has preferred to err on the side of Type II errors. On the other hand, because civil penalties do not threaten liberty and livelihoods as much as criminal penalties, our system has been more tolerant of Type I errors in private litigation. However, post-2002, changes in prosecutorial strategy, substantive laws, and sentencing guidelines have combined to create a criminal law system that creates an intolerable number of Type I errors in prosecutions of corporate misconduct. Ironically, due to laws creating additional obstacles for private plaintiffs in both federal securities law litigation and state law fiduciary duty litigation, the civil system creates an unusually high number of Type II errors in trials for the same or similar misconduct. This article argues that not only is this prosecutorial paradox adverse to traditional preferences regarding protections of criminal defendants, but it is also potentially dangerous to vulnerable shareholders. As the public outcry regarding overcriminalization causes prosecutors and legislators to decrease
criminal prosecutions, investors will be left with no other recourse but a private litigation system that is currently “undercivilized.”
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I. Introduction

In recent years, regulators, industry participants, practitioners and academics have debated the causes of and cures for corporate misconduct. In the aftermath of the bursting of the technology bubble and the disclosures of accounting irregularities1 in the early part of the decade, citizens and their representatives have attempted to redress corporate wrongs in both civil lawsuits and criminal prosecutions.2 Because of the convergence of many factors, including the creation of the Corporate Fraud Task Force and new federal sentencing laws, the choice of criminal prosecution seems to have become a popular path of corporate discipline, as reflected in its frequency of use by federal prosecutors.3 However,

* Associate Professor of Law, Richard W. and Marie L. Corman Scholar, University of Illinois College of Law. This thoughts in this paper were developed immensely by comments at the University of Maryland Roundtable on Criminalizing Corporate Law, the 2006 Law & Society Conference and the 2006 Big Ten UnTENured Conference. The author would also like to thank Kim Krawiec, Dave Hoffman, Larry Ribstein, Tom Kirkendall, Mitu Gulati, Deborah De Mott, Marjory Sachs, and Mark Skilling for helpful comments and direction and also readers of Conglomerate (www.theconglomerate.com) who have challenged me on the ideas presented in this paper.

1 See Daniel J. Morrissey, After the Ball is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals, 83 NEB. L. REV. 732, 735 (2005) (noting that “[b]y the end of 2002, over two dozen large public companies admitted to inflating their revenues by improper accounting practices”).

2 At this early point in the Article, the author would like to distinguish “corporate criminal liability,” in which the entity itself is indicted and possibly convicted relating to violations of criminal law and criminal liability of individuals who violate laws in a business setting. These individuals are executive and nonexecutive employees of a business, usually a corporation. Much has been written on the costs and benefits of entity-level criminal liability. See, e.g., V.S. Khanna, Corporate Criminal Liability: What Purpose Does it Serve?, 109 HARV. L. REV. 1477 (1996); Kimberly D. Krawiec, Organizational Misconduct: Beyond the Principal-Agent Model, 32 FLA. ST. L. REV. 1 (2005) [hereinafter “Organizational Misconduct”]. This Article, however, focuses on examples of prosecutorial tools and judicial precedent relating to individual criminal liability and their comparison to parallel civil litigation against Boards of Directors.

3 See Kathleen F. Brickey, In Enron’s Wake: Corporate Executives on Trial, 96 J. CRIM. L. & CRIMINOLOGY 397, 419 (2006) [hereinafter Enron’s Wake] (“The corporate fraud prosecution cycle following Enron’s collapse has produced an unparalleled number of criminal trials of senior
following guilty verdicts in high-profile corporate criminal cases that resulted in lengthy prison sentences for individuals with no criminal records, commentators have complained about the “overcriminalization” of corporate law. Critics argue that the types of misconduct in question in these cases, such as nondisclosure, bad decisionmaking, conflicts of interest, opportunism, and violations of technical banking rules and flexible accounting principles, are manifestations of the principal-agent problem that are better corrected by other means, specifically the civil system or the capital markets. Moreover, recent appellate reversals of convictions and reductions of sentences have shed doubt on these prosecutions. However, what these otherwise persuasive arguments do not address is the fact that the current civil system does not easily offer redress for these principal-agent problems. Due to incremental changes in both federal and state law, victims of corporate misconduct, former and current shareholders, face substantial obstacles in obtaining relief based on investor losses, which are increasingly seen as foreseeable costs of investing in a risky environment. These obstacles result in only the largest corporations associated with the largest investor losses facing any fear of successful private litigation because only cases against these firms have a high expected value to a contingency fee attorney. Ironically, civil
lawsuits have the greatest chance of success when a parallel criminal prosecution is also pursued; corporate officers who are convicted generally settle civil lawsuits shortly thereafter because of the collateral effect of the criminal conviction.\(^{10}\) However, once the current, and possibly waning, fervor for prosecuting high-profile corporate defendants abates, shareholder plaintiffs again will face a civil system designed to keep most lawsuits from proceeding, with little attention to the substantive merits. The civil litigation system, frequently seen either as an alternative to criminalization of corporate law or as a reason for its underenforcement,\(^ {11}\) serves as a weak substitute for criminal prosecutions. Therefore, what the current dialogue regarding overcriminalizing corporate law is lacking is a parallel complaint about the “undercivilization” of corporate law.

Under the same set of facts suggesting corporate misconduct, public and private actors can seek to discipline the bad actors and provide a remedy to the victims of the misconduct in four major ways.\(^ {12}\) Federal and state prosecutors may investigate the misconduct, indict individuals and possibly the entity, and seek convictions under existing laws, including securities laws.\(^ {13}\) In addition, investors who bought shares of the firm during certain times may bring a cause of action against the firm for violation of securities laws in connection with the purchase and sale of those shares. Current shareholders may also choose to bring

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\(^{10}\) Studies have shown that cases with parallel SEC actions and DOJ investigations tend to have a higher settlement value, possibly because those cases have “hard evidence” or because they involve accounting fraud. In addition, once a conviction or plea agreement is obtained in a criminal case, then that fact may be used in the civil lawsuit, creating an incentive to settle.


\(^{12}\) For example, after the SEC began investigating the practice of backdating stock options by many publicly-held companies, federal prosecutors issued the first indictments based on the illegality of those actions. Three officers of Brocade Communications Systems Inc., including the chief executive officer Gregory Reyes, were indicted on a single count of securities fraud for violating accounting rules in the nondisclosure of this compensation practice. The SEC simultaneously charged the individuals with securities fraud and filing false documents. See Charles Forelle, James Bandler & Steve Stecklow, *Brocade Ex-CEO, 2 Others Charged in Options Probe*, WALL ST. J., July 21, 2006, at A1. Almost immediately, investors in Brocade filed both a securities class action and a derivative claim against the company. See The D&O Diary, available at http://dandodiary.blogspot.com/2006/07/counting-options-backdating-lawsuits.html (July 20, 2006).

\(^{13}\) This Article focuses on federal criminal prosecutions, which are more subject to abuse due to national agendas and powerful tools such as the Sentencing Guidelines.
a state law cause of action against directors and specific officers for violations of fiduciary duties that such actors owed to the firm. Finally, the Securities and Exchange Commission (SEC) may investigate and bring a civil action, either a judicial action or an administrative action, against the firm or individuals for violations of securities laws.14

Participants in the capital markets should desire that one or more of these paths will be effective in both deterring future corporate misconduct and in providing restitution or other relief to anyone harmed by that misconduct. However, whether criminal penalties or civil penalties provide greater deterrence is empirically unknown and perhaps undeterminable,15 and therefore beyond the scope of this analysis. However, participants in the capital markets should also prefer that these systems obtain a reasonable balance between ensuring that culpable corporate misconduct is punished while at the same time preventing innocuous corporate misconduct from not being punished. A system that allows the nonculpable to be punished can be described as having Type I errors, and a system that allows the culpable to go unpunished will have Type II errors.16 This Article examines characteristics of both criminal prosecutions and private litigation under this type of analysis. Because no system is perfect, lawmakers must determine which type of error is more palatable and adjust pleading burdens, evidentiary burdens, and presumptions accordingly. Historically, the relative burdens and defendant protections have reflected a concern that false criminal convictions, Type I errors, have greater negative utility than either Type I errors in the civil system or Type II errors in the criminal system.17

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14 This article focuses only on a comparison of criminal prosecutions and private civil lawsuits. One topic for further research is whether SEC civil investigations, given adequate resources, could be an optimal substitute for criminal prosecutions.

15 Although scholars often theorize on the deterrent impact of differing white-collar crime regimes, these theories cannot be supported by data on the incidence of white-collar crime. Because this kind of crime is not self-revealing, one cannot measure incidence without resorting to a using an imperfect proxy, such as number of prosecutions, indictments or convictions. These proxies may relate more to budgetary restraints than incidence of white-collar crime.

16 The legal adage, attributed to Blackstone, that it is better for ten guilty men to go free than for one innocent man to go to jail embodies the belief that in a criminal system, we would prefer Type II errors to Type I errors. WILLIAM BLACKSTONE, 4 COMMENTARIES *352. See generally Alexander Volokh, N Guilty Men, 146 U. PA. L. REV. 173 (1997) (chronicling the history of speakers declaring that it is better for “n” guilty persons to escape some sort of punishment than for one innocent person to be so punished, from Aristotle to the Old Testament to modern times).

17 Khanna, supra note 2, at 1513 (noting that “the social cost of a false conviction of an individual is likely to exceed the cost of a false acquittal,” but that “for purely civil cases, the costs of a false
Accordingly, criminal convictions have traditionally been more difficult to obtain than civil judgments for the same misconduct.18

This Article argues that this balance between criminal prosecutions and civil litigation no longer holds in the corporate arena. Currently, the U.S. system for disciplining corporate misconduct has the worst of both worlds: a criminal law system that produces Type I errors, and a civil law system that produces Type II errors.19 Many aspects of criminal law that favor the prosecution’s quest to the detriment of the defendant’s presumption of innocence suggest that corporate prosecution is the path with the greatest likelihood of “success” measured in terms of the probability of a guilty verdict.20 Moreover, private litigation brought by investors has become greatly disfavored in the law. One only has to look at recent congressional enactments, such as the Private Securities Litigation Reform Act (PSLRA)21 and the Securities Litigation Uniform Standards Act (SLUSA)22 to see examples of the obstacles that investors face in bringing actions against companies they invest in under either federal or state securities laws. In addition, cases brought in Delaware alleging breaches of fiduciary duty also show grim prospects for the average shareholder derivative claim against a corporation due to procedural hurdles and the presumption of the business judgment rule.23


19 See Lynn A. Stout, Type I Error, Type II Error, and the Private Securities Litigation Reform Act, 38 Ariz. L. Rev. 711, 712 (1996) (discussing how aspects of the PSLRA reduce Type I errors by creating opportunities for more Type II errors in private securities litigation) (hereinafter Error).

20 See Khanna, supra note 2, at ___ (noting that with regard to recent corporate misconduct criminal trials, “the government enjoys a respectable, if not spectacular, conviction rate”).


Although public opinion of these private lawsuits has turned negative because of perceived abuses such as unscrupulous attorneys bringing meritless lawsuits with hopes of settling quickly, the same may now be said of prosecutors investigating questionably legal corporate conduct with hopes of quick guilty pleas and future career gains.

This prosecution paradox reflects disparate responses to two competing constituent concerns: the desire to protect, or overprotect if necessary, corporations from civil suits brought for “nuisance” value, on the one hand, and the desire to restore investor confidence by selectively punishing high-profile corporate officers on the other. These two divergent public policy goals grew out of different eras. The pressure to limit civil class actions and derivative suits grew out of an era of prosperity in the mid-1990’s when the U.S. economy was riding a strong Wall Street wave that promised long-term profits for all. In this era, plaintiffs’ attorneys and strike suits were seen as threatening that prosperity. Conversely, the pressure to publicly prosecute corporate criminals to the fullest extent of the law arose as a response to the corporate scandals of the post-boom era, beginning in 2001. The result is a disconnect between the two methods of monitoring corporate conduct, private civil enforcement and public criminal enforcement, a simultaneous overcriminalization and undercivilization of corporate law. This disconnect in levels of enforcement is contrary to traditional differences of policy in civil and criminal law doctrines. Regardless of whether the conventional wisdom is that too much corporate misconduct is being disciplined or too little, the historical balance in this area would mandate that misconduct would be more easily disciplined by in a civil proceeding, not a criminal proceeding.

Furthermore, victims of corporate misconduct may receive only intangible retribution through corporate prosecutions, but may not be compensated for their harms. In addition, the costs of criminal prosecution of corporate misconduct are quite high, both in terms of public resources and in terms of the costs borne by the criminal defendants. Life and near-life sentences for certain non-violent white-collar criminals do not seem to be a reasonable price to pay for minimal deterrence and crude desires for retribution. Regulators should compare the effectiveness of civil suits against the effectiveness of criminal prosecutions in determining which system most adequately (1) screens out meritless investigations while allowing bona fide proceedings to continue; (2) metes out

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24 See Stout, Error, supra note 19, at 712-13 (debunking the hyperbolic argument that so-called “strike suits” were creating enormous costs for U.S. corporations).
liability or punishment to the deserving; and (3) provides a remedy to the victim of the corporate misconduct in question. Although recent regulation seems to reflect a societal preference for criminal avenues of corporate law enforcement, the relative effectiveness of criminal prosecution in meeting these objectives over civil redress is not clear.

This Article argues that civil law and criminal law in the corporate law arena must be harmonized to restore the traditional policy preferences of allowing free access to the civil courts while harnessing prosecutorial power. In making this argument, this article analyzes particular trends in corporate law prosecutions and compares these trends to stated fears of private corporate litigation. This article argues that if regulators truly wish to restore investor confidence in the capital markets, then shareholder confidence in the private litigation system must also be restored. Furthermore, recent events seem to signal a retreat from aggressive criminal prosecution of corporate actors and a possible era of correction of the “overcriminalization of corporate law” phenomenon. If so, then investors will be left necessarily relying on an anemic and “undercivilized” private litigation option. Moreover, regulators are hinting that one possible response to industry backlash against overcriminalization will be still more tightening of access to shareholder lawsuits.25 Again, this possible response moves in the least preferable direction.

Before turning to a depiction of the undercivilization in private corporate law litigation in Section III, Section II will provide the background of the overcriminalization debate. Section IV will briefly discuss why leaving the disciplining of corporate misconduct to the discipline of the capital markets is not a viable alternative to either criminal prosecutions or civil litigation. Sections V and VI will discuss recent corporate law prosecutions and the powerful tools that enabled prosecutors to win pleas and convictions, regardless of the merits. Because this Article argues that at least in theory, the same corporate misconduct incident might result in criminal convictions but no civil liability, Sections VII and VIII look at two examples of recent cases where this possibility was realized. Finally, Section IX analyzes criticisms of both corporate prosecutions and civil litigation, and Section X develops ideas for “civilizing” corporate law.

25 See Stephen Labaton, S.E.C. Seeks to Curtail Investor Suits, N.Y. TIMES, Feb. 13, 2007 (reporting that the SEC had filed a brief in a shareholder suit in front of the U.S. Supreme Court arguing that the Seventh Circuit’s interpretation of the PSLRA’s increased pleading requirements should be increased further, to requiring plaintiffs to provide evidence in pleadings that show a “high likelihood” that the defendant acted with intent).
II. The Overcriminalization of Corporate Law

A. Defining “Overcriminalization”

Recently, corporate law scholars have viewed the current legal landscape with alarm and have critiqued newly promulgated or amended laws and sentencing guidelines and prosecutorial tactics for their roles in questionable investigations, convictions and sentences of corporate officers and employees. These critiques often take the form of labeling the current environment as one of “overcriminalization” or sometimes “overenforcement.” Because both of these terms can mean several different things, some definitional work is necessary. First, however, a definition of scope is required. A criticism of overcriminalization may imply that too many undeserving activities have been criminalized. Here, the argument would be that the criminal law has become overbroad and creates criminal penalties for activities that are either innocuous, questionably innocuous or obscure and therefore trivial. This type of overcriminalization argument is often made in corporate law, where existing laws are so broad as to conceivably cover ordinary business practices or common breaches of duties that agents owe their principals. Overcriminalization may also refer to the depth of criminal law; when one action violates several overlapping criminal provisions with cumulative penalties, then that activity may be overcriminalized. Another accusation of overcriminalization may mean simply

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29 See Brown, Overcriminalization, supra note 27, at 1 (characterizing criticisms of overcriminalization as concerns that adding new criminal laws leads to a world in which innocent acts create liability for criminal punishment).
30 See Sara Sun Beale, The Many Faces of Overcriminalization: From Morals and Mattress Tags to Overfederalization, 54 AM. U.L. REV. 747, 778 (2005) (presenting the argument that regulatory crimes such as “mattress tag” offenses are “the paradigm of overcriminalization”).
31 See id. at 3 (defending overcriminalization somewhat if the targets of the criminalization are trivial and the laws are rarely enforced).
32 See id. at 7 (using carjacking as an example of a single act that would violate multiple federal crimes)
that illegal conduct is penalized too severely in relation to the harm caused by the conduct.\textsuperscript{33} For example, one variation of that definition is a balancing analysis, Professor Geraldine Moohr defines “overcriminalization” more broadly, as the result when “the costs of treating conduct as a crime exceed the benefits of the new criminal law.”\textsuperscript{34} These costs include not only traditional enforcement costs, but the costs to the individual and the costs created by the overdeterrence of legitimate conduct.\textsuperscript{35}

The term “overenforcement” is closely related to “overcriminalization,” and Professors Richard Bierschbach and Alex Stein define “overenforcement” in a way similar to Professor Moohr’s definition of “overcriminalization”: “Overenforcement occurs when the violator of a legal rule suffers excessive harm--or more harm than is necessary for optimal deterrence--from the actual implementation of that rule.”\textsuperscript{36} This harm may be caused by broad laws casting a net that captures the technically guilty but innocuous culprits\textsuperscript{37} or by penalties higher than necessary for optimal deterrence.\textsuperscript{38} In addition, excess harm may be caused by spillover effects of conviction and incarceration, such as loss of income to families, reputational effects, and loss of future earnings.\textsuperscript{39}

This Article will begin with the assertions that in the previous five years, U.S. federal corporate law has been in a cycle of overcriminalization and overenforcement. However, this Article will not attempt to try to distinguish between these two labels. The existing laws are overbroad in every sense: broad rules capture both conduct deserving of penalty and undeserving conduct,\textsuperscript{40} overlapping provisions overpenalize individual criminal acts,\textsuperscript{41} illegal activities

\textsuperscript{33} See id. at 8 (“Finally, a separate but related complaint addresses not crimes but sentences: even for appropriately defined crimes, punishment levels can be excessive.”).

\textsuperscript{34} See Moohr, Overcriminalization, supra note 4, at 785.

\textsuperscript{35} See id.

\textsuperscript{36} See Bierschbach & Stein, supra note 29, at 1744.

\textsuperscript{37} See id. at 1755 (defining “definitional spillovers”).

\textsuperscript{38} See id. at 1744.

\textsuperscript{39} See id. at 1749 (defining “market spillovers”).

\textsuperscript{40} United States v. Brown, 459 F.3d 509, 522 (5th Cir. 2006) (reversing convictions under 18 U.S.C. § 1346 and stating that under the government’s theory, any breach of duty by an employee, whether it caused a harm to the employer or a benefit to the employee, would constitute a crime).

\textsuperscript{41} Although Martha Stewart was never indicted for insider trading, by asserting that she was innocent of insider trading, she allegedly made false statements, obstructed justice, committed securities fraud, and conspired to make false statements, obstruct justice and commit perjury.
are penalized too severely, and the penalties assessed create negative ripple effects that exacerbate already too-severe punishment. This Article also argues that corporate law is experiencing a period of overenforcement in which individuals who are not even technically guilty of violating laws are prosecuted at great costs to themselves and their families.

Any debate surrounding overcriminalization or overenforcement involves a debate on the deterrence value of criminalization and resulting punishment. However, deterrence of corporate misconduct is extremely difficult to measure in any intelligent way as these types of crime are not self-revealing. In addition, the normative statement that an area of the law has been overcriminalized presumes a knowledge of a baseline of criminalization that is preferable. This Article does not purport either to quantify the deterrence value of criminalization or to proffer a desirable level of criminalization. Instead, this Article asserts that the U.S. is experiencing an increase in prosecutorial power and strength of weapons with a corresponding decrease in defendant protections in the corporate arena. The character of this increase in prosecutorial strength is at odds with historic protections given to criminal defendants. Furthermore, this increase in criminalization seems ironic given the parallel decrease in regulatory interest in private litigation in the corporate arena. Even as the avenue to civil recovery for corporate misconduct has become increasingly narrow and corporate civil defendants enjoy great procedural protections from lawsuits, the avenue to criminal prosecutions has grown quite broad, with corporate prosecutors enjoying advantages in procedure and legal infrastructure. In addition, this Article analyzes how mistakes made by overenforcement in civil litigation may be easily remedied, but mistakes in criminal overenforcement are not.


42 For example, although Ken Lay, former CEO of Enron, died before sentencing, the aggregate amount of prison time he faced merely for four counts of bank fraud, just part of his conviction, was 120 years.

43 See Moohr, Overcriminalization, supra note 4, at 801 (“Economic harm to families of the convicted and the value of the imprisoned felon’s lost income can also be established and should be included in the tally.”).

44 See, e.g., Scott Wiegand, How to Avoid Risky In-House Positions, Law.com, available at http://www.law.com/jsp/article.jsp?d=1145885172207 (describing former in-house counsel author’s prosecution and indictment on charges of conspiracy, securities fraud and making false statements and ultimate acquittal following over a year of unemployment, frozen assets and exorbitant legal bills).
B. Regulatory Responses to Perceived Increases in Corporate Misconduct

1. Sarbanes-Oxley Act of 2002

By enacting the Sarbanes-Oxley Act of 2002 (commonly known as “SOX”), Congress both enhanced existing criminal fraud penalties and fashioned new crimes. In addition, Congress directed the United States Sentencing Commission to amend the U.S. Sentencing Guidelines to increase penalties available for corporate fraud.


Congress added two new criminal provisions under SOX § 802, codified at 18 U.S.C. §§ 1519 and 1520, designed to preserve accurate documentation. Section 1519 supplements existing Section 1512.

The statute provides that violators “shall be fined under this title, imprisoned not more than 20 years, or both.” Any fine assessed under Title 18 may be up

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46 Id.
50 “Prior to the Sarbanes-Oxley Act of 2002, anyone who ‘corruptly persuades’ others to destroy, alter or conceal evidence [could] be prosecuted under 18 U.S.C. § 1512. Section 1512 reaches destruction of evidence with intent to obstruct an official proceeding which may not yet have been commenced. However, Section 1512 does not reach the ‘individual shredder.’ While prosecution of obstruction under 18 U.S.C. § 1505 does not require ‘corrupt persuasion,’ it does require the existence of a pending proceeding.” USAG Memo, supra note 47.
to $250,000 for an individual offender and up to $500,000 for an organization. In addition, Section 1102, amending and enhancing 18 U.S.C. § 1512, imposes a fine and a twenty year maximum prison term on a person who “corruptly . . . alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding; or . . . otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so.” Section 1512 “should be read in conjunction with the new Section 1519 [imposing criminal penalties for altering documents]. Further, [t]he term ‘corruptly’ shall be construed as requiring proof of a criminal state of mind on the part of the defendant.”

Section 807, codified at 18 U.S.C. § 1348, created a new felony for securities fraud. The previous law did not provide for “any specific crime directly prohibiting securities fraud schemes,” forcing prosecutors to “reach many securities fraud schemes through the mail and wire fraud statutes.” Because the new statute provides for a stand-alone crime, prosecutors need not show proof of the use of the mail or wires. Violators are subject to a maximum fine of $250,000 per individual and $500,000 per organization.

One of the most discussed aspects of SOX was Section 906, codified at 29 U.S.C. § 1350, which requires CEOs and CFOs to personally certify that the periodic reports “filed by an issuer with the SEC . . . fully compl[y] with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act . . . and

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52 Id. § 3571. Section 3571(d) provides an alternative fine based on pecuniary gain or loss. If a person derives pecuniary gain from the offense, or if the offense results in pecuniary loss to any person, the defendant can be fined up to twice the amount of gross gain or loss, “unless imposition of a fine under this subsection would unduly complicate or prolong the sentencing process.” Id. § 3571(d).

53 Id. § 1512.

54 USAG Memo, supra note 47.

55 Id.

56 18 U.S.C. § 1348 (2004) ( The statute generally provides that “[w]hoever knowingly executes, or attempts to execute, a scheme or artifice . . . to defraud any person in connection with [certain securities]; or . . . to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of [certain securities]; shall be fined under this title, or imprisoned not more than 25 years, or both.”); see also USAG Memo, supra note 47.

57 USAG Memo, supra note 47.

58 Id.

59 Id. § 3571.
that the information contained in the periodic reports fairly presents, in all material respects, the financial condition and results of operations of the issuer.\textsuperscript{60} Prior to SOX, only CEOs and CFOs “of the largest 947 companies whose securities are registered with the SEC” were required to make such certifications (per SEC order).\textsuperscript{61} Prior to 2002, an officer or director’s signature on a document did not convey any verification as to the accuracy or completeness of the filing.\textsuperscript{62} Certifying a report while \textit{knowing} that it does not comply with § 1350 carries the potential for a $1 million fine and imprisonment for up to ten years.\textsuperscript{63} A \textit{willful} violator may be subject to a maximum $5 million fine and twenty years’ imprisonment.\textsuperscript{64}

\textbf{b. Enhanced Criminal Penalties}

SOX also increased penalties available under existing federal laws. For example, prior to SOX, a conviction for conspiracy to commit a federal offense was punishable by a sentence of up to five years in prison, in addition to the punishment available for the underlying crime.\textsuperscript{65} Under SOX, however, convictions for conspiracies to commit a federal offense are punishable by a sentence of ten to thirty years imprisonment, depending on the punishment provided under the substantive offense statute.\textsuperscript{66}

In addition, Section 903, amending 18 U.S.C. §§ 1341 & 1343, increases the maximum penalty for mail or wire fraud from five to twenty years.\textsuperscript{67} Section 902, codified at 18 U.S.C. § 1349, also provides that attempts and conspiracies to commit mail fraud, wire fraud, bank fraud, health care fraud, and the new offense of securities fraud, will have the same maximum punishment as the substantive crime.\textsuperscript{68} Although most of these crime statutes already included the inchoate

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{60} Id. § 1350.
\item \textsuperscript{61} USAG Memo, \textit{supra} note 47.
\item \textsuperscript{62} Id.
\item \textsuperscript{63} 18 U.S.C. § 1350(c)(1) (2004).
\item \textsuperscript{64} Id. § 1350(c)(2).
\item \textsuperscript{65} USAG Memo, \textit{supra} note 47.
\item \textsuperscript{66} 18 U.S.C. § 1349 (2004).
\item \textsuperscript{67} Id. §§ 1341, 1343.
\item \textsuperscript{68} Id. § 1349.
\end{itemize}
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version of the offense, this section ensures for the first time that an attempt to commit wire fraud is a federal offense.\(^69\)

Section 1106 increased the penalties for individuals under § 32(a) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78ff) from a fine of up to $1 million, and up to ten years imprisonment,\(^70\) to a maximum fine of $5 million and twenty years maximum imprisonment.\(^71\) This same provision also increased the fines for organizations tenfold from $2.5 million to $25 million.\(^72\)

2. **Amendments to Federal Sentencing Guidelines**

In addition to enhancing existing criminal fraud penalties and fashioning new criminal offenses by passing SOX,\(^73\) Congress directed the United States Sentencing Commission to increase available penalties for corporate fraud,\(^74\) which the Commission did first, by emergency amendment, effective January 25, 2003,\(^75\) and second, by permanent amendment, submitted to Congress on April 30, 2003.\(^76\) In addition to increasing penalties under the Guidelines for existing crimes,\(^77\) the amended Guidelines also incorporate the new white-collar offenses created under SOX by listing them in the Guidelines’ Statutory Index.\(^78\) As a result, violations of 18 U.S.C. § 1350 (corporate officers certification) and 18

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\(^69\) USAG Memo, *supra* note 47.

\(^70\) *Id.*


\(^72\) *Id.*


\(^74\) *Id.* §§ 805, 905 & 1104.

\(^75\) Pursuant to §§ 805, 905 & 1104, Congress requested that the Commission “promulgate the guidelines or amendments provided . . . as soon as practicable, and in any event not later than 180 days after [enactment].” U.S. SENTENCING GUIDELINES MANUAL §§ 805(1)(b), 905(1)(c) & 1104(1)(c) (2006).


U.S.C. § 1348 (securities fraud), are sentenced under § 2B1.1, and are subject to the enhancements.79

a. Fraud, Theft, Property Destruction

The Commission modified Guideline 2B1.1 to “build on a comprehensive economic crime package . . . [that] consolidated three separate guidelines covering theft, property destruction, and fraud into one guideline, §2B1.1.”80

First, the Commission expanded the “victims table,” increasing penalties for harming 250 or more individuals. This expansion would apply to most violations thought to harm investors of a publicly-held corporation. The Commission amended Guideline 2B1.1(b)(2) to provide an additional two level increase, for a total of six levels, if the offense involved 250 or more victims.81 Prior to amendment, the Guidelines only provided a two level enhancement if the offense involved more than ten victims, and a four level enhancement if the offense involved fifty or more victims.82 This revision is significant; a six level enhancement “approximately doubles the term of imprisonment required by the sentencing guidelines.”83

Second, the Commission responded to Congress’s request to increase penalties for any offense “that endangers the solvency or financial security of a substantial number of victims.”84 The Commission met this directive by expanding the existing §2B1.1(b)(12)(B) enhancement.85 Prior to amendment, the Guidelines provided a four level enhancement and a minimum offense level of twenty-four if the offense “substantially jeopardized the safety and soundness of a financial institution.”86 The amendment provided two new prongs that

79 U.S. SENT. COMM’N, supra note 77, at 8
80 Id. at 2.
81 Id. at 2. This provision remains unchanged under the current Guidelines. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1(b)(2)(C) (2006).
82 U.S. SENT. COMM’N, supra note 77, at 2. See also U.S. SENTENCING GUIDELINES MANUAL at Appendix B-1.
83 Id. at 3.
84 SOX § 805(a)(4).
85 U.S. SENT. COMM’N, supra note 77, at 3.
86 Id.
would trigger enhancement, both providing a four level increase.\textsuperscript{87} The first new prong “applies to offenses that substantially endanger the solvency or financial security of an organization that, at any time during the offense, was a publicly traded company or had 1,000 or more employees.”\textsuperscript{88} The second prong applies to offenses that substantially endanger the solvency or financial security of 100 or more victims.\textsuperscript{89}

Taken together, these two Guidelines combine to cumulatively increase substantially the enhancement for offenses relating to securities fraud and other fraud violations regarding publicly-held corporations.

b. Enhancement for Officers or Directors of Publicly Traded Companies

Congress further directed the Commission to “consider the promulgation of new sentencing guidelines or amendments to existing sentencing guidelines to provide an enhancement for officers or directors of publicly traded corporations who commit fraud and related offenses.”\textsuperscript{90} The Commission met this directive by providing a new four level enhancement (an approximate 50 percent increase in the sentence length required by the sentencing guidelines)\textsuperscript{91} that applies if the defendant was an officer or director of a publicly traded company and violated securities law.\textsuperscript{92} This amendment applies quite broadly: the Guidelines expressly provide that “[a] conviction under a securities law or commodities law

\textsuperscript{88} \textit{Id.} This provision remains in the current Guidelines, but has been renumbered. \textsc{U.S. Sentencing Guidelines Manual} § 2B1.1(b)(13)(B) (2006) (emphasis added). An application note for this section sets forth a non-exhaustive list of factors that the court shall consider in determining whether the offense “endangered the solvency or financial security” of such an entity: “The list of factors that the court shall consider when applying the new enhancement includes, among others, consideration of insolvency, filing for bankruptcy, substantially reducing the value of the company’s stock, and substantially reducing the company’s workforce. Other factors not enumerated in the application note also could be considered by the court as appropriate.” \textit{Id.} § 2B1.1(b)(13)(B) cmt. n. 12.
\textsuperscript{90} \textsc{SOX} § 1104(a)(2)
\textsuperscript{91} \textsc{U.S. Sent. Comm’n, supra} note 77 at 4.
\textsuperscript{92} \textit{Id.}
is not required in order for subsection (b)(15) to apply,” meaning that a defendant would be subject to increased penalties even if the defendant was convicted of conspiracy or wire fraud if the conduct was thought to violate securities laws.

c. Added Loss Categories

The emergency amendment also operates to more severely punish offenses that cause catastrophic losses of large magnitude, “such as the serious corporate scandals that gave rise to several portions of [SOX].” The amendment added two level increases: adding twenty-eight points when the total loss exceeds $200 million, and thirty points when the loss exceeds $400 million. The current Guidelines also reflect the additions.

d. Obstruction of Justice

Congress also directed the Commission to ensure that the Guidelines are sufficient to deter and punish obstruction of justice offenses; under this guidance, the Commission enhanced penalties under §2J1.2 by increasing the base offense level for obstruction of justice and adding a new enhancement for destroying evidence. Based on the higher statutory maximum penalties for new obstruction of justice offenses created under SOX, the Commission increased the base offense level applicable to defendants sentenced under §2J1.2 by two

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93 Id. § 2B1.1(b)(13)(B) cmt. n. 14(B).
94 Id.
95 U.S. SENT. COMM’N, supra note 77, at 6.
98 SOX §§ 805(a) & 1104(b).
99 U.S. SENT. COMM’N, supra note 77, at 8 -10.
100 E.g., 18 U.S.C. § 1519 (providing a maximum term of imprisonment of twenty years); 18 U.S.C. § 1512(c) (providing a maximum term of imprisonment of twenty years); and 18 U.S.C. § 1513 (providing a maximum term of imprisonment of ten years).
levels – from a level twelve to a level 14.101 The current Guidelines reflect this change.102 The Commission further amended the Guidelines to add a new two level enhancement to the obstruction of justice section if a “substantial number” of records were involved or an “especially probative record.”103

e. Organizational Sentencing Guidelines

Although this Article focuses on criminal prosecutions of individuals, note that SOX also directed the Commission to “review and amend, as appropriate, the Federal Sentencing Guidelines and related policy statements to ensure that . . . the guidelines that apply to organizations in United States Sentencing Guidelines, chapter 8, are sufficient to deter and punish organizational criminal misconduct.”104 These enhancements, although not detailed here, directly influence the criminal prosecutions of individuals that are employed by organizations under investigation. Because of enhanced penalties to organizations that are convicted of federal crimes, organizations have increased incentives to cooperate with prosecutors, name individuals, waive attorney-client privilege with respect to those individuals, and assist prosecutors in other ways.

3. Corporate Fraud Task Force

Because SOX was enacted as a response to a perceived increase in corporate misconduct, most of the misconduct in question had to be prosecuted under law existing prior to 2002. To more effectively prosecute these actors using traditional laws, President George W. Bush established the President’s Corporate Fraud Task Force to coordinate the response of the various agencies with jurisdiction over corporate fraud, including the Department of Justice (DOJ)

101 Id. at 8.
102 U.S. SENTENCING GUIDELINES MANUAL §2J1.2(a) (2006).
103 U.S. SENT. COMM’N, supra note 77, at 9.
104 SOX § 805.
and the SEC. With this task force came a $24.5 million increase in the DOJ’s budget for corporate fraud investigations and a 73% budget increase for the SEC. Between July 30, 2002 and May 31, 2003, the DOJ indicted 354 individuals and firms for corporate fraud, obtained more than 250 convictions, and began investigations of 500 other individuals and firms. On August 9, 2006, the Task Force announced, in connection with the indictments of three former executives of Converse Technology, Inc. for backdating options, that since its inception in 2002, the Task Force had convicted over 1,000 individuals for corporate fraud, including 100 CEOs and Presidents, 100 Vice-Presidents, and 30 CFOs.

C. The Cycle of Underenforcement and Overenforcement in Corporate Law

In non-white collar crime, or “street crime,” scholars have noted the interconnection between police underenforcement, the levels of crime, and subsequent overenforcement. In areas that are typically underpoliced, actors in that environment tend to act like the unlawful, both out of a sense of survival and out of a sense that the law is meaningless. If members of one neighborhood routinely carry concealed weapons with seeming immunity, then law-abiding citizens will also begin to carry weapons. However, when any arrest is made,

106 Id. at VII-1-2.
107 Id.
111 See id. at 1772 (“A young black male who illegally carries a weapon because he fears for his life is a victim of underenforcement; he believes, often accurately, that the police will not protect him.”)
the prosecution and penalty will be disproportionately swift and severe, to send a message to the underpoliced area.112

The corporate law arena may also be seen as an underpoliced arena. In fact, some hypothesize that corporate law has been deliberately underenforced in the criminal arena because of the sense that the civil arena is better suited to discipline corporate misconduct.113 Because of these parallel systems, federal regulators with limited budgets may for some time leave certain areas of securities fraud enforcement to the private litigators.114 However, because of the economics of private litigation, smaller frauds will go unchallenged.115 In times of good economic conditions, regulators may also adopt a more collaborative approach to corporate law enforcement.116 Because the probability of individual criminal prosecution is low, then individuals may begin to emulate the worst actors in the corporate arena and engage in misconduct that creates competitive advantages, such as earnings management and accounting fraud. Managers may adopt questionable practices either out of a sense of competition with other firms or out of a sense that regulators are not concerned with these practices and have somehow acquiesced to their use through underenforcement.

Although underenforcement has definite costs to the industry and to investors, in a world of limited resources, regulators may have few good

112 See id. (arguing that a cycle of underenforcement and overenforcement “combines the harshest of punishments with visible inaction, appearing at once unfair and ineffective”).
113 See Darryl K. Brown, Street Crime, supra note 11, at 1331 (describing how prosecutors do not feel compelled to convict knowing corporate law actors when civil sanctions are available and full restitution is possible).
114 James D. Cox, Randall S. Thomas & Dana Kiku, Public and Private Enforcement of the Securities Laws: Have Things changed Since Enron?, 80 Notre Dame L. Rev. 893, 897 (2005) (describing data that show that historically, the SEC has targeted firms with significantly smaller capitalizations than companies targeted by shareholder suits, leaving more costly targets to private litigation).
116 See id. at 1314 (describing pre-2001 corporate law enforcement as characterized by “new regulatory strategies aim[ing] to foster self-regulation, voluntary compliance, and a sense of social responsibility. Cooperative, nonconfrontational approaches begin enforcement with dialogue and efforts to coax voluntary responses, followed only later, for a recalcitrant subgroup, with warnings, civil sanctions, and criminal prosecution”).
options.\textsuperscript{117} Focusing on certain defendants, such as smaller, insolvent businesses, that require fewer resources to prosecute,\textsuperscript{118} the SEC can share the responsibility of penalizing misbehaving issuer firms to “private attorneys general.” However, when the economy experiences a downturn and much corporate fraud is exposed at once, the federal government may feel pressure to ramp up criminal enforcement and agency budgets, and individual prosecutors may see opportunities to build careers through high-profile corporate law prosecutions. The U.S. has experienced such post-scandal eras of heightened enforcement following the stock market crash of 1929, the stock market crash of 1987 and the recent economic downturn following the bursting of the technology bubble in 2001.

Corporate law is also underenforced, however, in the civil arena. Although private litigation is currently even more skewed toward large firms with large investor losses,\textsuperscript{119} private lawsuits have never been a particularly efficient vehicle for disciplining low-level fraud.\textsuperscript{120} Because of collective action problems and the contingency fee system, corporate misconduct that creates small losses rarely is addressed in private litigation. This phenomenon may be analogized to the underenforcement of graffiti, vandalism, public drunkenness, and other petty crimes. Scholars have argued for over twenty years that continued underenforcement of smaller crimes leads to “urban decay” and eventually to more serious crime.\textsuperscript{121} Again, continued underenforcement of

\textsuperscript{117} See generally Joel Seligman, Rethinking Private Securities Litigation, 73 U. CIN. L. REV. 95, 113 (2004) (remarking that between 1993 and 2000, the SEC budget grew at a mere 6% a year, although the securities market expanded at a much greater rate during this time).

\textsuperscript{118} See Cox, supra note 114, at ___ (noting that the SEC generally targets companies with statistically significantly smaller market capitalization than companies sued by private plaintiffs and also focused on firms in financial distress).

\textsuperscript{119} See Stephen J. Choi, Do the Merits Matter Less After the PSLRA? (NYU Sch. of Law Law & Econ. Res. Paper Series, Paper No. 03-04) available at http://ssrn.com/abstract=558255, at 8 (providing evidence for the hypothesis that after the PSLRA, the minimum potential damage award will determine whether a private class action is filed).

\textsuperscript{120} See Coffee, Reform, supra note 115, at 14 (stating that the ratio of settlements to investor losses has never exceeded 7.2\%). However, this ratio assumes that the stated amount of losses was caused fully by the fraud, an assumption that critics of private securities litigation consistently challenge.

\textsuperscript{121} See Natapoff, supra note 110, at 114 (discussing recent “zero balance” and “quality of life” programs that focus on creating a sense of lawfulness by policing petty crimes); James Q. Wilson & George L. Kelling, Broken Windows: The Police and Neighborhood Safety, ATLANTIC MONTHLY 29-83 (1982).
small-scale corporate frauds may lead to an environment of renegade entrepreneurs who are not able to properly assess the probabilities of penalties for certain behaviors.

D. The Cycle of Overcriminalization Ends: What Happens When the Pendulum Swings Back

For better or worse, criminal enforcement of corporate law has followed a cyclical pattern for the past century. Although imperfect, the aggregate impact of this regime has not significantly impacted the continued global success of U.S. capital markets.122 For the post-2001 enforcement cycle to be notable, its legacy, the SOX and the amendments to the Sentencing Guidelines, would have to stymie the U.S. business climate more than the Securities Acts of 1933 and 1934, the Williams Act of 1968, and other legislative responses to perceived scandals. Whether the lasting effects of the criminal overenforcement season will prove that the pendulum swung too far remains to be seen; however, when the pendulum swings back, U.S. corporate law will be in a period of severe civil underenforcement. Due to changes in federal securities procedural laws, as well as class-action law generally, should the current prosecution policies ebb, investors will be left with little remedy and recourse.

The continued cry of overcriminalization will eventually prove cogent and possibly persuade regulators to decrease the criminalization of corporate law. Recent commentary reflects a growing sense that prosecutorial fervor for corporate investigations is ebbing.123 In addition, appellate court reversals also


122 But see Larry E. Ribstein & Henry Butler, The Sarbanes-Oxley Debacle (2006) (arguing that the additional costs to U.S. companies to comply with SOX may send companies to foreign stock exchanges and markets).

123 See, e.g., Stephen Labaton, S.E.C. Eases Regulations on Business, N.Y. TIMES, Dec. 14, 2006, at C1. (“Responding to criticism that regulators have overreacted to years of major corporate scandals, the SEC on Wednesday issued a flurry of deregulation orders and proposals designed to lower costs to public companies.”); Purva Patel, Prosecutors Easing Back on Methods, HOUS. CHRON., Dec. 12, 2006, at __.
reflect a growing judicial frustration with prosecutorial overzealousness. 124 Annual reports from the Corporate Fraud Task Force provide evidence of a shift away from the record number of indictments and convictions of earlier years. 125 However, this eventual decrease in criminal focus, whether embodied by decreases in resources available to prosecute cases 126 or in changes in the law, should not occur without a thorough examination of the abilities of the private litigation system. Although critics of overcriminalization argue that the civil system is the appropriate arena for disputes regarding corporate misconduct, this argument is disingenuous if the civil system is overly tolerant of these investor harms. Once the era of overcriminalization ends, then the only arena for disciplining corporate misconduct will be the civil litigation system. This system, untouched by post-Enron reforms, will prove to be ill-equipped to either deter or remedy future corporate misconduct. In fact, corporate defendants ironically may be more protected by the civil system than the criminal system.

III. Decreasing Shareholder Relief or “The Undercivilization of Corporate Law”

Scholars who are critical of the overcriminalization of corporate law often suggest that the civil sphere can more readily discipline corporate misconduct. Even scholars who support the criminalization of corporate law insist that the ideal regime has some mix of criminal and civil penalties. 127 However, few of these scholars explore how well-equipped the private litigation system is to provide a vehicles for shareholders to be these ideal private attorneys-general. 128

124 Enron Overkill, WALL ST. J., Aug. 15, 2006, at A12 (stating that the message the Enron Task Force sent was “beware of prosecutors bearing overbroad theories”).

125 Although 2006 was a busy year for prosecutions of the Corporate Fraud Task Force, the number of defendants charged and number of convictions of CEOs and presidents reported by the Task Force in August 2006 were unchanged from August 2005.

126 See Carrie Johnson, SEC Enforcement Cases Decline 9%, WASH. POST., Nov. 3, 2006, at D3 (describing recent budget cuts and hiring freezes at the SEC which may shift the enforcement burden of the stock options backdating investigations to “the shoulders of investors, just as existed before Enron was exposed”).

127 See Khanna, supra note 2.

128 See Ideoblog, http://busmovie.typepad.com/ideoblog/2007/02/pick_your_poiso.html (Feb. 7, 2007, 6:50 CST) (acknowledging both that “the efficiency of private litigation can be assessed only
Following the emergence of numerous highly publicized corporate scandals involving accounting fraud, the federal government turned its attention in 2002 to using federal laws and resources to combat corporate misconduct. At the same time, regulators did not turn their attention to increasing liability under the private litigation system.129 Some commentators noted that much of the misconduct took place after 1996, the year Congress enacted the PSLRA, which was designed to decrease shareholder securities lawsuits and protect corporate defendants from litigation that was seen as meritless.130 However, legislators did not accept a connection between insulating corporate defendants from civil redress with a surge in corporate misconduct and so left the PSLRA intact.

A. Private Shareholder Litigation

The theory of the firm states that shareholders in corporations have two primary courses of action when they are unhappy with management: voice and exit. Shareholders can exercise their voice through the mechanisms of voting, rules for amending bylaws and the proxy machinery. Few corporate scholars would disagree that in a publicly-held corporation, the shareholder voice option is extremely weak for all but the most well-funded significant shareholders. Even in these cases, shareholders who push for internal reforms are generally either individual investors with a large minority ownership or institutional investors, such as pension funds or even private equity funds; both of these groups have their own agendas and reasons for pushing for change that may not be representative of the concerns of the scattered individual investors.

129 See Vikramaditya S. Khanna, A Political Theory of Corporate Crime Legislation, 82 WASH. U.L.Q. 95 (2004) (giving a public choice rationale for business industry to acquiesce to SOX rather than repeal the PSLRA under the theory that prosecutors would not be as vulnerable to bringing meritless suits as plaintiffs' lawyers).

130 See Perino, supra note 7, at 932-33 (questioning the argument that because more lawsuits have been filed in recent years that the passage of the PSLRA created more fraud and therefore more filings); Seligmann, supra note at 113 (“To be precise, the diminution in the effectiveness of private federal securities litigation was one of several factors that contributed to a reduction in fraud deterrence.”).
Bringing lawsuits as shareholders against a firm can be seen as another, perhaps ex-post, attempt to exercise shareholder voice. However, this voice option is just as weak as internal voice options; those with small but representative claims have collection action problems in joining together for litigation and proceeding litigation has the hallmark of being driven by an individual or group with an agenda or by a contingency fee lawyer whose interests may also not be aligned with the collective whole. In addition, even after lawsuits are filed, procedural hurdles and substantive law combine to guarantee that most lawsuits do not survive.

Similar to other reform activities undertaken by shareholders, private litigation is rarely economically rational for an individual shareholder. A shareholder with 100 shares of a corporation worth $50 each will rarely bear the costs of litigation to sue for damages resulting from misconduct that diminished share value 25% or even more. Moreover, shareholders with small stakes will pause before bringing an expensive lawsuit for nonmonetary, remedial action. Again, organizing a large group of shareholders with small stakes to share the costs of litigation is rarely feasible without a coordination effort.

Because of the collective action problem endemic to shareholder litigation, plaintiff attorneys have typically played the role of litigation coordinator. As has been discussed elsewhere at length, this system is subject to abuse because at different points in the litigation the attorneys’ incentives may not be aligned with the incentives of shareholders as a class. In addition, shareholders may have heterogeneous goals that can not simultaneously be pursued. Many criticisms of private shareholder litigation center around distrust for the objectives of the plaintiffs’ attorney and perceived abuses of the system. However, reforms aimed at eliminating “strike suits” and frivolous litigation brought by plaintiffs’ attorneys only result in exacerbating the problems that have

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131 Shareholders in a corporation willing accept risk of price fluctuation, both for systematic risk and unsystematic risk. However, illegal corporate activities should not be seen as a foreseeable unsystematic risk inherent in a given security. Although some commentators argue that shareholders accept the risk of corporate misconduct and so should protect themselves by diversifying their portfolios, just as shareholders diversify against unsystematic risks, this paper argues that public policy demands that illegal activities, gross negligence and self-dealing not be considered foreseeable risks in the ordinary course of business.

132 See William A. Klein & John C. Coffee, Jr., Business Organization and Finance 206 (2004) (“In theory, the action is brought by an aggrieved shareholder; in reality, it is typically brought by a plaintiff’s attorney who finds a shareholder, who may own only a few shares, to serve as the nominal plaintiff.”).

133 See Ribstein, supra note 5.
given the contingency fee attorney so much power in the first place. By making shareholder litigation more costly and success less probable, contingency-fee attorneys who finance the litigation are more firmly ensconced in the driver seat than ever before.

**B. Fiduciary Duty Claims**

A plaintiff in a state law cause of action claiming breach of fiduciary duty by a board of directors, like all plaintiffs in a civil lawsuit, has the burden of proof and must convince the trier of fact that the defendant is liable by a preponderance of the evidence. However, a plaintiff in a lawsuit against a board of directors has a number of other burdens to meet before a lawsuit may proceed to a successful judgment.

1. Procedural Hurdles

A board of directors owes fiduciary duties to the corporation. Because the corporation is a fictional entity, these duties are said to run to the shareholders. As an initial matter, a plaintiff must decide whether the lawsuit is one in which the board breached its duties to the shareholders as a class or to a specific shareholder directly. If the shareholder can persuade the court that the harm was one done to the shareholder specifically and not to all shareholders generally, then the shareholder may bring suit personally against the company, board of directors, officers, or agents in a “direct” action. The universe of these types of claims is quite small and the direct harm must be sufficiently large to induce the shareholder to sue. Most causes of action involve actions that harmed shareholders as a class or, in other words, harmed the corporation as a whole. Because the corporation is managed by the same individuals that it would

134 See JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 420 (2003) (explaining the difference between a direct, individual suit and a derivative action).

135 Id. (noting that many times the classification of a harm as an individual harm or a collective harm is difficult).
be suing and because it cannot sue itself, these “derivative” actions are brought in the name of the company by the shareholders.136

Although direct shareholder suits are then allowed to proceed, derivative claims must first be filtered through the board of directors, a requirement that theoretically eliminates the possibility of shareholders wasting the corporation’s time and resources on frivolous complaints but that in reality eliminates most derivative lawsuits.137 State law requires that shareholders must first ask the corporation, through its board of directors, to take action (against itself) before the action may proceed.138 Occasionally, boards create special litigation committees to either bring such an action or to terminate it.139 If the plaintiff-shareholders believe that such a request will be rejected because of conflicts within the board, they may attempt to file the lawsuit without taking this step by claiming “demand futility.”140 However, the court then will analyze whether conflicts on the board exist that would make such demand futile and determine whether the cause of action can proceed. The court will determine that a demand would not have been futile if “(1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”141 Note that this is not an analysis of the merits of the cause of action or even of whether the directors would refuse the demand, but merely an analysis of whether the directors meet a narrow definition for being disinterested. Practically, if a court finds that half or more of the directors are disinterested, then the demand futility claim will fail.142 Accordingly, the

136 See KLEIN & COFFEE, supra note 132, at 205.
137 Delaware Court of Chancery Rule 23.1.
138 See KLEIN & COFFEE, supra note 132, at 207 (“The most substantial present-day barrier to derivative actions, however, is a doctrine under which the corporation’s board of directors. . .can successfully move to dismiss the action on the ground that it has reviewed the action and deems it contrary to the corporation’s best interests.”).
139 See Oracle Corp. Deriv. Litig., 824 A.2d 917 (Del. Ch. 2003) (refusing to terminate the derivative litigation, stating that the special litigation committee was not independent from the defendant directors).
140 See COX & HAZEN, supra note 134, at 428.
142 See James D. Cox, The Social Meaning of Shareholder Suits, 65 BROOK. L. REV. 3, 23-24 (1999) (arguing that a derivative lawsuit questioning director decisionmaking will almost always fail because it will be screened by the demand inquiry, leaving only complaints of self-dealing to proceed to trial).
demand requirement serves as a very powerful gatekeeper that screens out most lawsuits, whether meritorious or not. \(^{143}\)

The determination of whether a case is direct or derivative may determine the outcome of the case. \(^{144}\) By deciding that a board may be trusted with a shareholder complaint, the court tosses the complaint out of the judicial realm into the informal arena of board of director customer service, where the shareholder’s concern may or may not be addressed in a relevant way. Should the shareholder decide to make demand on the board before proceeding to trial, determination by the board not to pursue a proposed derivative action is presumed to be a legitimate determination under the auspices of the business judgment rule, which protects decisionmaking by the board. In addition, by seeking action from the board, the shareholders may be waiving any further argument that the board was not acting independently, making a “wrongful refusal” case difficult to win.

In addition, in a derivative suit, damages are generally paid to the corporation. \(^{145}\) In the event of a settlement, the court must approve the settlement. \(^{146}\) This settlement, which may involve only changes in management practices and not a monetary sum, will almost certainly include a monetary amount paid to the plaintiffs’ attorney, who has advanced the costs of litigation during the life of the lawsuit. \(^{147}\) As mentioned earlier, the availability of attorney

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\(^{143}\) In the case of Morillo v. Abrams, a special litigation committee formed by the board of Mercury Interactive Corporation sued 4 former officers for breaching fiduciary duties by backdating stock options. The complaint contained copies of emails evidencing the conduct. However, the Superior Court of California dismissed the complaint after Hewlett-Packard acquired Mercury, holding the shareholders no longer had standing. See Mark Boslet & Mark Maremont, *Emails Reveal Backdating Scheme*, WALL ST. J., Feb. 20, 2007, at A4 (revealing substance of complaint, which had been filed under seal but inadvertently attached as an exhibit to a motion not under seal).


\(^{145}\) See *KLEIN & COFFEE*, supra note 132, at 205.

\(^{146}\) See *COX & HAZEN*, supra note 134, at 458.

\(^{147}\) See Notice of Pendency of Derivative Action and Hearing on Proposed Settlement, In re The Limited, Inc. Shareholders Litigation, Civ. No. 17148-NC (Del. Ch. June 10, 2004). In this action, shareholders were allowed to pursue a derivative claim without making demand on the board of directors due to the court’s finding that at least half of the board was not independent from the from the company’s founder, chairman and CEO, Leslie H. Wexner, whose conflict of interest was at the center of this duty of loyalty lawsuit. In re The Limited, Inc. Shareholders Litigation, 2002 WL 537692 (Del. Ch. 2002). The shareholders challenged a board action that would rescind an
fees in court-approved settlements may give the attorney stronger incentives to settle rather than proceed to trial at certain stages of the litigation than the shareholders.

Second, derivative actions involve other procedural requirements beyond the demand requirement. Should the lawsuit proceed as a derivative action, then the plaintiff must satisfy state law rules regarding continuity of share ownership during the time period in question and the duration of the lawsuit. For example, shareholders bringing the action must have owned shares in the company at the time of the actions in question and must hold those shares while the litigation is pending. In addition, some states, including Delaware, shareholders must surrender an amount of money to the court as a bond to reimburse the corporation for litigation expenses in the event that the lawsuit is found to be without merit. The Model Business Corporations Act requires plaintiffs to pay the corporation’s attorney fees and expenses if the lawsuit is found to be without merit or for an improper purpose.

2. Business Judgment Rule

Once the lawsuit is allowed to proceed as either a direct or derivative action, the plaintiffs must then satisfy the burdens of the business judgment rule. This rule has both a procedural and substantive aspect. Because courts recognize that boards of directors make numerous business decisions in the operation of a corporation and that courts should not be in the business of second-guessing these decisions with the benefit of hindsight, directors are presumed to have made decisions in accordance with the duties owed to the corporation. In other agreement between that would have given the company the right to buy back shares from a family trust at a fixed price that had become a bargain and a separate self-tender offer to purchase 15 million shares of The Limited stock. In the settlement that occurred five years after these board actions, Wexler agreed not to tender any shares owned by himself or his family in a 2004 tender offer, just as he had in the 1999 tender offer, and for six months following the tender offer. Although this remedy may seem of questionable benefit to the shareholders, the settlement included payment of up to $10 million in attorney fees, to be paid by the company in an amount up to $3 million and the balance by Wexler.

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148 See, e.g., DEL. CORP. ANN. § 327 (2000).
149 See KLEIN & COFFEE, supra note 132, at 206.
150 MODEL BUS. CORP. ACT § 7.46.
151 See COX & HAZEN, supra note 134, at 184.
words, directors are presumed to act in good faith, with due care for the purposes of furthering legitimate business interests. However, this presumption can be rebutted should the shareholders be able to show marked deviations from this standard, such as gross negligence, bad faith, or waste. Depending on the amount of evidence that shareholders can plead early in the litigation, this presumption may result in a case being dismissed before trial. Even if the case proceeds to trial, the defendant directors still benefit from the presumption when the court is weighing the evidence.

Historically, cases with the most potential for success as derivative suits are duty of loyalty claims, where shareholders can prove that one or more decisionmakers were on both sides of a business decision and that the process did not insulate the decision from bias. Cases in which courts find evidence of deviations from due care such as gross negligence are rare; waste, even rarer.

C. Securities Fraud Claims

Shareholders of a public company have a private cause of action against that company for violations of various federal securities laws. Depending on when the shareholder bought shares in the company, the shareholder may allege violations of the Act, including, among others, Section 10(b) of the Securities Exchange Act, Sections 11 and 12, Section 15, and Section 20. As in

152 See Thompson & Thomas, supra note 144 (showing that zero of 233 cases alleging “Revlon” duties violations won at trial in Delaware; zero of 10 cases alleging breaches of “Unocal” duties; and 228 out of 581 cases alleging breaches of duties of loyalty).


154 See In re The Walt Disney Company Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005) (“Corporate waste is very rarely found in Delaware courts because the applicable test imposes such an onerous burden upon a plaintiff – proving “an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”).

155 §11 (providing a civil remedy for purchasers of securities based on registration statements with either a material misstatement or omission, subject to various defenses, including the “due diligence” defense); §12(a)(2) (allowing for a civil action relating to a misstatement or omission in a prospectus).

156 §15 (allowing for recovery against certain controlling persons for misconduct of the company or persons violating §§11 or 12 under their supervision under certain circumstances).
state law derivative claims, shareholders must overcome a threshold obstacle before proceeding: to be certified as a class action under federal law.158 Because individual claims are usually not sufficiently large to justify the costs of litigation, these suits only survive if one or more contingency-fee attorneys is allowed to proceed on behalf of a class of shareholders. If the trial judge does not believe that the plaintiffs do not constitute a valid class, then only individual cases can proceed.159

1. **Private Securities Litigation Reform Act of 1995**

The watershed event in the history of private securities litigation came in 1994 with the Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver*.160 In *Central Bank*, the court held that shareholders had a private cause of action in Section 10(b) cases against primary actors, not “aiders and abettors.”161 Therefore, plaintiffs had to allege the elements for a primary violation of Section 10 against any defendant, including accountants, consultants and attorneys who were involved in any purported securities fraud. The elements of a 10(b) primary violation are difficult to plead and to prove: (1) misrepresentation; (2) duty; (3) scienter; (4) materiality; (5) reliance; and (6) injury.162

These changes were codified in 1995 with the passage of the PSLRA,163 which also increased the pleading standard for violations of Section 10. For

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157 §20 (allowing for recovery against certain controlling persons for misconduct of the company or persons violating 10b-5 under their supervision under certain circumstances).
158 FED. R. CIV. P. § 23(a).
159 At the time of this writing, the Fifth Circuit Court of Appeals is considering an appeal of the certification of a class in the shareholder class action against Enron, its employees, banks, and outside law firms.
161 See Tanya Patterson, *Heightened Securities Liability for Lawyers Who Invest in Their Clients: Worth the Risk?* 80 TEX. L. REV. 639, 648 (2002) (“As a consequence of the *Central Bank* decision, anyone sued in a private action under Section 10(b) must be sued as a primary, and not a secondary, violator.”)
162 Rothman v. Gregor, 220 F.3d 81, 89 (2d Cir. 2000).
example, the PSLRA created a new provision, Section 21D, which requires that plaintiffs plead “with particularity facts giving rise to a strong inference” as to scienter of the defendant in question. Proponents of the Act argued forcefully that plaintiffs’ attorneys were bringing frivolous lawsuits, which threatened defendant firms with expensive preliminary litigation, including intensive discovery, before these meritless cases could be dismissed. This valuable weapon arguably allows the plaintiffs’ attorney to extort a settlement soon after the filing of the lawsuit for less than the cost of preliminary litigation. Accordingly, certain provisions of the Act intend to force the plaintiff to prove the merits of the action before the defendant has to incur substantial costs. In addition to increasing the threshold matters that a plaintiff must plead, the PSLRA stays discovery while a defense motion to dismiss is pending. Therefore, a defendant may not face substantial costs until a trial judge has determined that the plaintiffs’ statement of the case has passed a substantive merit review.

However, the Act contains many acts of overkill that combine together to eliminate most private securities litigation. To increase the level of specificity that plaintiffs must know and plead but to block the same plaintiffs from any information-producing discovery creates a Catch-22 situation that few can surmount. Although numerous individual provisions of the PSLRA seem to further the goals of eliminating Type I errors, the aggregate effect is to create many more Type II errors.

164 § 21D(b)(2) (“In any private action arising under this Act in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this Act, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”).

165 See Seligman, supra note 117, at ___ (describing the arguments made in the legislative history supporting passage of the PSLRA).


167 See Seligman, supra note 117, at 117 (“The 1995 Act is a type of “kitchen sink” legislation consisting of idea after idea piled upon one another to address an applicable problem with a disproportionate response.”).

168 See Choi, supra note 119 (“[T]he PSLRA may have reduced the incidence of both nuisance litigation as well as a subset of the pre-PSLRA meritorious claims where the additional costs imposed by the PSLRA made such claims unprofitable.”).
Another concern of proponents of the Act was that shareholders, if allowed to recover the full amount of stock price decreases, would be overcompensated. In effect, these shareholders would be compensated for systematic risk, or general economic movements, which shareholders are presumed to have assumed by becoming investors. Also, downward stock movements may be the result of other industry events or firm-specific events, reflecting unsystematic risk that shareholders are assumed to reduce by diversifying their portfolios. Therefore, drafters of the PSLRA also used its large hammer against these types of nails. Although, the PSLRA does not expressly increase the pleading standard for causation, the drafters of Section 21D(e) sought to curb damages that included losses attributable to other factors and therefore limits recovery to the difference in the price in question and the average trading price during the 90-day period after the disclosure of the corporate misconduct.

Although the PSLRA applies only to securities law claims brought in federal court, its requirements now also apply in state court following the passage of the Securities Litigation Uniform Standards Act (SLUSA).

2. **Dura Pharmaceuticals, Inc. v. Broudo**

Since the passage of the PSLRA, circuit courts have been attempting to sort out and interpret the various provisions of the new amendments, creating circuit court splits. One such case, *Dura Pharmaceuticals, Inc. v. Broudo*, has been decided by the United States Supreme Court, and the opinion in that case

169 See Ribstein, *supra* note 173, at 155 (noting also that if the market is “noisy” or irrational, then damages are even more difficult to attribute to disclosures of fraud).

170 See *Coffee, supra* note 8.


attempts to clarify the impact of the PSLRA on Rule 10b-5 “fraud on the market” cases. Prior to Dura, courts were split as to how plaintiffs could prove damages in a securities fraud case and also what evidence would prove a causal link between the fraud and those damages. For example, if a company made false claims that artificially raised the price of a stock, inducing a buyer to pay too much for the stock, then the price for the stock subsequently declined prior to the buyer’s sale of the stock, courts were split as to whether disclosure of the fraud had to precipitate the price decline or if damage occurred on the sale. In addition, if because of unrelated economic conditions the price remained higher than the purchase price, even after disclosure, the buyer could not recover for the difference between the sale price and what the sale price would have been without the fraud and the disclosure of the fraud. In addition, after the PSLRA, the question remained as to whether this loss causation had to be proven in the pleadings.

Although Dura appeared to settle some questions relating to loss causation, some questions remain. However, the Court was clear in stating that “an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.” Although the Court did not say what would have served to prove causation in the case, language does suggest that disclosure of the fraud must be close in time to the drop in share price. The Court did not address the situation of where a purchaser sells at a higher price that is lower than what it

174 See Ribstein, supra 173, at __ (explicating the “fraud on the market’ theory).
175 Compare Dura Pharmaceuticals v. Broudo, 339 F.3d 933 (9th Cir. 2003) (holding that “plaintiffs establish loss causation if they have shown that the price on the date of purchase was inflated because of the misrepresentation”) with Robbins v. Koger Properties, Inc., 116 F.3d 1441 (11th Cir. 1997) (dismissing complaint where stock price declined prior to revelation of incorrect statements).
176 See Patrick J. Coughlin, Eric Alan Isaacson, & Joseph D. Daley, What’s Brewing in Dura v. Broudo? The Plaintiff’s Attorneys Review the Supreme Court’s Opinion and its Import for Securities-Fraud Litigation, 37 Loy. U. Chi. L.J. 1, 10 (2005) (“Therefore, since subsections (b)(1) and (b)(2) impose heightened pleading standards only for pleading falsity and scienter, and subsection (b)(4) addresses loss causation only after the heightened pleading standards have been cleared, it is a fair inference that the section leaves loss causation subject to ordinary notice-pleading standards.”).
177 See Amy Liu v. Credit Suisse First Boston, 04 Civ 3757 (Scheindlin, J.) (stating that what constituted loss causation in the Second Circuit was still ambiguous because the Supreme Court “did not establish what would be a sufficient loss causation pleading standard” but “merely established what was not”).
178 Dura, 544 U.S. at 342.
179 Id. at 343 (“Other things being equal, the longer the time between purchase and sale, the more likely” that intervening factors will have caused the loss).
might have been but for the fraud. 180 Furthermore, although the Court seems to say that the PSLRA does not require an increased pleading standard as to loss causation than normal rules requiring “a short and plain statement of the claim,” 181 the Court seems to say that this “short and plain statement” must be more particular as to loss causation than the pleading in front of them. 182

3. Empirical studies of Post-PSLRA Effects

The PSLRA affected securities litigation in two ways: (1) changing which cases survive motions to dismiss and (2) changing which cases get brought. Scholars have found dismissal rates to be much higher post-PSLRA (66.9%) than pre-PSLRA (28.7%). 183 In addition, because the PSLRA effectively decreases the expected value of a lawsuit given increased probability of dismissal, fewer cases are brought against companies that cause smaller damages. 184 In addition, fewer meritorious cases are brought in situations without “pre-filing hard evidence,” such as an accounting restatement or a parallel SEC investigation. 185

IV. Capital Markets as an Alternative to Criminalization or Private Litigation

Although this section has been devoted to analyzing the weakness of the shareholder voice option, some critics of the overcriminalization of corporate law point to the strength, in an efficient market, of the “exit” option.

However, many who recognize the illusion of shareholder voice defend current structural obstacles to voice because of the easily exercised “exit” option in publicly-held corporations. Shareholders unhappy with management have the ability to share their liquid shares into a ready market; theoretically, rational managers will make decisions designed to keep shareholders satisfied and

180 Id. at 346.
181 FED. R. CIV. P. 8(a)(2).
182 Dura, 544 U.S. at 346-47.
183 See Choi, supra note 9
184 Id.
185 Id.
unwilling to exit because stock sales in the aggregate will force the company’s share price downward. Rational managers will foresee reputational harm to them individual that will affect their future market price, and they will conform their behavior accordingly. However, a useful exit option not only requires rational managers but also diligent investors. To use the exit option successfully, shareholders must actively monitor their investments and sell quickly before corporate mismanagement negatively affects their shareholder value. Obviously, this technique works better in theory than in practice as most corporate misconduct is unknown until it is made public. The act of making such misconduct public causes the share price to decline, thus punishing shareholders who wish to exit after such disclosure. Accordingly, when shareholder wealth is in danger because of corporate misconduct that rises to the level of violations of law or breaches of duty, shareholders may not be able to anticipate that misconduct until share prices drop as a result of disclosure of that misconduct, making the exit option also relatively weak.

The weakness of the exit option in situations involving corporate misconduct supports a counterargument to assertions that the capital markets are an alternative to criminal prosecution or private litigation for disciplining corporate misconduct. The market-as-disciplining agent theory relies on market response to discoveries of corporate misconduct to both punish bad actors and deter future misconduct. However, this theory does not provide a remedy to the investors who lost wealth as a result of the decrease in share price. This potential loss may not properly incentivize investors to invest resources choosing firms ex-ante or monitoring ongoing investments. An individual investor has little chance of identifying corporate fraud before the market does. Once the market reacts, the existing shareholders own the discounted shares of a firm with known problems, although they purchased shares of a firm without known problems. Therefore, if criminal prosecutions are disfavored as overcriminalizing misconduct, and the market cannot redistribute shareholder losses, then private shareholder litigation may be the only realistic avenue of disciplining corporate misconduct.

V. Recent Responses to Perceived Increase in Corporate Misconduct
   A. Criminal Prosecutions

In the past five years, federal and state prosecutors have conducted a number of high-profile corporate crime prosecutions that have resulted in many guilty
convictions and guilty pleas that included lengthy prison sentences. Although most of these trials have been widely publicized, listing the outcomes of those trials here is not superfluous because of the various reversals and ongoing litigation surrounding each trial. Note that in each of these large-scale investigations, prosecutors are able to use many powerful tools, discussed more thoroughly in Section IV, to ensure victories. In many of these cases, cooperating witnesses testify in return for greatly reduced sentences against other participants who are charged with multiple, overlapping charges. In addition, many of these hard-charging prosecutions continued after one or more mistrials and hung juries, doubling or tripling the costs of prosecutions. Finally, many of these convictions and sentences have been vacated or reversed on appeal, signaling that these prosecutions may have been too hard-charging.

1. **WorldCom, Inc. – From Intent to “Willful Blindness”**

In 2000, MCI WorldCom, Inc. was ranked No. 25 in the Fortune 500,\(^\text{186}\) up from No. 80 in 1999\(^\text{187}\) and No. 210 in 1998,\(^\text{188}\) the year that WorldCom acquired MCI, Inc. In that same year, plans to acquire Sprint were thwarted by DOJ and FTC antitrust concerns that the resulting company would be too large and powerful in terms of market share. However, in June 2002, WorldCom restated its financial statements and reduced earnings by $11 billion. WorldCom would eventually file bankruptcy in July 2002, making it one of the largest bankruptcies in U.S. history. The company would emerge from bankruptcy in 2004 as MCI. This rapid decline of WorldCom resulted in criminal investigations, an SEC investigation, and various shareholder suits. WorldCom was investigated for suspected financial accounting fraud, specifically the capitalizing of expenditures that have historically been deducted as operating costs. Although the SEC eventually settled with WorldCom in February 2003 on corporate charges, requiring only that WorldCom agree not to violate any securities laws in the future, the individual criminal investigations continued. At least five officers pleaded guilty, including CFO Scott Sullivan and controller David Myers, on charges of securities fraud and related offenses. Sullivan and others testified against CEO Bernard Ebbers at trial in exchange for drastically reduced


sentences. Ebbers was convicted on all nine counts brought against him, including one count of securities fraud and one count of conspiracy to commit securities fraud, on March 15, 2005 and sentenced to a 25-year term with an additional three years of supervised release.

Although trial testimony did not produce proof that Ebbers knew of the fraud, the prosecutors were able to instruct the jurors on the doctrine of “willful blindness” so that Ebbers could be guilty of securities fraud if deliberately chose not to confirm any suspicions he had of such misconduct. That conviction was upheld on appeal. Defenders of corporate criminal penalties point out that criminal laws require specific intent, which makes them harder to prove, thus resulting in a more certain outcome, than civil causes of action. However, the ability to use the “willful blindness” theory of intent makes criminal convictions of securities fraud easier to obtain in some cases than in civil securities fraud cases.

2. Rite Aid – The Power of the Wiretap and a Plea Bargain

Like Tyco, Rite Aid was a company on the move in the 1990s, expanding rapidly through acquisitions with CEO Martin Grass at the helm. However, Grass was forced to resign in October 1999 amid rumors of accounting fraud. Reportedly, in addition to causing Rite Aid to engage in real estate transactions that benefited his family, Grass also backdated severance letters to various

189 United States v. Ebbers, 458 F.3d 110, 2006 WL 2106634 at *18 (2d Cir. 2006) (denying Ebbers’ argument on appeal that his lengthy prison sentence was unfair in comparison to the lighter sentences given Sullivan (five years) and Myers (one year and one day). A prison sentence of one year and one day is a common sentence in federal crimes given the ability of parole at ten months for any sentence over one year, but not for sentences of one year or less.

190 See Brooke A. Masters, WorldCom’s Ebbers Convicted, WASH. POST, March 16, 2005, at A1 (describing the end of the story of “a former milkman and high school coach who built WorldCom from a tiny Mississippi long-distance reseller into a national powerhouse”).

191 These counts were one count of conspiracy to commit securities fraud, one count of securities fraud, and seven counts of making false filings with the SEC. See Ebbers, 2006 WL 2106634 at *6.

192 See id. at *19 (acknowledging that “[t]wenty-five years is a long sentence for a white collar crime, longer than the sentences routinely imposed by many states for violent crimes, including murder, or other serious crimes such as serial child molestation”).

193 See id.

officers totaling $23 million after resigning. In December, the SEC launched an investigation into the alleged fraud, and the DOJ, with the Federal Bureau of Investigation, also began an investigation, which included wiretapping conversations of various officers. In June 2002, the DOJ indicted various officers, including Grass, Vice-Chairman of the Board and Chief Legal Officer Frank Brown, Vice President Eric Sorkin, and CFO Franklyn Bergonzi in a 37-count indictment. In its civil charges, the SEC alleged that Grass and the other officers had participated in “one of the most egregious accounting frauds in recent history.” Eventually, Rite Aid would restate earnings from the period May 1997 to May 1999, reducing net income by $1.6 billion.

In June 2003, Grass pleaded guilty to Counts 1 and 33 of the indictment: conspiracy to defraud and conspiracy to obstruct justice and was sentenced to eight years imprisonment and a $3 million forfeiture. Brown, who was 74 years of age at the time of his trial, was convicted of ten of eleven counts after a trial on the merits in October 2003. He was later sentenced to 120 months in federal prison. Five other officers plead guilty to various charges, including Bergonzi, who was sentenced to 28 months imprisonment, and Sorkin. Timothy J. Noonan, President and Chief Operating Officer, was sentenced to

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195 Id.
198 SEC Litig. Rel. No. 18728, SEC Settles Fraud Case Against Rite Aid Former CEO, May 27, 2004, available at http://sec.gov/litigation/litreleases/lr18728.htm (announcing that Grass had settled accounting fraud charges with the SEC in exchange for the promise not to violate securities laws in the future and to accept a ban from being an officer or director of a public company).
199 See id.
200 Ex-Chief Pleads Guilty in Rite Aid Case, N.Y. TIMES, June 18, 2003, at C12.
201 Although Grass’s plea agreement was first rejected by the trial judge as being too lenient, the prosecution argued that although his plea, given just days before his trial would have begun, ordinarily would not have seemed “timely” under the Federal Sentencing Guidelines, the timing assisted the prosecution’s office in preparing for other trials during that time. Government’s Sentencing Memo, 2004 WL 905611 (M.D. Pa. April 7, 2004).
203 See id. (upholding sentence notwithstanding an erroneous jury instruction and concerns raised by U.S. v. Blakely).
204 Former Rite Aid Officer Pleads Guilty, N.Y. TIMES, June 6, 2003, at C3.
205 Defendants in Rite Aid Case Expected to Plead Guilty Today, N.Y. TIMES, at C6.
probation after assisting prosecutors, including wearing a recording device during conversations with Brown.\footnote{See United States v. Grass, 239 F. Supp. 2d 535 (M.D. Pa. 2003) (not excluding from evidence tape made by co-conspirator Noonan of conversations with Brown while Brown was represented by counsel but before Brown was indicted).}

3. **HealthSouth Corp. – Getting Another Bite at the Apple**

The trial of HealthSouth’s founder, CEO and Chairman, Richard Scrushy, is notable among the other corporate criminal trials for several reasons. First, in addition to being charged with the usual crimes of conspiracy, accounting fraud, securities fraud, and money laundering, Scrushy was also the first CEO to be charged under the Sarbanes-Oxley Act’s provision regarding certification of financial statements.\footnote{See United States v. Scrushy, 2004 WL 2253553 (M.D. Ala. Sept. 29, 2004) (superseding indictment); see also Tom Bassing, *HealthSouth’s Scrushy Indicted on 85 Counts*, BIRMINGHAM BUSINESS J., Nov. 4, 2003, at C4.} Although Scrushy attempted to have that charge dismissed on constitutional law grounds, the charge remained.\footnote{Sarbanes-Oxley Law Is Upheld, As Challenge by Scrushy Fails, WALL ST. J., Nov. 30, 2004, at C4.} However, on June 27, 2005, Scrushy was acquitted on all counts, including making false certification of financial statements.\footnote{Dan Morse, Chad Terhune & Ann Carrns, *Clean Sweep: HealthSouth’s Scrushy Is Acquitted*, WALL ST. J., June 29, 2005, at A1.}

The acquittal of Scrushy in a federal court in his hometown of Birmingham, Alabama, was a blow to the prosecution.\footnote{Id.} Before indicting Scrushy in November 2003, the prosecution had accepted fifteen plea agreements from HealthSouth officers in exchange for their cooperation in the Scrushy’s prosecution.\footnote{Id.} Five CFOs of HealthSouth testified against Scrushy.\footnote{Id.} However, after six weeks of deliberations, the jury exonerated the defendant.

Not wanting to go home empty-handed, federal prosecutors shortly thereafter indicted Scrushy and former Alabama governor Don Siegelman on charges of bribery, conspiracy, and mail fraud in connection with a $500,000 payment by
Scrushy to the governor. The payment was allegedly in return for a seat on the state’s hospital regulatory board. On June 29, 2006, Scrushy was convicted on all counts; he vows to appeal that conviction, which has some procedural vulnerabilities.

4. *Enron Corp. – Using the Domino Theory*

The implosion of Enron Corp., ranked as high as No. 5 on the Fortune 500 list, spawned a wide-ranging investigation by both the DOJ and the SEC. In November 2001, Enron announced that it would restate its financial statements from 1997 forward, resulting in over $500 million in unclaimed losses. The stock price, which had been declining following the resignation of CEO Ken Lay in October, fell even more, to about $.29 by the end of November. An eleventh-hour proposed merger with Dynegy, Inc. did not materialize when Dynegy terminated the agreement, citing material adverse changes. On December 2, Enron declared bankruptcy.

Enron will be remembered both for the complex related transactions with special purpose entities created by CFO Andrew Fastow that hid losses and allowed Fastow to pay himself millions of dollars and for the impact of the fall of Enron on its employees. In this era of 401(k) plans and retail stock ownership, Enron had encouraged its employees to invest their retirement plan monies in Enron stock. In October 2001, when executive officers surely knew of coming troubles and the stock was falling, Enron changed the plan administrator for its employees’ retirement plan. Although this change may seem like a mere administrative move, this action effectively froze employees’ accounts for thirty days, during which time they could not sell the Enron stock inside of their


accounts. The frustration of these employees watching their retirement accounts disintegrate was replayed in the media, creating very fierce negative opinions about Enron and the officers there.

As the investigation progressed, plea agreements with lower-level employees, such as Michael Kopper, allowed prosecutors to gather evidence implicating executive officers, and on April 30, 2003, prosecutors indicted Fastow, former Treasurer Ben Glisan, and Dan Boyle. The same day, prosecutors indicted Fastow’s wife, Lea Fastow, on six felony charges relating to her signing their joint tax returns, which did not properly account for the money that Fastow was siphoning off the firm. In January 2004, both Fastows pleaded guilty.\textsuperscript{216} Prosecutors agreed to recommend that Andrew Fastow be sentenced to ten years imprisonment after testifying against other Enron officers. Lea Fastow, who was allowed to plead to one misdemeanor charge of tax evasion, was sentenced to a prison sentence of one year, more than the five months in prison that prosecutors had recommended, which she served in a maximum security prison in downtown Houston in order to be closer to her children. Information provided by Fastow, Glisan and others allowed prosecutors to indict former CEO Ken Lay, President Jeff Skilling and Richard Causey.

Because of the complexity of the nonstandard transactions that kept liabilities off of the balance sheet and artificially inflated the stock price, prosecutors decided to choose the simplest cases to bring criminal charges against Enron and individuals. One such case was the “Nigerian Barge” case in which the government accused Enron executives of selling several power-producing barges to Merrill Lynch at the end of December 1999 in order to include profits from the sales in that year’s financial statements. Because Enron eventually bought the barges back six months later, the government labeled the transaction a sham and not a “true sale” under accounting rules. This case was surprising for the prosecution to pick as the first Enron trial because the actual damage to investors was arguably zero. Enron and its shareholders lost no money on the sale or repurchase. Glisan testified in that trial after pleading guilty in return for a five-year sentence. The trial, which no doubt prompted many plea bargains, ended in a conviction for one Enron executive and four Merrill Lynch bankers, although the convictions of the bankers were reversed on appeal. In fact, the Fifth Circuit Court of Appeals chided prosecutors for bringing dubious charges under an overbroad federal statute.

Another piece of the Enron prosecution was the trial surrounding Enron Broadband. The prosecution secured information and testimony from Enron executives, including Kevin Hannon, who pleaded guilty to conspiracy charges in August 2004, and charged unit chief Kevin Howard and Michael Krautz with five counts each of fraud, conspiracy and falsifying records. At trial in May 2006, Krautz was acquitted of all charges, but Howard was convicted on all five. However, following the Fifth Circuit Court of Appeals’ vacating of the convictions in the Nigerian Barge case on the same theories that underlay Howard’s conviction, the prosecution asked that four of the five counts of the conviction be vacated. On January 31, 2007, U.S. District Judge Vanessa Gilmore vacated all five counts.

The benchmark case in the Enron drama was the trial of Lay, Skilling and Causey. Days before the trial was to begin, Causey plead guilty and agreed to testify against Lay and Skilling. In fact, most of the prosecutor’s witnesses were Enron insiders who had pled guilty in return for their testimony. Although Causey never took the stand, he was repaid by his late cooperation with a five-and-a-half-year prison sentence. Lay and Skilling were convicted, although Skilling’s conviction is now on appeal. Shortly after the verdict, Lay suffered a massive heart attack and died, effectively vacating his criminal conviction. At the time of this writing, the strength of Skilling’s conviction to survive an appeal is in question after the successful appeals of Enron defendants in both the Nigerian Barge case and the Enron Broadband case. Because Skilling’s conviction in part was based on jurors believing he had knowledge of the conduct in those cases, if that conduct is not known seen as criminal, then his knowledge would be irrelevant.

5. **Dynegy, Inc. – Paying The Price of Going to Trial**

The movement creating a backlash against overcriminalization has a martyr, and his name is Jamie Olis. Olis, a 38-year-old, mid-level executive, was convicted for his participation in a fraudulent accounting scheme; this

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217 See Kristen Hays, *Enron’s Top Accountant Gets 5 ½ Years, Fine*, HOUS. CHRON., Nov. 16, 2006, at ___ (reporting that the judge reduced his sentence by one year more than prosecutors had requested).

218 See Laura Goldberg, *Ruling May Benefit Convicted Executive*, HOUS. CHRON., July 1, 2004, at ___.

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conviction was based in part on testimony given by Olis’ boss, Gene Foster, who had entered a guilty plea and would eventually be sentenced to 15 months imprisonment in exchange for his testimony. 219 Although the accounting scandal prompted an investigation and the resignation of Dynegy’s CEO, the brunt of the prosecutorial power seemed to fall on Olis, who seemed the least involved. 220 Olis, who chose not to accept a plea bargain, was sentenced to twenty-four years in prison in 2004. 221 However, the Fifth Circuit vacated this sentence October 31, 2005; 222 on remand, Judge Sim Lake reduced the sentence to six years.

6. Cendant Corp. – Third Time’s a Charm

Although a deadlocked jury in a criminal trial is not a clear signal of agreement with the defendant’s story and may simply mean that a majority, but not all, of the jurors voted for conviction, 223 in private litigation a similar setback would make the plaintiff (or realistically the plaintiff’s lawyer) recalculate the expected value of the litigation. The additional cost of another trial would probably make pursuing the litigation not a viable option. However, in recent years, prosecutors have retried corporate defendants not just twice, but even three times. One such example is the prosecution of two executives of Cendant Corp.

Just as Cendant Corp. was formed by the merger of CUC International, a direct marketing firm that sold memberships in discount shopping, travel and entertainment club, and HFS, a franchiser of hotels, Avis Car Rental centers, and Century 21 Real Estate brokerage services, the new officers discovered accounting irregularities in the financial statements of CUC. 224 The new board promptly fired Cosmo Corigliano, CUC’s chief financial officer, but could not reach a consensus concerning Walter Forbes, CUC’s founder and former chief

219 See Tom Fowler, Two Sentenced in Dynegy Project Alpha Case, HOUS. CHRON., Jan. 6, 2006, at __ (reporting Foster’s sentence as well as the sentence of Helen Sharkey, who received a sentence of one month).
221 See Alex Berenson, Prosecutors Score White-Collar Verdict, N.Y. TIMES, April 4, 2004, at A31.
223 FED. R. CRIM. P. 31.
executive and current Cendant chairman, or CUC’s former chief operating officer, E. Kirk Shelton.225 Cendant announced these findings on April 15, 1998, and the stock price of Cendant dropped 46.5%, destroying more than $14 billion of its market capitalization.226 The DOJ began its own investigation and issued its own indictments.

Corigliano testified against both Forbes and Shelton, stating that both officers were knowing participants in the scheme to inflate revenue and earnings.227 Former CUC Controller Anne Pember and another accountant also reached plea deals with the government in 2000 and cooperated in the cases against Shelton and Forbes.228 The first trial against Forbes and Shelton in 2004 ended with the jury being deadlocked on all sixteen counts against Forbes, including securities fraud, mail and wire fraud, conspiracy, making false statements and insider trading.229 The jury convicted Shelton, who was later sentenced to ten years in prison.230 Prosecutors retried Forbes again in 2005 on the securities fraud, conspiracy and making false statements counts.231 Once again, the jury deadlocked and the judge declared a mistrial.232 In 2006, Forbes was tried for a third time in as many years, again for securities fraud, conspiracy to commit securities fraud, and two counts of making false statements. In October 2006, a jury convicted Forbes of conspiracy to commit securities fraud and two counts of making false statements, although he was acquitted of securities fraud.233 Forbes

228 See id.
230 Id.
232 Id.
was sentenced to twelve years, seven months in prison and ordered to pay $3.28 billion in restitution.\textsuperscript{234}

Interestingly, Corigliano and Pember were sentenced in January 2007 to three and two years of probation, respectively.\textsuperscript{235} The prosecutor in that case remarked on Corigliano’s continued involvement in the prosecution and his “indispensable” testimony. The judge agreed, saying, “Without your testimony, I don’t think Walter Forbes could have been convicted. You were the only witness that was kind of inside the corporate hierarchy.” In other words, Corigliano’s substantial involvement in the corporate misconduct resulted in his avoiding prison, whereas someone with less culpability and less information would have been less valuable to the prosecution and may have gone to jail.

7. Westar Energy – No Stone Left Unturned in Haystack Search

Westar Energy is the largest electricity provider in Kansas, providing utility service to approximately 667,000 customers.\textsuperscript{236} As Westar struggled because of losses generated by the acquisition of several unregulated companies, Kansas’ utility watchdog groups began paying close attention to the company’s rate increases and declining stock price.\textsuperscript{237} In 2001, at consumer advocacy groups’ urging, the Kansas Corporation Commission (KCC) began a detailed review of Westar’s rates and practices.\textsuperscript{238} In conjunction with this review, examiners noticed entries in the company’s aircraft logs that did not seem to reflect business-related outings, but suggested that Chairman and CEO David Wittig and other executives used the aircraft for personal trips.\textsuperscript{239} On September 17, 2002, the Topeka, Kansas U.S. Attorney’s Office issued grand jury subpoenas to

\textsuperscript{239} Id.
Westar for records related to “aircraft use, annual shareholders’ meetings, and CEO David Wittig.”

While the U.S. Attorney investigated Westar and Wittig, the company discovered it had overstated good will at Protection One, a home security service provider it had acquired, and found accounting errors relating to liabilities from a call option on Westar’s debt. As a result, on November 2, 2002, Westar restated its earnings for the first half of the year, increasing its net loss figures for the period by $98.4 million – from $639.6 million ($8.94 a share) to $738 million ($10.31 per share).

In December, 2003, federal prosecutors charged Wittig and former Westar vice president Douglas Lake with “personally profiting at the company’s expense, pushing out ‘troublesome’ board members and monitoring employee telephone calls to ensure the alleged scheme was not uncovered.” Under the 40-count indictment, prosecutors alleged that while Westar stock fell from $44 to less than $9 per share, “Wittig ‘exploited’ his authority over capital expenditures to approve a $6.5 million renovation of the Westar headquarters in Topeka, which included building a gourmet kitchen and installing a $29,000 television wall unit.” Prosecutors also alleged that both “caused Westar to falsify records related to their use of the corporate jet, saving them thousands of dollars in personal income taxes because they did not reimburse the company nor report the use of the planes as compensation for tax purposes.” In addition, both Wittig and Lake were accused of taking financial incentives from the company’s relocation program when they moved from New York to Topeka without selling their New York homes. Prosecutors also claimed that Wittig and Lake used Westar funds to create a scheme they called “Project X,” wherein they hired lawyers and private investigators to monitor employee use of company email and telephone, and “to probe the backgrounds of reporters and regulators ‘in an effort

240 Id.
242 Id.
244 Id.
245 Id.
246 Id.
to squelch the truth about what was occurring within the company,"247 at a cost of approximately $100,000.247

Wittig and Lake were tried on all 40 counts in 2004, but when the jurors could not reach a verdict on more than half the charges, Judge Julie A. Robinson declared a mistrial.248 After re-trying the case in 2005, prosecutors secured the conviction of both men on all 40 counts, and Judge Robinson sentenced Wittig and Lake to 18 and 15 years in prison, respectively.249

However, on January 5, 2007, the 10th Circuit Court of Appeals overturned the convictions on all 40 counts,250 finding that “[n]one of the evidence supported the core criminal charge – that the two men used corporate planes for their personal use and committed wire fraud by failing to disclose that use in filings with the Securities and Exchange Commission.”251 Because many of the counts were reversed due to insufficient evidence, the defendants may not be retried on those charges.252

247 Id.


250 United States v. Lake, 472 F.3d 1247 (2007) (reversing convictions of wire fraud, money laundering, and conspiracy to commit both because the documents that were the subject of the wire use were not fraudulent and reversing conviction of circumvention of internal controls because of lack of evidence on intent).

251 The relevant SEC regulation only requires disclosure of airplane use if the flights’ “aggregate incremental cost” exceeds either $50,000 or 10 percent of the user’s salary and bonus. In both trials, prosecutors argued that the regulation was irrelevant: instead of using the SEC’s method for valuing the trips, prosecutors called an expert accountant to testify that the flights “amounted to a $1 million benefit each over a period of five years … ‘not an unreasonable method of measuring the value of the trips,’ the appeals court noted, ‘but it is not the method required by the S.E.C.’” Lake, 472 F.3d at __.

252 Posting of Peter Henning to White Collar Crime Prof Blog, http://lawprofessors.typepad.com/whitecollarcrime_blog/2007/01/convictions_of.html (Jan. 6, 2007, 9:21:52 CST) (“[T]he court's conclusion that the government did not introduce sufficient evidence to prove the wire fraud counts means that those charges cannot be retried under the Double Jeopardy Clause because the reversal, if it stands, means that the defendants should have been found not guilty by the jury, a decision that bars any future proceedings. The conspiracy and circumvention charges, however, can be retried if the government so chooses, although the loss of the wire fraud counts might make it more difficult to win a retrial because prosecutors may not be able to allege the circumvention was part of a broader fraudulent scheme.”)
B. New Horizons

Even as the number of new corporate prosecution is declining, prosecutors are focusing on other categories of misconduct rather than accounting improprieties and financial fraud. One such new category is backdating of stock options. The increased issuance of stock options to corporate executives, board members and employees is not news. In fact, even the practice of regularly “reloading” holders options when the strike price is higher than the market price is widely known to investors. However, new attention has been focused on the practice of issuing stock options and backdating the grant date to an earlier date in which the closing market price was lower. Using this method, a firm could offer a new hire or existing employee a stock option that was already “in the money” on the date of the grant. Although employers are free to compensate employees and directors at any level, this practice may violate accounting rules or tax laws if not disclosed properly.

The DOJ issued the first indictments for backdating in a case against executives at Brocade Communications Systems, Inc. However, public opinion has become critical of criminalizing backdating, which may have been a widespread practice at many firms, including Apple. The investing public may be supportive of convictions against unknown executives of small technology firms, but not Steve Jobs. Although stock prices at subject firms go down once this practice is disclosed in the media, this evidence of investor nervousness

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254 See Charles Forelle & Nick Wingfield, Apple Spots More Options Missteps, WALL ST. J., Aug. 4, 2006, at ___ (noting that in the summer of 2006, eighty firms were under investigation for backdating improprieties).


may reflect concerns about a possible criminal investigation more than concerns over the business decision to compensate the option holder in this fashion.257

VI. The Prosecutorial Toolbox v. Private Litigator’s Bundle of Rights

A. Historic Criminal/Civil Balance

Generally, pleading burdens differ in criminal prosecutions and civil cases that involve the same facts. Pleading burdens in criminal prosecutions are generally greater, putting more of the burden on the prosecution to prove each element of a crime while protecting the defendant, who has the presumption of innocence. Civil evidence rules are also generally more liberal than criminal evidence rules because of this increased concern of prejudicing the criminal defendant.258 Because of these evidentiary and procedural differences, history gives examples of civil litigants being successful in getting judgments of liability against defendants on the same facts that prosecutors could not marshal successfully to obtain guilty verdicts against the same defendants.259 Traditionally, the challenge to prove someone’s guilt “beyond a reasonable doubt” has been far greater than to prove someone’s fault “by a preponderance of the evidence.” In addition, prosecutors are at least theoretically officers of the court and not zealous advocates, and so have different obligations than a civil attorney would have. For example, prosecutors must turn over exculpatory evidence found during an investigation to the accused.260

In the corporate misconduct arena, however, the differences between civil actions and criminal prosecutions seem to have been reversed. In criminal cases brought alleging corporate misconduct, prosecutors are able to prove guilt or


258 statement against interest?

259 In the most publicized instance of how differing civil and criminal burdens can generate different results, O.J. Simpson, who was acquitted by a jury after being tried for the murders of his ex-wife, Denise Brown Goldman, and her friend Ronald Goldman, was the subject of a civil trial for damages under wrongful death and survivor statutes. In the civil case, the family members prevailed in persuading the jury to find Simpson liable by the preponderance of the evidence. See Rufo v. Simpson, 86 Cal. App. 4th 573 (2001) (affirming judgments in wrongful death and survival case brought by family members of Denise Brown Simpson and Ronald Goldman against O.J. Simpson).

260 starts with a B obligations
extract a guilty plea using an effective combination of broad criminal statutes, legal prosecutorial tactics and defendants’ fears of incarceration. 261 Prosecutors also have the ability to gather evidence through surveillance activities, subpoenas, and warrants before indicting suspected persons. 262 However, in the civil corporate law arena, private parties must overcome substantial hurdles before being allowed to attempt to prove liability on the facts. Due to recent legislative and judicial changes affecting federal securities law cases, the pleading and evidentiary burdens on plaintiffs in civil cases is quite high, and a large number of cases are dismissed prior to discovery at the pleading stage. 263 In state law fiduciary duty cases brought by shareholders, the corporate defendant enjoys a presumption of innocence far greater than a criminal defendant. The business judgment rule serves to protect corporate directors by creating a presumption of good faith and due care that must be rebutted with certain evidence. 264 In addition, states, historically the regulators of corporate governance, restrict the ability of shareholders to bring suits against directors in the form of derivative suit requirements. 265

This Section IV compares the powerful tools that prosecutors can use to obtain a successful result in a white-collar crime investigation and how these tools are not available to investor plaintiffs. The following Section V will analyze further pro-defendant aspects of the securities law and state corporate law regimes that create obstacles to investor plaintiffs. Given these

261 See Geraldine Szott Moolhr, Prosecutorial Power in an Adversarial System: Lessons From Current White Collar Cases and the Inquisitorial Model, 8 BUFF. CRIM. L. REV. 165, 189 (2004) ("Taken together, the cases of Arthur Andersen, Martha Stewart, and the Enron executives show how several factors combine to confer great power on prosecutors at the investigation, charging, and pleading stages of a criminal matter.") [hereinafter Prosecutorial Power].


264 See In re Walt Disney Co. Derivative Litigation, ___ A.2d ___, 2006 WL 1562466 (June 8, 2006) (Our law presumes that "in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."). See also Section IV(B)(2), infra.

265 See Thompson & Thomas, supra note 23, at ___ (describing the procedural requirements of bringing a derivative lawsuit). See also Section IV(B)(1), infra.
developments, a corporate law defendant could theoretically\textsuperscript{266} be convicted and
go to prison under the same set of facts that would not allow a plaintiff to prevail
on a defense motion to dismiss in a private lawsuit under either federal securities
laws or state fiduciary duty law.

B. Criminal Prosecutions v. Private Causes of Action

Although corporate crimes may be harder to detect initially than some street
crimes\textsuperscript{267} which are more self-revealing, prosecutors have some effective
investigatory and charging tools at their disposal to identify and confront
individuals suspected of corporate crimes. Section V will detail the procedural
obstacles that decrease shareholders’ likelihood of success; in contrast, the
weapon in a prosecutor’s arsenal described in this section greatly increase the
likelihood of a guilty plea or conviction.

1. Aiders and Abettors; Conspiracy

After the \textit{Central Bank} decision in 1994\textsuperscript{268} and the passage of the PSLRA in
1995,\textsuperscript{269} private litigants were barred from bringing causes of action under the
securities laws against those who were merely “aiders and abettors” of the

\textsuperscript{266} This claim uses the word “theoretically” because private lawsuits rarely exist in isolation from a
parallel criminal lawsuit. Because of the lengthy duration of private lawsuits, any parallel criminal
prosecution will usually be resolved first, and any criminal conviction will prompt an immediate
settlement in the civil lawsuit. For example, in June 2003, Martin Grass, ex-CEO of Rite Aid, both
plead guilty to federal criminal charges in connection with allegations of accounting fraud and also
settled shareholder claims against him. See \textit{Ex-Chief Pleads Guilty in Rite Aid Case}, \textit{N.Y. Times},
June 18, 2003, at C12; Tom Dochatt, \textit{Some Rite Aid Investors to Collect From Newly Approved

\textsuperscript{267} See Brown, \textit{Street Crime, supra} note 11, at 526-27 (arguing that corporate crime is more
difficult to prosecute than street crime because it is complex, it is located in private, and the parties
have access to sophisticated counsel).

\textsuperscript{268} 511 U.S. 164, 191 (1994) (disallowing a private cause of action for aiding and abetting against
the indenture trustee in connection with a bond offering).

underlying securities law violation. All defendants in a securities law claim must have been primary actors in the violation. In addition, private litigants cannot bring causes of action against individuals for conspiracy with primary actors for “conspiracy” to violate the securities laws. These plaintiffs must not only prove but plead with particularity all of the elements of the underlying securities law violation, including intent, against each defendant. Therefore, if the primary actors have either gone bankrupt or absconded, shareholders may never be compensated for corporate misconduct even if the misconduct was assisted by a deep-pocket, repeat player in the industry such as an accounting firm, consulting group, or law firm. Only in rare cases since 1994 have shareholders successfully survived a motion to dismiss claims against these groups by pleading enough facts to portray the defendants as primary actors.

In contrast, federal prosecutors have wide latitude to indict the same defendants for aiding and abetting primary actors in a criminal investigation. Although these defendants are immune from a private civil lawsuit, they may be


271 Dinsmore v. Squadron, 135 F.3d 837 (1998) (holding that no private cause of action for conspiracy lies in §10(b) or Rule 10b-5).

272 In re case where defendants were dismissed because not primary actors

273 Newby v. Enron, Memorandum and Order Re: Secondary Actors’ Motion to Dismiss, Civ. Action No. 01-3624 (Dec. 19, 2002), available at http://www.enronfraud.com/pdf/order_secondarymtd.pdf (denying to dismiss shareholder claims against outside counsel Vinson & Elkins LLP, outside auditor Arthur Andersen LLP, and various commercial and investment banks allegedly involved in accounting fraud at Enron, but granting motion to dismiss against outside counsel Kirkland & Ellis, LLP); see also Taylor, supra note 270, at 379-81 (noting that critics of the Enron decision say that Judge Melinda Harmon took “a detour around Central Bank”).

274 18 U.S.C. § 2 (“Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.”); see also Adam Harris Kurland, To “Aid, Abet, Counsel, Command, Induce, or Procure the Commission of an Offense”: A Critique of Federal Aiding and Abetting Principles, 57 S.C. L. Rev. 85, 94 (2005) (“The prosecution finds aiding and abetting liability attractive because, like conspiracy liability, its expansive nature permits aiding and abetting liability to be established upon a finding that the defendant did not actually commit all elements of the offense.”)
convicted and sentenced to jail for their role in the corporate misconduct.\textsuperscript{275} In addition, federal prosecutors may also bring charges against defendants for conspiracy to violate securities laws.\textsuperscript{276} These broader provisions not only allow prosecutors to indict more individuals, they also allow prosecutors to indict particular individuals with multiple counts of criminal wrongdoing. For example, if two corporate insiders are charged with violating securities laws under the same set of facts, the insiders may be charged both with a substantive crime and with conspiracy to commit that crime.\textsuperscript{277}

The value of the ability to charge individuals with conspiracy cannot be overstated.\textsuperscript{278} Prosecutors can focus on relatively minor participants and threaten them with being charged both with conspiracy and with the full weight of the underlying crime. As discussed below, these participants can then provide prosecutors with private information in return for leniency. Proponents of the charge of conspiracy argue that the existence of the charge deters the formation of conspiracies because the addition of each participant increases the risk of the enterprise and makes the coalition less stable.\textsuperscript{279} This reasoning does not seem to hold with fraudulent misconduct within a corporation, where coalition is formed out of necessity and generally isolated to a particular event, not an ongoing criminal enterprise. In addition, conspiracy charges are seen as a way to balance incentives of an organized crime participant who may resist providing information because of fear of group retaliation or loss of reputation within the

\textsuperscript{275} For example, Mark Koenig, a former vice-president at Enron, was indicted and plead guilty on one count of aiding and abetting securities fraud for participating in the dissemination of false information to analysts and investors. See United States v. Koenig, Cooperation Agreement, CR-H-04-389 (Aug. 1, 2004), available at http://www.usdoj.gov/enron/exhibit/02-02/BBC-0001/ocr/EXH025-01655%5EFullText.TXT (last visited Feb. 13, 2007).

\textsuperscript{276} 18 U.S.C. § 1349 (2004) (“Any person who attempts or conspires to commit any offense under this chapter shall be subject to the same penalties as those prescribed for the offense, the commission of which was the object of the attempt or conspiracy.”) Judge Learned Hand once referred to the charge of conspiracy as the “darling of the modern prosecutor’s nursery.” Harrison v. United States, 7 F.2d 259 (1925).

\textsuperscript{277} In just one of many examples, Martha Stewart was charged with, among other things, obstruction of justice and making false statement, as well as with conspiracy to obstruct justice and conspiracy to make false statements. See United States v. Stewart, 305 F. Supp. 2d 368 (S.D.N.Y. 2004).

\textsuperscript{278} See Neal Kumar Katyal, Conspiracy Theory, 112 Yale L.J. 1307 (2003) (discussing the benefits to law enforcement of being able to charge minor participants with serious crimes through the doctrine of conspiracy).

\textsuperscript{279} See id. at __.
criminal group. Again, these rationales seem less apt in the corporate law arena where corporate officers generally do not gain reputations for participating in daring criminal exploits and remaining loyal to other criminals in the face of incarceration.

2. Cooperating Witnesses

Unlike shareholder plaintiffs in civil actions, criminal prosecutors not only have a broader selection of defendants, but also have the ability to bargain with these participants in corporate misconduct investigations in order to obtain evidence that will result in indictments and convictions of higher-ranked officers. Although shareholders may have difficulty pleading with particularity that a CEO or CFO knew or condoned the corporate misconduct, which required a number of participants, prosecutors can build a case against these officers with the assistance of cooperating witnesses. These corporate actors cooperate with prosecutors in return for a less severe penalty or sentence or perhaps no criminal charges at all. Potential white-collar defendants may be more willing than other defendants to trade information in order to avoid lengthy jail time, a penalty that destroys reputations, careers, families and wealth, even if the bargained-for sentence is still severe. Unlike other actors involved in ongoing

280 See id. at __.
281 See Alexei Barrionuevo & Kurt Eichenwald, The Enron Case That Almost Wasn’t, N.Y. TIMES, June 4, 2006, at C1 (chronicling the life cycle of the Enron prosecution and noting that the prosecution team had no evidence against Ken Lay until “dominoes” of lower-level employees agreed to testify against him).
282 President and COO of Rite Aid, Timothy Noonan, agreed to assist the prosecution in its investigation of Rite Aid officers by wearing a recording device and arranging a meeting with Frank Brown. This tape was admissible evidence against both Brown and CEO Martin Grass. Noonan was sentenced to probation, but Grass received an eight-year sentence and Brown, a ten-year sentence. See United States v. Grass, 239 F. Supp. 2d 535 (M.D. Pa. 2003).
283 See Brickey, Enron’s Wake, supra note 3, at 402-03 (stating that between March 2002 and July 2004, 90% of the criminal indictments that were resolved in corporate fraud cases were resolved by guilty pleas). According to Brickey, almost all pleading defendants became cooperating witnesses. Id. at 403.
284 See Uzi Segal & Alex Stein, Ambiguity Aversion & the Criminal Process, 81 NOTRE DAME L. REV. 101, 103 (2006) (describing a criminal defendant’s “ambiguity aversion” to the unpredictable outcome of a jury trial and noting that “might exploit it in order to boost his or her performance and career” to “offer the defendant a harsh plea bargain that the defendant will have to accept”).
criminal activities, alleged corporate conspirators face no reputational harm and do not jeopardize safety of family members by divulging incriminating facts of corporate misconduct. Because the U.S. Sentencing Guidelines create a substantial probability that a convicted defendant will serve some time in prison and give much discretion to prosecutors in recommending sentences to the court, prosecutors wield huge bargaining power in persuading potential witnesses.\(^{285}\) This combined bargaining power of the prosecution and risk-aversion of the defendants results in a great number of those indicted ultimately pleading guilty.\(^{286}\)

Proponents of criminal prosecutorial discretion argue that without the ability to bargain with witnesses, prosecutors will only focus on middle-managers who leave figurative fingerprints on the fraud, while the untraceable architects of the fraud receive no punishment.\(^{287}\) Therefore, the ability to provide immunity and to recommend lighter sentences is necessary to the success of criminal prosecutions in corporate fraud cases.\(^{288}\) White collar cases are then built pyramid style, with lower-level employees providing information that helps indict higher executives, who then cooperate and provide information that helps indict still higher executives.\(^{289}\)

However, this system creates some substantive problems. First, this system creates great incentives for both innocent actors to plead guilty and for both innocent and guilty actors to lie in order to give prosecutors the information that they demand.\(^{290}\) Both of these perverse incentives increase the likelihood of

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\(^{285}\) See Moohr, supra note 261, at 186 ("[D]efendants who recognize the prosecutor’s influence in recommending a final sentence to the court may rationally decide that it is wiser to plead guilty than to risk facing the same prosecutor if convicted.").

\(^{286}\) See Segal & Stein, supra note 284, at 146 (reporting that of all criminal indictments, 85% are resolved by guilty pleas, only 6% go to trial, and only 9% are dismissed before trial).

\(^{287}\) See Kathleen F. Brickey, From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley, 81 WASH. U. L.Q. 357, 373-74 (2003) (arguing that because “massive accounting frauds” are elaborate and complex schemes, prosecutors can only unwind these transactions with the help of insiders) [hereinafter Sarbanes-Oxley].

\(^{288}\) See id. at 371 (giving as examples the assistance given by insiders in the Adelphia Communications and WorldCom cases as part of plea bargains).

\(^{289}\) See Moohr, supra note 261, at 193-85 (describing the Enron investigation as typical of this type of pyramid, with lower-level cooperating witnesses providing information that allowed prosecutors to indict Andrew Fastow on ninety-eight courts, who then entered into a plea bargain in return for information that allowed prosecutors to indict Jeff Skilling and Richard Causey).

\(^{290}\) But see Katyal, supra note 278, at 176 ("the risk always looms that conspirators will lie. Concerns about reliability, however, pervade the criminal justice system; restrictions on the use of..."
innocent actors being convicted and sentenced. In the parlance of this Article, the existence of conspiracy charges and the ability of prosecutors to manipulate cooperating witnesses increases the prevalence of Type I errors in the criminal corporate law system. Second, this system creates perception problems because sentences will be based primarily on the timing of a plea bargain and the extent of the cooperation, not on moral fault. Therefore, masterminds of corporate misconduct who cooperate early will receive substantially lower sentences, if any, than lesser culpable individuals who either plead guilty much later or who take their chances at trial.

Note that criminal defendants do not have the same ability to offer immunity to witnesses who might testify on behalf of the defendant and provide exculpatory evidence. This asymmetry of resources may result in an unfair playing field for the defense. In addition, potential helpful witnesses may be reluctant to testify for the defense if the prosecution names “unindicted co-conspirators” in the indictment, leaving open the possibility that others, including flipped witnesses may force prosecutors to rely on more unreliable sources, from unnamed confidential informants to innuendo.

291 Ex-Cendant Finance Chief Gets Three Years Probation, WALL ST. J., Jan. 31, 2007, at C4 (reporting that a main participant in the Cendant fraud received probation due to his substantial cooperation in obtaining indictments against his co-participants).

292 For example, in the investigation of Computer Associates International, all defendants eventually pleaded guilty. However, the first senior executives to plead guilty received light sentences of a few months of at-home detention, even though they played key roles in the accounting fraud and ensuing cover-up of the fraud. See Robert Kessler, Home detention for former CA VP: Judge cites David Kaplan’s cooperation in fraud scandal and his fire-rescue service in granting light sentence, N.Y. NEWSDAY, Jan. 30, 2007, at A44. Executives that pleaded late in the investigation received much heavier sentences, such as CEO Sanjay Kumar, who was sentence to twelve years in prison. William Bulkeley, Former CA Chief Is Sentenced To 12-Year Prison Term, Fined, WALL ST. J., Nov. 3, 2006, at A3.

293 For example, Jamie Olis chose to go to trial in connection with accounting fraud at Dynegy and received a 24-year sentence, while his boss, who plead guilty, received a 15-month sentence. See Tom Fowler, Two Sentenced in Dynegy Project Alpha Case, HOUS. CHRON., Jan. 6, 2006, at __ (reporting Foster’s sentence as well as the sentence of Helen Sharkey, who received a sentence of one month).

294 See Katyal, supra note 278, at 168-69 (arguing that the criminal law system and the Sentencing Guidelines should also reward exculpatory witnesses).

295 United States v. Skilling, 2006 WL 1737546 (S.D. Tex. June 23, 2006) (detailing, but not accepting, defendants’ argument that in this trial of the Enron CEO and President, the trial was fundamentally unfair given that “the bulk of the Task Force’s percipient witnesses testified pursuant to plea or cooperation agreements . . . or government-requested and court-ordered immunity”).
those potential defense witnesses, may be indicted at a future time. 296 The naming of unindicted co-conspirators also allows prosecutors to use prior statements of those conspirators at trial through an exception to the hearsay rules. 297 Although defendants have argued that this asymmetry in the criminal system is inherently unfair, that argument has not been successful in most jurisdictions. 298

In the civil system, the same complexity and organization of corporate fraud creates an identical situation without a corresponding remedy; middle management are not subject to lawsuit by shareholders and the officer-architects will be able to dismiss many lawsuits for lack of evidence that the officers had the requisite state of mind. Shareholders and their attorneys have no power to create an incentive for corporate insiders to share their knowledge to help private litigants build a case against corporations and their officers. Unlike prosecutors, shareholder plaintiffs are strictly forbidden from offering witnesses anything of value in return for testifying. 299

296 See Mary Flood, Only Two Defendants, But Many Accused, HOU. CHRON., Jan. 27, 2006, at __, available at http://www.chron.com/cs/CDA/prinstory.mpl/business/3616426 (quoting various defense attorneys as saying that the number of unindicted co-conspirators in the trial of Ken Lay and Jeff Skilling was unprecedented, although the use of unindicted co-conspirators happens in almost every conspiracy case).

297 See Fed. R. Evid. 801(d)(2)(E) (excluding from the definition of hearsay “a statement by a coconspirator of a party during the course and in the furtherance of the conspiracy); see also U.S. v. Inadi, 475 U.S. 387 (1986) (holding that the Confrontation Clause did not require that the statements of a nontestifying, unindicted co-conspirator be excluded from evidence).

298 See United States v. Skilling, 2006 WL 1737546 (S.D. Tex. June 23, 2006) (denying defense motion seeking judicial immunity to seven witnesses who promised to provide exculpatory testimony if immunized but who planned on invoking their Fifth Amendment Privileges otherwise). Although the defense argued that these witnesses feared reprisal from prosecutors if they testified for the defense, Judge Sim Lake presumed that the witnesses most likely wanted use immunity because they were, in fact, guilty of crimes. See id. at *9.

Bernard Ebbers, former CEO of WorldCom, Inc. appealed his securities fraud conviction on various theories, including the theory of “selective immunization of witnesses,” i.e., the theory that the prosecution granted immunity only to witnesses for the prosecution and not to exculpatory witnesses. See United States v. Ebbers, __ F.3d __, 2006 WL 2106634 (July 28, 2006). The court rejected Ebbers’ argument, reasoning that Ebbers had not shown that the prosecution used immunity in a “discriminatory way.” See id. at *8.

3. “Cooperation”

Besides inducing witnesses to cooperate with the lure of reduced sentences or perhaps no indictments at all, federal prosecutors also have the reverse ability to induce cooperation with the threat of designating the individual as “not cooperating.” Under the U.S. Sentencing Guidelines, cooperation is a significant factor in sentencing. Defendants who do not cooperate face tougher penalties than those that do cooperate. Again, these leniency for cooperators works against the innocent, who by merely mounting their own defense can be described as uncooperative.

Commentators have also focused attention on the cooperation of the fictitious corporate entity in the investigations of its constituent parts. Under federal law and the Organizational Sentencing Guidelines, corporate entities may be indicted and convicted for the violations of their agent employees under the doctrine of respondeat superior. Although corporations cannot be incarcerated, the fact of criminal conviction and corresponding financial penalties may be an effective death sentence against a corporation, resulting in losses to innocent employees and shareholders. Therefore, boards of directors have an incentive to avoid entity-level indictment by cooperating with authorities in their investigations of the individual employees. Part of what constitutes cooperation with authorities for corporate entities involves the waiving of attorney-client and work product privilege, which creates opportunities for collecting evidence that may be used against individuals. Such cooperation may be required in order to avoid criminal charges for the entity. Because criminal charges would be detrimental to the firm itself, the board of directors may be extremely willing to waive the rights of others in order for the entity to escape prosecution. In addition, firms will seek to distance themselves from “rogue employees” by firing individuals, launching internal investigations, and cooperating fully with prosecutors. In addition, individuals may be pressured into waiving rights not to incriminate themselves and speaking freely with investigators to prove their cooperation.

300 See Darryl K. Brown, The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement, 1 OHIO ST. J. CRIM. L. 521, 538 (providing the example of Merrill Lynch, who in exchange for nonprosecution by the DOJ and a monetary fine from the SEC, cooperated in the indictments of certain executives, who were sentenced to prison in connection with transactions with Enron, Inc.).

301 See Moohr, Prosecutorial Power, supra note 261, at 175.
In 2003, the Department of Justice outlined various strategies for using the incentives to cooperate against organizations in a memo to its assistant United States Attorneys, known familiarly as the Thompson Memorandum, after its chief author, Larry Thompson. In December 2006, after the details of the Thompson Memorandum became critiqued in the media during a case involving KPMG and its employees, the DOJ replaced the Thompson Memorandum with a different procedural memorandum, known as the McNulty Memorandum. Many commentators dispute any real differences between the McNulty Memorandum and the Thompson Memorandum.

4. **Broad Criminal Provisions**

Because many of the statutes in question in a corporate crime prosecution are extremely broad, including securities fraud, obstruction of justice, wire fraud and mail fraud statutes, prosecutors have much discretion in applying these statutes to a wide range of conduct. For example, federal prosecutors in Houston charged four Merrill Lynch employees with depriving their client, Enron Inc., with “honest services” for buying power barges from Enron before the end of the year in 1999 and then selling them back six months later. Prosecutors argued that the sale was a sham, effected only to increase 1999 revenues, and that the parties had agreed beforehand to resell the barges. Prosecutors applied fairly recent federal statute to this transaction and obtained guilty pleas and criminal


307 See id. at 514.

308 18 U.S.C. § 1346 (2004) (adding to the definition of “scheme or artifice to defraud” used in the wire fraud statute, 18 U.S.C. § 1343 any “scheme or artifice to deprive another of the intangible right of honest services”).
convictions against both Enron employees and Merrill Lynch employees under the theory that they deprived Enron of “honest services” of their employees. However, the Fifth Circuit on its own motion released the defendants on bail pending appeal and then reversed the Southern District of Texas, holding that the statute did not apply to this situation. Judge Harold DeMoss, in his concurrence, stated that the statute was unconstitutionally vague and overbroad and rebuked legislators for creating federal criminal statutes so broad as to leave lawmaking to prosecutors and courts. The officers were eventually released from prison; however, prior to the Fifth Circuit correcting such prosecutorial overreaching, the defendants had spent a year in prison and incurred astronomical legal fees.

5. Multiple, Overlapping Charges

Federal prosecutors also have the ability to charge the same conduct with violating multiple criminal law provisions. Therefore, one action will give rise to multiple counts in a criminal indictment, each with penalties that may be accumulated. For example, being charged with securities fraud, conspiracy to commit securities fraud, obstruction of justice, conspiracy to obstruct justice, and wire fraud may result in a very lengthy sentence. Again, this tool gives prosecutors great power in leveraging defendants against each other and encouraging plea bargains.

However, shareholder plaintiffs’ recovery is limited to a much stricter assessment of damages, and even if multiple parties are involved in the corporate

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309 See Mary Flood, Ex-Enron, Merrill Execs Sentenced, HOUS. CHRON., May 13, 2005, at __. Note that Merrill Lynch avoided entity-level indictment by cooperating with prosecutors.

310 Brown, 459 F.3d at 522 (reversing convictions under 18 U.S.C. § 1346 and stating that under the government’s theory, any breach of duty by an employee, whether it caused a harm to the employer or a benefit to the employee, would constitute a crime).

311 See id. at __ (DeMoss, J., dissenting) (“The cumulative effect of a vague criminal statute, a broad conception of conspiracy, and an unprincipled theory of harm that connects the ultimate demise of Enron to a single transaction is a very real threat, of potentially dramatic proportion, to legitimate and lawful business relationships and the negotiations necessary to the creation of such relationships.”).

misconduct, the recovery will be the same. If a corporate law fraud involving ten persons results in an aggregate sentence of ten years multiplied by ten persons, the civil recovery from each person is the assessed damages divided by ten. The existence of conspiracy charges may add five years’ imprisonment to each criminal defendants’ sentence, but each additional corporate fraud conspirator reduces the amount that each defendant might pay.

6. Second-Order Crimes

Shareholder plaintiffs have a limited universe of causes of action to bring against corporate officers and directors who engage in misconduct. Generally, the plaintiffs must frame their complaint either as a violation of securities law in a federal lawsuit or as a violation of fiduciary duties owed by the firm to its shareholders in a state lawsuit. Many times the elements of these claims will be hard to prove or at least difficult to ascertain without discovery of internal documents. Prosecutors, however, can avoid difficulties in proving all the elements of an underlying crime by charging defendants with “second-order crimes” such as obstruction of justice, making false statements, and perjury. Any defendant who protests her innocence to authorities can be charged with obstruction of justice and making false statements; any defendant who protests her innocence to a grand jury or at trial can be charged with perjury. If a co-conspirator does the same, then she can be charged with conspiracy to obstruct justice, make false statements or commit perjury. In addition, if investigators were investigating a corporate defendant and an individual defendant shredded documents or deleted emails during that time in a suspicious volume, the prosecutors could choose to prosecute on an obstruction charge instead of the harder-to-prove fraud charge.

One advantage of a second-order charge is that these charges are easy to explain to a jury. Proving that documents were shredded or an entry in a diary was erased is not difficult, but the underlying charge of fraud, insider trading or broker-dealer improprieties may be almost impossible to prove to a jury. Besides allowing the prosecution to try a much more understandable case in front of a jury than a Byzantine financial fraud, second-order crimes may also be used to

enhance penalties under the Guidelines. One count of accounting fraud may become twenty or thirty counts of accounting fraud, obstruction of justice, making false statements, perjury, conspiracy to obstruct justice, and more. Because of the broad language of these crimes, many of these statutes may be applied to the same conduct, creating a multi-count indictment for a single act.\footnote{See Mookh, \textit{supra} note 261, at 177-78 (describing the federal criminal code as both broad and deep, allowing the provisions “to be applied to a wide and unspecified range of conduct).} Prior to the Supreme Court case \textit{United States v. Blakely}\footnote{Blakely v. Washington, 542 U.S. 296 (2004) (holding that the Sixth Amendment right to trial was violated by a state sentencing system that allowed facts introduced during sentencing and not at trial to increase the statutory maximum sentence).} and its progeny, \textit{United States v. Booker},\footnote{United States v. Booker, 543 U.S. 220 (2005) (holding that under the Sixth Amendment, the U.S. Sentencing Guidelines were unconstitutional when used as mandatory system whereby unproven facts increased mandatory penalties at sentencing phase). See Douglas A. Berman, \textit{The Roots and Realities of Blakely}, 19 CRIM. J. 5 (2005) (describing the traditional acceptance of using unproven facts during sentencing phases because “sentencing courts have traditionally considered a wide range of information without the procedural protections of a criminal trial”).} prosecutors sometimes chose the tactic of convicting only on second-order crimes, but using the unproven fact of the uncharged primary crime at sentencing to enhance the penalties, even though evidence of the primary crime was not tried before the finder of fact. Notwithstanding these watershed cases, in the federal system, unproven facts may still be introduced in the sentencing phase as long as the judge only uses the Guidelines as guidelines, and not as mandatory sentencing constraints.\footnote{See Edward Lazarus, \textit{The Supreme Court’s Sentencing Guidelines Decision: Its Logic, and Its Surprisingly Limited Practical Effect}, FindLaw, Jan. 21, 2005, available at http://writ.news.findlaw.com/lazarus/20050121.html.}

A few very high-profile cases in recent history involve only second-order charges. Arthur Andersen was convicted not of accounting fraud, but of obstruction of justice, although that sentence was eventually reversed by the U.S. Supreme Court.\footnote{Arthur Andersen LLP v. United States, 544 U.S. 696 (2005) (reversing conviction of accounting firm based on erroneous jury instructions that did not tie the requisite mens rea, “knowingly” to the element of “corruptly persuading”).} Martha Stewart was not charged with violating insider trading laws; instead, she was charged with obstruction of justice, making false statements and conspiracy to obstruct justice, make false statements, and commit perjury.\footnote{United States v. Stewart, Indictment (June 4, 2003), available at http://fl1.findlaw.com/news.findlaw.com/ndocs/docs/mstewart/usmspb60403ind.pdf.}
Frank Quattrone, one of the most celebrated stock analysts during the 1990s and early 2000s, was also charged with only one count of obstruction of justice relating to investigations by the SEC and DOJ into practices of allocating shares in initial public offerings to clients in return for their purchasing liquid securities from Credit Suisse First Boston and paying excessive brokerage fees for those trades. Quattrone was not charged with this violation, only obstruction of justice. Although his first trial ended with a hung jury, Quattrone was convicted in his second trial. However, that conviction was reversed by the Second Circuit, relying on United States v. Arthur Andersen. Although the SEC eventually dropped its civil charges against Quattrone, federal prosecutors vowed to retry Quattrone a third time before Quattrone agreed to twelve-month "deferred adjudication." Notably, investors who have sued CSFB and other investment banks because of related spinning practices have been even less successful.

7. State of Mind

A determination of whether someone should be liable for a certain action generally depends on the person’s level of involvement in the action and the person’s state of mind, or scienter, at the time of the action. Broadly, criminal

322 At trial, emails were introduced between Quattrone and various clients, including Michael Dell, in which he promised IPO shares in hot issues as a way to “build the relationship” between CSFB and their firms.

323 See Kara Scannell & Randall Smith, Quattrone Mistrial May Give Prosecutors Reason to Hesitate, WALL ST. J. Oct. 27, 2003, at C1 (describing charges relating to Quattrone sending or forwarding email instructions to CSFB employees to destroy documents relating to an SEC investigation into spinning practices).

324 See id.


328 This practice has spawned lawsuits in numerous variations: lawsuits by shareholders of firms whose executives accepted IPO shares, thereby breaching the duty of loyalty; lawsuits by issuers against underwriters for underpricing and spinning their own shares; and lawsuits by investors who bought shares after the spinning practice artificially inflated the market price.
prosecutions have historically required proving higher levels of scienter on the part of the defendant than a civil action would require. For example, although the law of torts allows recovery in some areas for mere negligence, most criminal laws require some degree of at least recklessness, if not intention. However, corporate and securities laws have again flipped this historical distinction, which protected defendants from being criminally convicted for actions that were involuntary, accidental, or unknowing but allowed recovery in civil trials for the more innocent victim. \(^{329}\) The PSLRA has effectively not only increased the level of intent required perilously close to specific intent but also requires evidence of such intent to be provided in pleadings. Federal criminal law, however, has created an exception to intent for the same securities law misconduct.

In criminal prosecutions of senior executive officers of large, public companies, prosecutors predictably face difficulties in proving that a high-ranking individual had actual knowledge of corporate misconduct and specifically condoned or orchestrated the misconduct. \(^{330}\) In a civil lawsuit, this same difficulty may be insurmountable and may result in a dismissal of suit before trial. \(^{331}\) In recent prosecutions, however, the government has been allowed to proceed under a “conscious avoidance” \(^{332}\) theory of criminal liability. Under this theory, the defendant may be found guilty of securities fraud if the defendant was in a position to know of the fraud but turned a somewhat knowing blind eye to the possibility. Prosecutors may submit this theory of guilt to the jury if “(a) the element of knowledge is in dispute, and (b) the evidence would permit a rational juror to conclude beyond a reasonable doubt that the defendant was aware of a high probability of the fact in dispute and consciously avoided confirming that fact.” \(^{333}\) Under this theory of culpability, Bernard Ebbers, CEO

\(^{329}\) Although a negligent party does not have a “guilty heart,” compensation to the plaintiff is considered reasonable because the plaintiff is clearly innocent and the negligent defendant is the best loss-avoider.

\(^{330}\) Note that criminal liability for the entity may be proved merely by proving the intent of any agent through the doctrine of respondeat superior. However, a supervisor would not be found criminally responsible for actions of another employee. See generally Krawiec, supra note 2.

\(^{331}\) See Stout, supra note 19, at 712 (stating that because the requirements of what kind of proof satisfies the new showing of intent is so vague, the determination at the motion to dismiss stage could be “determined at least as much by what the judge had for breakfast”).

\(^{332}\) See generally Robin Charlow, Willful Ignorance and Criminal Culpability, 70 Tex. L. Rev. 1351 (1992) (chronicling the rise of the willful ignorance theory of criminal liability from drug trafficking and money laundering cases).

\(^{333}\) See United States v. Ebbers, 458 F.3d 110 (2d Cir. 2006) (citing United States v. Hopkins, 53 F.3d 533, 542 (2d Cir. 1995)).
of WorldCom, was convicted of one count of conspiracy to commit securities fraud, one count of securities fraud, and seven counts of making false filings with the SEC in the absence of proof of knowledge of the specific illegal acts.\textsuperscript{334} In addition, this jury instruction was used in the trial of Enron’s Lay and Skilling. However, the Fifth Circuit has signaled that this instruction may be vulnerable to appellate attack.\textsuperscript{335}

At least in prosecutions of chief executive officers for financial fraud after 2002, this theory of conscious avoidance may prove unnecessary after the passage of the Sarbanes-Oxley Act. In the post-SOX era, CEOs must certify financial statements and will be held criminally responsible for fraudulent accounting in those statements.\textsuperscript{336} At present, Section 302 of SOX has no implied private right of action.\textsuperscript{337} Instead, in private litigation, even directors and officers who sign registration statements, prepare SEC disclosure documents, or issue press releases are not presumed to be responsible for false statements contained in those documents without additional evidence of involvement.\textsuperscript{338}

8. \textit{Pushing the Legal Envelope}

In a civil lawsuit, plaintiffs pursuing a novel theory of law or a claim against an untraditional defendant are subject to dismissal before a federal trial under Rule 12(b)(6) for failure to state a claim for which relief can be granted and under pleading requirements of the PSLRA, which shifts the burden to the plaintiff to put forth sufficient facts before discovery. In state law fiduciary duty cases, plaintiffs also are vulnerable to motions to dismiss for novel claims. Although the federal rules of criminal procedure provides for the same

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\textsuperscript{334} At trial, prosecutors could not provide documentation proving a link between Ebbers and the financial manipulation of CFO Scott Sullivan, but argued to the jury that Ebbers’ statement to Sullivan to “hit the numbers” was evidence of willful disregard of the means to producing financial statements that met market expectations. See Brooke A. Masters, \textit{Arguments Hinge on What Ebbers Knew at WorldCom}, WASH. POST, Jan. 26, 2005, at E1 (noting that the Ebbers case involved “no smoking gun”).

\textsuperscript{335} U.S. v. Skilling, 06-20885 (5th Cir. Dec. 12, 2006) (on file with author).

\textsuperscript{336} SOX, § 302, 906.

\textsuperscript{337} Cf. Neer v. Pelino, 389 F. Supp. 2d 648 (2005) (holding that Congress did not intend a private cause of action under § 304 of SOX by negative implication because two other sections regarding officer misconduct expressly created a private cause of action).

\textsuperscript{338} Need cite.
adjudication in Rule 12(b)(3), in practice this rule is rarely used to dismiss counts in an indictment.\textsuperscript{339} For example, in the prosecution of Martha Stewart, prosecutors in the Southern District of New York charged Stewart with violating securities laws in connection with shares of Martha Stewart Living Omnimedia by protesting her own innocence. This creative claim, which argued that stating that Stewart was innocent was tantamount to making a false statement in connection with the sale of shares of the company that Stewart owned, survived a motion to dismiss.\textsuperscript{340} Although Stewart was acquitted of the charge after the prosecution presented its evidence at trial,\textsuperscript{341} the defense was required to address the charges in court. In criminal law, concerns that prosecutors are overreaching usually can be ameliorated only through facts developed at trial, judicially controlled jury instructions or on appeal. For example, the prosecution’s creative use of the “honest theft of services” theory survived until the Fifth Circuit Court of Appeals considered it on appeal.

9. \textit{One More Bite at the Apple}

If all else fails, prosecutors can retry defendants on charges of other crimes, crimes which may have been discovered during the investigation of the first crime. For example, Richard Scrushy, former CEO of HealthSouth, was acquitted of all charges of accounting fraud at trial, but federal prosecutors quickly indicted Scrushy and former Alabama governor Don Siegelman on charges of bribery, conspiracy, and mail fraud in connection with a $500,000 payment by Scrushy to the governor. The payment to Siegelman was allegedly in return for granting Scrushy a seat on the state’s hospital regulatory board. On June 29, 2006, Scrushy was convicted on all counts;\textsuperscript{342} he vows to appeal that conviction. In addition, Dennis Kozlowski, former CEO of Tyco International,

\textsuperscript{339} \textit{See} Segal & Stein, \textit{supra} note 284, at 146 (noting that only 9\% of criminal indictments are dismissed).

\textsuperscript{340} \textit{See also} Moohr, \textit{Prosecutorial Power}, \textit{supra} note 261, at 179-80 (explaining how prosecutors have great power to interpret what conduct falls within the broad criminal provisions and how courts give great discretion to prosecutorial interpretation, creating “an incremental, but inexorable, expansion of the laws”).


\textsuperscript{342} \textit{See} Carrie Johnson, Jury Convicts HealthSouth Founder in Bribery Trial, \textit{WASH. POST}, June 30, 2006, at D1.
Ltd., was threatened with being indicted on charges of tax evasion had his second trial not ended in a conviction.

10. **Damages, Part I: No Harm, But Still Foul**

In the civil system, proof of damages is necessary to present a prima facie case for fraud. However, in the criminal system, damages are not necessary for a finding of criminal liability. For example, Ken Lay, the former CEO of Enron Corp., was tried separately for violations of obscure banking regulations for borrowing money from a commercial bank while simultaneously buying stock on margin.343 These regulations require “purpose loans” for margin stock to meet different criteria.344 Lay’s four lines of credit were “nonpurpose loans.” Lay was charged with one count of bank fraud and three counts of obstructing justice, counts that could have added up to thirty years in prison for each count and a $4 million fine. Due to the fungibility of money, proving that the proceeds of those loans went to buy the margin stock is difficult; in addition, Lay never defaulted on these loans and the banks involved suffered no losses. In addition, Lay argued that the banks would have made the same loans to him as purpose loans. However, Lay was convicted on all four charges. Because Lay died of a heart attack before sentencing, an appropriate sentence was never determined by Judge Sim Lake.345

11. **Damages, Part II: Calculating Damages**

One reason often cited by critics of shareholder securities law lawsuits that these suits are frivolous is that the damages claimed by shareholders are phantom losses. Plaintiffs may not merely claim that the stock price decreased by X amount during time period Y, which began when the false statement was made and ended when the falsity was revealed. As any observer of the stock market would agree, the totality of the stock drop was affected by multiple factors, many

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343 See Mary Flood, Lay’s Trial on Bank Charges Likely Speedy, HOUS. CHRON., May 17, 2006, at___.


of which are unrelated to the fraud, such as general economic conditions, industry volatility or other firm-specific happenings. Separating out damage caused solely by the fraud is an exercise in futility, according to these critics. However, the same price drop is cited under the Sentencing Guidelines as the damage caused by the criminal activity and is used as a factor in sentencing. Moreover, each participant in the fraud is treated as being wholly responsible for the entirety of the damages. The “poster child” for lengthy white-collar crime sentences is Jamie Olis, a mid-level accountant at Dynegy who went to trial for securities fraud and received a 24-year sentence because Judge Sim Lake believed that the Sentencing Guidelines mandated that sentence for a participant in a conspiracy that caused shareholders $105 million in share losses.  

346 On remand from the Fifth Circuit, Judge Lake revised the estimate of damages caused to the amount of foregone taxes to the U.S. government because of the fraud, $79 million, and considered other mitigating factors in resentencing Olis to six year in prison.347

12. Damages, Part III: Sentencing Disparities

Even though criminal prosecutions in federal courts operate under the Guidelines, the prosecutors have the power and incentive to enter into plea bargains with some defendants but not others. This offer to plea may not be based on the substantive nature of the defendant’s conduct, but on other facts such as how much information the defendant has about other defendants, whether the prosecution needs additional information, and whether the prosecution has sufficient evidence to go to trial. Because of the frequency of plea bargains, defendants who commit the same wrongs, including co-conspirators may have vastly different sentences.348 In addition, defendants who arguably masterminded the wrongs, but who exchanged their thorough knowledge for a plea bargain, may have vastly more lenient sentences than the defendants against whom they testify. Two examples of this phenomenon would be Enron CFO Fastow,

346 See Tom Fowler & Jenalia Moreno, Ex-Dynegy Executive’s Sentence Cut to Six Years; Reduction From 24 Years in Olis Sentence Could Impact Cases Nationwide, HOUS. CHRON., Sept. 23, 2006, at A1.

347 See id.

348 See Katyal, supra note at 278 (characterizing inconsistent sentences for cooperators and those who go to trial as “price discrimination”).
receiving a reduced sentence of six years for testifying that Skilling, who was sentenced to twenty-four years, knew of his financial frauds at Enron,\(^{349}\) and Cendant CFO Cosmo Corigliano, whose testimony secured a twelve-year conviction for CEO Forbes while earning him three years probation.\(^{350}\)

In addition, federal law allows for one person to be convicted of conspiracy even if all other conspirators are acquitted or not charged.\(^{351}\) A corporate actor could even be convinced to plead guilty to conspiracy, and that plea bargain would be binding even if all other conspirators were acquitted.

Inconsistent sentencing does not further the goals of criminal law specifically or disciplining corporate conduct generally. Corporate actors will not be deterred sufficiently if consequences are seen to be distributed randomly or arbitrarily. If possible punishment is seen to be a function of a corporate crime lottery, marked by selective prosecution and sentences, then the laws lose their moral suasion.\(^{352}\)

### VII. Case Study: Martha Stewart/Martha Stewart Living Omnimedia, Inc.

Theoretically, in the current environment, a civil lawsuit alleging breach of fiduciary claims may fail under the same set of facts that are the basis of a successful criminal prosecution. Although further empirical study is necessary to determine how often this situation occurs, the recent investigations into Martha Stewart’s stock trades demonstrate the potential disconnect quite well. The claims made against Stewart in both criminal and civil proceedings were fairly creative and to some, unjustified. However, these claims resulted in a judgment

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\(^{349}\) See Kristen Hays & Tom Fowler, Some Shocked at Sentence, HOUS. CHRON., Sept. 28, 2006, at ___ (reporting that although the prior plea agreement was binding, prosecutors had recommended a five-year sentence to U.S. District Court Judge Kenneth Hoyt, which he took into consideration before sentencing Fastow to six years in prison).


\(^{351}\) See Nicholas J. Schuler, Jr., The Lone Conspirator, Criminal Law’s Oxymoron – In Defense of the Rule of Consistency in Federal Conspiracy Cases, 2004 U. ILL. L. REV. 755 (2004) (chronicling the demise of the common law rule that one person’s conspiracy conviction could not stand if all other conspirators were acquitted).

\(^{352}\) See Moohr, Prosecutorial Power, supra note 261, at 211-12 (Sentences that are viewed as inconsistent or as not reflecting the seriousness or harm of the conduct raise doubts about fairness and do not produce respect for the law or for its enforcement.”).
in a criminal action but failed to survive a motion to dismiss in a state law derivative action.353

A. The Fact Scenario

Martha Stewart is the chairman of the board and chief executive officer of Martha Stewart Living Omnimedia, Inc. as well as its majority shareholder, holding 62.6% of the outstanding Class A common stock and 100% of the Class B common stock of MSLO. In December 2001, Stewart owned 3,928 shares of stock in ImClone Systems Incorporated, a company which had as its president and CEO Samuel Waksal, a friend of Stewart’s. Waksal has admitted to selling almost 120,000 shares of ImClone stock held by himself and his daughter Aliza (identified in the indictment only as “Waksal Family Member”) on the morning of December 27, 2001. After trading had closed on December 28, ImClone announced that the application of Erbitux, a medicine proposed to be used in the treatment of colorectal cancer and described by ImClone as its “lead product candidate,” had been rejected by the United States Food and Drug Administration. The share price of ImClone declined 18%; by selling their ImClone shares, the Waksal family avoided a short-term loss of approximately $1.3 million. The share price continued to drop over the next twelve months. Samuel Waksal pled guilty to insider trading and numerous other charges in a criminal proceeding brought by the Department of Justice and was sentenced to prison for 87 months. In addition, he was ordered to pay a $3 million fine and an additional $1.27 million to the State of New York. The SEC also launched a civil proceeding against him related to the insider trading charges, which he settled for $800,000.

353 This same set of facts were also under scrutiny in other proceedings. On the same day that Stewart was indicted by the DOJ, the SEC filed a civil suit against Stewart and Peter Bacanovic for insider trading. See Securities & Exchange Comm’n v. Stewart, 03 CV 4070 (NRB) (Jun. 4, 2003) (Complaint). Bacanovic settled these charges on August 27, 2004, but Stewart stated even after her conviction that she would vigorously defend herself against these charges. Martha Stewart to Contest SEC Charges of Insider Trading, FOXNews.com, May 26, 2006, available at http://www.foxnews.com/printer_friendly_story/0,3566,197161,00.html. However, on August 7, 2006, the SEC announced that Stewart had settled these charges and would pay $195,000 in fines. She also agreed not to be a director or executive officer of any public company for five years, including her own. Press Release, Martha Stewart and Peter Bacanovic Settle SEC’s Insider Trading Charges, available at http://www.sec.gov/news/press/2006/2006-134.htm (Aug. 7, 2006).
The facts surrounding Martha Stewart’s subsequent sale of ImClone stock are not as tidy or uncontested. Samuel Waksal was a client of Merrill Lynch, and a broker there, Peter Bacanovic, sold Waksal’s ImClone stock on December 27 with the help of his assistant, Douglas Faneuil. At 10:04 a.m. that day, Bacanovic called Stewart and left a message with her assistant that “Peter Bacanovic thinks ImClone is going to start trading downward.” Later that day, at 1:39 p.m., Stewart returned the call and spoke with Faneuil. Thirteen minutes later, Faneuil sold all of Stewart’s ImClone shares at an average share price of $58.63. After the news of the FDA decision was released, the shares opened on December 31 at $45.39; Stewart avoided a loss of $51,222.

B. The Criminal Case

Whether or not Stewart violated securities laws regarding insider trading on December 27 depends on the substance of the phone conversation between her and Faneuil and whether Faneuil divulged any material, nonpublic information. However, prosecutors indicted Stewart not on insider trading charges, but on charges of obstruction of justice, making false statements and conspiracy to obstruct justice, make false statements, and commit perjury based on its theory that Stewart’s justification of the sale was fabricated with assistance from Bacanovic. Stewart insisted that the sale of stock was pre-arranged according to a verbal stock trading plan designed to capture tax losses once prices of various stocks dipped below the purchase price for those stocks. The prosecutors claimed that actions of Stewart and Bacanovic in altering prior documents were attempts to bolster their explanatory theory.

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354 At the time that Stewart spoke to Faneuil on December 27, she was traveling with Marianna Pasternak, a friend. On December 28, Pasternak’s husband sold 10,000 shares of ImClone. Beam v. Stewart, C.A. No. 19844-NC (Del. Ch. Ct. Sept. 30, 2003), at 9.

355 The DOJ admits that because the price rose again during the day of December 31, Stewart’s losses could be characterized as only $45,673, the difference between the sale price on December 27 and the price at the end of business December 31. Id.

356 See Kathleen F. Briceky, Mostly Martha, 44 Washburn L.J. 517, 527 (2005) (describing how Stewart and Bacanovic told investigators that on December 20, Stewart had directed Bacanovic to sell her ImClone stock should the price drop below $60 per share) [hereinafter Mostly Martha].

357 See id. at 527-28 (detailing the prosecution’s attempts to prove that a handwritten notation on Bacanovic’s worksheet that read “@ 60” had been inserted after December 27). In an interesting turn of events, the prosecution’s expert witness, Larry Stewart, who testified that the ink used for the notation was different from the ink used on the rest of the worksheet, was later charged with
The DOJ also indicted Stewart on charges of securities fraud based on the novel theory that because Martha Stewart the individual was so intertwined with MSLO that her making statements to the press protesting her innocence was tantamount to making false and misleading statements in connection with the purchase and sale of securities. Upon motion by Stewart, the trial court judge granted a judgment of acquittal on that count due to insufficiency of the evidence.

At trial, Stewart was convicted on specifications in all counts and sentenced to five months in prison, followed by five months under house arrest. All defense motions for a new trial were dismissed, and the conviction and sentence was upheld on appeal to the Second Circuit.

C. The Shareholder Suit

Shareholders in MSLO brought a derivative lawsuit against Stewart and the board of directors in the Delaware Court of Chancery. These shareholders were not as successful as the prosecutors in the criminal action. The basis of the fiduciary duty lawsuit brought against Martha Stewart and five directors was that because of the public identification of MSLO with Stewart, a connection perjury for his testimony in the Stewart trial. He was acquitted after a jury trial. See id. at 529, 533.

Ironically, when Stewart argued at sentencing for a downward departure from the Federal Sentencing Guidelines based on a legitimate factor that her being imprisoned would result in an “extraordinary hardship” to her company and its stakeholders because her participation was integral to the company’s success, the prosecution argued that the success of MSLO was not dependent on Stewart’s daily participation. See id. at 536-40.


Stewart was also fined a total of $30,400. See United States v. Stewart, 433 F.3d 273, 280 (2d Cir. 2006).


Id. at 319.


The primary asset of MSLO is “an exclusive, worldwide, perpetual royalty-free license to use [Stewart’s name, likeness, image, voice and signature for its products and services.” Id. at 7.
fostered by MSLO,\(^{365}\) Stewart’s actions and the board’s imperfect monitoring of her actions,\(^{366}\) constituted a breach of fiduciary duty. These claims were buttressed by the fact that in the two months following the commencement of investigations into Stewart’s sale of ImClone stock, the price of MSLO stock fell 65\%. Although some counts of the complaint were dismissed under Rule 12(b)(6), the main complaint against Stewart survived: “Stewart breached her fiduciary duties of loyalty and care by illegally selling ImClone stock in December of 2001 and by mishandling the media attention that followed, thereby jeopardizing the financial future of MSO.” However, the entire complaint was dismissed by the trial court because the plaintiff did not make demand on the board and the failure to make demand was not excused.\(^{367}\)

The court, using the \textit{Aronson} analysis, found that demand was not excused because the plaintiff could not plead facts showing that less than a majority of the directors were disinterested. Although the court conceded that two of the six directors were not disinterested, because the plaintiff could not prove that an additional director met that criterion, the court dismissed the complaint. Although the plaintiff had pled facts describing Stewart’s personal friendship with other outside directors, the court held that specific facts needed to be alleged that indicate that a director will not be able to put aside that friendship in making serious decisions. In addition, the trial court judge, Chancellor Chandler, chided the plaintiff in the opinion: “It is troubling to this Court that, notwithstanding repeated suggestions, encouragement, and downright admonitions over the years both by this Court and by the Delaware Supreme Court, litigants continue to bring derivative complaints pleading demand futility on the basis of precious little investigation beyond perusal of the morning newspapers.”\(^{368}\) The dismissal in this case was upheld by the Delaware Supreme Court.\(^{369}\)

\(^{365}\) The Delaware Chancery Court pointed out that MSLO’s public offering prospectus stated “‘Martha Stewart remains the personification of our brands as well as our senior executive and primary creative force.’” \textit{Id.}

\(^{366}\) The “duty to monitor” count was dismissed by the trial court under Rule 12(b)(6) because of the novelty of asserting a duty to monitor individual’s personal, as opposed to professional, actions. \textit{Id.} at 17.

\(^{367}\) \textit{See Beam v. Stewart, C.A. No. 19844 - NC,} at 47.

\(^{368}\) \textit{See id.} at 40-41. The court acknowledged that plaintiffs in derivative suits are not able to conduct discovery before filing and pleading demand futility. However, plaintiffs may request a “books and records inspection” as shareholders under section 220 of the Delaware General Corporation Law. \textit{See Del. Gen. Corp. L. § 220} (DATE). The court noted that in the highly publicized shareholder litigation against directors and officers of Walt Disney Co., the trial court dismissed the complaint on grounds that the plaintiffs had not proven demand futility and that the
D. Martha Stewart Goes to Prison: Type One Error?

The two cases against Martha Stewart were both substantively difficult to win. At the heart of both allegations is a presumption that Stewart violated traditional insider trading laws by selling her ImClone stock. This claim would be very difficult to prove because it hinges on facts and motivations known only to Stewart, Faneuil and Bacanovic. In addition, both the criminal indictment and Count 1 of the complaint attempted to characterize as corporate misconduct Stewart’s statements to the press regarding her innocence because of Stewart’s “personification” of her publicly-traded company.

In the criminal trial, prosecutors were able to avoid having to prove the troublesome insider trading violation by instead charging Stewart with her attempts to create, through her statements and actions, a false semblance of propriety surrounding her stock trade. By charging Stewart with making false statements, obstructing justice and conspiracy with Bacanovic to do the same, prosecutors were never forced to prove the underlying crime that they asserted was being illegally obscured. Prosecutors were also able to convince Faneuil, who himself was charged with crimes, into testifying against Stewart. Finally, prosecutors were able to use their substantial subpoena powers to amass a case against Stewart before trial.

_dismissal was upheld by the Delaware Supreme Court, although shareholders were given leave to replead. In re Walt Disney Co. Derivative Litig., 731 A.2d 342, 355 (Del. Ch. 1998), aff’d in part, rev’d in part sub nom. Brehm v. Eisner, 746 A.2d 244 (Del. 2000). After the plaintiffs gathered information from a books and records request, the plaintiffs successfully repled the action, which was allowed to proceed to trial. In this case, however, plaintiffs were not given an opportunity to replead._

369 Beam v. Stewart, No. 501, 2003 (Del. Mar. 31, 2004) (“To create a reasonable doubt about an outside director’s independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director’s stock ownership or voting power, the non-interested director’s stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.”). The court based much of its decision on its presumption that absent other facts, these directors had too many positions of a fiduciary nature to risk their own reputation in making a biased decision regarding their personal friend Stewart. This “reputational constraint” argument allows the speaker to presume innocence at a level questionably higher than the level given a corporate defendant.
Prosecutors were not able to gain a conviction against Stewart on the most novel charge in the indictment – that her protestation of innocence violated the securities laws. However, prosecutors were allowed to put on evidence at trial to that effect; Stewart was acquitted of that charge by the trial judge after the close of evidence.

By contrast, similar obstacles inherent in the civil complaint were never at issue because the case was dismissed on procedural grounds. In effect, the fiduciary duty claim had no potential to be tried because the board chose not to pursue it on their own and because the shareholder plaintiff was not able to sidestep the board through a derivative action because the plaintiff could not sufficiently plead, without discovery, facts that would show that a majority of the board was not disinterested. If the case had proceeded to trial, then the plaintiff would have had to rebut the business judgment rule by proving either that Stewart had violated securities laws or had been grossly negligent in her dealings with the media, prosecutors, and governmental agencies in a way that damaged the company. These charges would have been difficult to prove substantively, but were dismissed procedurally without regard to the substance of those complaints.

The Stewart investigations reflect a reversal in the traditional balance between defendants and accusers in criminal and civil cases. Although one would expect an opposite result, here charges were more successful in a criminal trial than in a civil case involving the same facts. Although one might consider these charges dubious at best and not be troubled by the civil court system quickly dispensing with the case, one must be troubled by the fact that the same charges successfully imprisoned a corporate defendant for five months in prison and five months in house arrest.\footnote{However expansive and well-decorated the house, house arrest is still a substantial limitation on a liberty interest.} In addition, if one believes these claims to be colorable claims, one must be disappointed that the civil system could find no remedy to damaged shareholders who invested in MSLO on the promised strength of its brand being associated with “good things” even though the criminal law could deliver retribution.
VIII. Case Study: Peregrine Systems, Inc.

In many instances, the existence of a guilty plea or guilty verdict will create huge incentives for the firm or individual officer or director to settle meritorious civil charges arising out of the same conduct. However, finding a case in which fairly standard charges of misconduct have resulted in quick criminal guilty pleas while a contemporaneous civil lawsuit meets procedural roadblocks is not impossible. The cases stemming from accounting fraud at Peregrine Systems, Inc. is one such example.

A. The Fact Scenario

Peregrine Systems, Inc., a San Diego-based software company, went public in 1997 and rode the wave of the technology boom until May 2002, when the company announced that it was re-examining its prior financial reports for possible misstatements. During each quarter of its publicly-traded life, Peregrine had managed to meet or exceed analyst expectations, and its stock had risen in March 2000 to $79.50 per share, giving Peregrine a market capitalization of $9 billion. Following the announcement on May 6, the stock price fell 65% to $0.89 per share. After declaring bankruptcy in September 2002, Peregrine eventually restated its financial statements for all quarters beginning with the first quarter in 2000 and ending with its last financial statements in the third quarter of 2002. Restated net losses were more than $4 billion for the 33-month period from 1999 to 2001. Peregrine delisted from NASDAQ on August 30, 2002, and was traded on the pink sheets after that time.

After emerging from bankruptcy in 2003, the scaled-down company, which had gone from employing 4,000 people to 732, hired John Mutch as its turnaround CEO. Mutch admitted in the press that Peregrine Systems had virtually

373 See Allen, supra note 371, at 1.
374 John Mutch’s Midas Touch, RED HERRING, Feb. 6, 2006, at __. (describing Peregrine Systems as Mutch’s third turnaround success, attributing his talent to “his sharp eye for identifying rusting assets worth polishing up.”)
no internal controls in place and that executives were engaging in improper revenue recognition schemes.\textsuperscript{375} Two years later, Peregrine Systems was acquired by Hewlett-Packard Co. in September 2005 for $425 million.\textsuperscript{376}

The corporate misconduct in the Peregrine case generally relates to accounting schemes that were designed to artificially inflate revenue numbers in financial statements filed with the SEC. These inflated revenues helped buoy the stock price associated with investor disappointment with negative earnings reports. In its parallel civil proceeding, the SEC described the outlines of Peregrine’s financial statement manipulations:

The heart of the fraud was the recording of hundreds of millions of dollars of revenue despite non-binding arrangements with customers, in violation of Generally Accepted Accounting Principles (GAAP). Among other things, material sale contingencies were secretly added by oral or written side agreement to what appeared on their face to be binding contracts. Peregrine then took fraudulent action to conceal the revenue fraud . . . To make it appear that Peregrine was collecting its receivables more quickly than it actually was, a senior officer entered into financing arrangements with banks to exchange receivables for cash. Peregrine improperly accounted for these financing arrangements as sales of the receivables and removed them from the company’s balance sheet. There were several problems with this. First, because Peregrine had given the banks recourse, and frequently paid or repurchased unpaid receivables from them, Peregrine should have accounted for the financing arrangements as loans and left the receivables on its balance sheet. Second, some of the “sold” receivables were not valid because the customers were not obligated to pay Peregrine. Third, several of the “sold” invoices were fake. One of the fake invoices purported to reflect a $19.58 million sale.\textsuperscript{377}

As part of the allegations made by the DOJ, these executives involved were accused of personally profiting from these schemes.\textsuperscript{378} The SEC complaints

\textsuperscript{375} Id. at __ (“Once installed in Peregrine, Mr. Mutch did what he had done in earlier turnarounds: He came to grips with its cash flow and accounting situation, and started running the company on a cash-flow accounting basis, since there was no other internal control he could detect.”).

\textsuperscript{376} Id. at __.


\textsuperscript{378} See, e.g., United States v. Gless, available at http://www.usdoj.gov/dag/cftf/chargingdocs/spitzerinformation.pdf (April 2003) (“It was a further part of this conspiracy that the conspirators would enhance their personal reputations and enrich themselves (via compensation, bonuses and stock options) through these fraudulent means.”).
detail that during the time periods in question, these executives sold common stock in to the market at inflated prices, even though the executives knew that the market prices did not reflect the true financial health of the company.  

B. The Criminal Case

The resulting investigation by the DOJ and the SEC implicated numerous officers of Peregrine, its business partners, and its auditors. Although numerous participants in the alleged scheme to falsify financial records cooperated with the government’s investigation in order to avoid being indicted, eight executive officers, one KPMG consultant, one Arthur Andersen auditor, and one business partner were indicted by the DOJ on October 6, 2004. Another business partner, David Thatcher, President of Critical Path, had been sentenced on January 13, 2004 for violating securities laws in connection with “software swaps” conducted with various other companies, including Peregrine Systems. Three other officers of the company, including the chief financial officer Matthew C. Gless, had pleaded guilty to either securities fraud, conspiracy to commit securities fraud, or obstruction of justice prior to the October 2004 round of indictments. On July 13, 2006, senior sales executive and Vice President of Worldwide Sales Douglas Stephen Powanda entered a guilty plea to conspiracy


to commit securities fraud, wire fraud, falsification of corporate books, records and accounts, and bank fraud. A few days later, on July 19, 2006, prosecutors indicted Richard T. Nelson, the company’s general counsel who was appointed interim CEO for approximately a month following the May 6, 2002 announcement that the company would restate its finances. The trial of those executives who have not pled guilty, including CEO Stephen Parker Gardner, is set for April 3, 2007.

C. The Shareholder Lawsuits: Type Two Error?

Shareholders of Peregrine Systems filed three notable lawsuits against the company and various officers and directors. Each of these three lawsuits has met with procedural obstacles that have slowed the path to investor remedies, even though the misconduct at Peregrine Systems has been admitted and acknowledged by many of the officer defendants in those suits. These three suits address, respectively, violations of federal securities laws, breach of state law fiduciary duties, and violations of California’s insider trading laws.

Among the director defendants named in this suits is John Moores, founder of BMC Software and owner of the San Diego Padres baseball team. In addition

383 News Release, Office of the United States Attorney, Southern District of California, Case Number: 04cr2605-W (July 13, 2006) (“According to Assistant U.S. Attorney Eric J. Beste and Sanjay Bhandari, who prosecuted the case, Powanda is the highest ranking executive at Peregrine Systems to have pled guilty to criminal charges relating to the fraudulent activities at the company.”).
384 See Bruce V. Bigelow, Ex-Peregrine General Counsel Faces Charges in Fraud Case, SAN DIEGO UNION-TRIB., July 20, 2006, at C1 (quoting the revised indictment as alleging that Nelson “attempted to prevent counsel for Peregrine’s audit committee from fully investigating allegations that Peregrine had engaged in a fraudulent software swap transaction”).
385 See Bruce V. Bigelow, Ex-Peregrine Sales Executive Pleads Guilty, SAN DIEGO UNION-TRIB., July 14, 2006, at C1.
386 Perhaps because of these admissions, the insurance companies providing insurance to the directors and officers of Peregrine rescinded those policies in 2002. Although the directors have taken legal action against the insurers for breach of contract, the defendants in these shareholder suits are litigating with the prospect that any settlement or recovery would be paid by the individual defendants. See Bruce V. Bigelow, Principals of Accounting, SAN DIEGO UNION-TRIB., Feb. 27, 2005, at __.
387 In re Peregrine Systems, Inc. Sec. Litig., 02-cv-870 (S.D. Cal. May 6, 2002).
to being a director and chairman of the board, Moores was at one time the majority shareholder of Peregrine Systems.\textsuperscript{390} Moores, who sold $665 million worth of Peregrine Systems stock in April 1999, maintains that he was unaware of any fraudulent schemes at Peregrine Systems.\textsuperscript{391}

1. \textit{Securities Law Class Action Suit}

A shareholder class action suit against Peregrine Systems, certain directors, officers, business partners, consultants, and auditors, has been pending in the Southern District of California since May 2002. These consolidated suits include a lawsuit filed by the trustee of an independent litigation trust created by Peregrine as part of its bankruptcy reorganization.\textsuperscript{392} The plaintiff group comprises one main group of shareholders (lead by the Loran Group, lead plaintiff (“Loran Group”)) who owned shares of Peregrine Systems during the class period, July 22, 1999 and May 3, 2002, and two subgroups of shareholders who acquired stock of Peregrine Systems when the company acquired two other companies, Harbinger Corporation and Remedy Corporation. The Loran Group alleges violations of Sections 10(b) and 20(a) of the Securities and Exchange Act., as well as violations of Rule 10b-5. The two subgroups allege violations of Sections 11 and 15 of the Securities Act and Sections 14 and 20(a) of the Securities and Exchange Act. Among the defendants, at least three had pled guilty to securities fraud at the time of defendants’ second motion to dismiss.\textsuperscript{393}

In March 2005, the district court dismissed the majority of claims in the complaint, including all of the Section 10(b) complaints against the defendant directors, including Moores. The court found that the allegations against the directors, including directors on the audit committee, did not comply with the PSLRA’s scienter requirement because even though the directors signed the securities filings containing false statements and the directors approved the change in accounting procedures because they were told the change would allow

\textsuperscript{390} See Bruce V. Bigelow, \textit{Early Ruling Clears Moores in Peregrine Suit}, \textit{San Diego Union-Trib.}, April 1, 2005, at __.

\textsuperscript{391} See Bruce V. Bigelow, \textit{Principles of Accounting}, \textit{San Diego Union-Trib.}, Feb. 27, 2005, at __.

\textsuperscript{392} See Bruce V. Bigelow, \textit{Fraud Claims v. Peregrine Ex-directors Tossed Out}, \textit{San Diego Union-Trib.}, April 4, 2005, at __.

\textsuperscript{393} Defendants’ first Motion to Dismiss was granted with leave to amend. Plaintiffs then filed an amended complaint.
the company to meet analyst targets, the directors were not specifically told that
the accounting change was not in conformity with GAAP. The court did not
consider an email from a whistleblower purportedly detailing the accounting
fraud that was sent to Moores because the email was not physically attached to
the complaint. These claims were also dismissed against two vice-presidents
who drafted false press releases because the allegations that they drafted the
releases was insufficient for the two officers to be considered primary actors and
not mere aiders and abettors.

The only allegations the court did not dismiss against the directors were
Section 11 complaints relating to registration statements filed in the context of
two acquisitions by Peregrine Systems; Section 11 claims are not subject to the
heightened pleading standard of the PSLRA. The court also sustained these
claims after defendants filed a motion to dismiss based on the Supreme Court’s
opinion in *Dura*. However, the court held that *Dura* did not apply to Section 11
claims.

On January 13, 2006, pursuant to an unopposed motion by the Loran Group,
the district court entered judgment as to the dismissed claims, which allowed the
plaintiffs to file an appeal with the Ninth Circuit Court of Appeals. If that appeal
is unsuccessful, the only non-Section 11 claims that will survive will be against
four Peregrine officers, three of whom have pled guilty to securities fraud. Due
to the bankruptcy of the company, the lack of insurance, and the financial
profiles of the four who seem to have caused that bankruptcy, the shareholders in
this action will very likely not receive an adequate remedy.

2. *Shareholder Derivative Suit*

The derivative suit against the board of directors has had an even more
complex history in both state and federal court since its filing in October 2002.
Because derivative actions are property of the issuer, Peregrine Systems’
bankruptcy stayed all derivative lawsuits.394 Accordingly, shareholders filed suit
in California state court alleging breaches of fiduciary duties by the directors and
officers of Peregrine Systems. According to the complaint, the defendants knew
and approved of the accounting frauds at issue in the criminal investigations.
According to company insiders, accounting changes were approved at a board of

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directors meeting in April 22, 1999.\textsuperscript{395} Defendants responded by removing the case to federal court on the grounds that the claims looked like claims preempted by SLUSA. Plaintiffs responded by amending the complaint to only include holders of shares of Peregrine Systems during the entire class period. The defendants then objected to complaint on the grounds that the claims were derivative and not direct and therefore stayed by the Peregrine bankruptcy. Plaintiffs amended their complaint again to add a claim of shareholder dilution, which can be a direct claim. However, the California Court of Appeals sustained the defendants’ demurrers and dismissed the action on March 3, 2005.

These claims are not lost, however, but can only be the subject of a separate suit by the litigation trustee.

3. California Insider Trading Suit

The litigation trustee also filed a separate civil action under California law,\textsuperscript{396} and its tortuous path through the civil state court system is worth noting. Although Peregrine Systems is a Delaware corporation, it is headquartered in San Diego, California. The California Corporations Code prohibits insider trading\textsuperscript{397} and also provides that an issuer may sue its own officers, directors or controlling persons alleged to have engaged in insider trading and recover three times the trader’s profits.\textsuperscript{398} The existence of this state law cause of action has created some uncertainty about whether a foreign corporation, a corporation incorporated outside the state of California, could be sued under Section 25402 in addition to facing a parallel, and possibly inconsistent, lawsuit for the same trading conduct in its state of incorporation.\textsuperscript{399}

\textsuperscript{395} Bruce V. Bigelow, \textit{Principles of Accounting}, \textsc{San Diego Union-Trib}, February 27, 2005, at (reporting that at the 1999 meeting, the board consented to changing from a “sell-through” method of revenue recognition to a less accepted “sell-in” method without disclosing the change in order to meet analyst predictions).


\textsuperscript{397} \textsc{Cal. Corp. Code} § 25402 (DATE).

\textsuperscript{398} \textsc{Cal. Corp. Code} § 25502.5 (DATE).

\textsuperscript{399} The CEO of Oracle Corp., Larry Ellison, was sued in both the Delaware Court of Chancery and in the Superior Court of California for selling $900 million of Oracle stock at $30.76 per share, one month before negative earnings reports were released and the stock price fell from $21.38 to $16.88 per share. The Delaware lawsuit was dismissed by the Chancery Court in November 2004,
The complaint, filed February 24, 2004, alleged breaches of fiduciary duty\(^{400}\) and violation of Section 25402 against ex-directors and senior management officers. Specifically, during the month of February 2001, during which Peregrine disclosed huge profits that were later restated, these defendants collectively sold over 5 million shares of stock for over $170 million. On April 1, 2005, the trial court dismissed the insider trading violations on grounds that the “internal affairs” doctrine required that only Delaware law govern the defendant’s actions.\(^{401}\) This doctrine is codified in California in Section 2116 of the Corporate Code\(^{402}\) and in the Restatement of Conflicts of Law.: “The local law of the state of incorporation will be applied to determine the existence and extent of a director’s or officer’s liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship. . . . in which event the local law of the other state will be applied.”\(^{403}\) The typical example of such state laws are state “blue sky” laws that govern the sale of securities to state residents. The trial court judge therefore must have reasoned that insider trading was more like daily corporate governance than the sale of securities and held that application of the Section 25402 against a Delaware corporation was barred by the internal affairs doctrine and Section 2116.

The trial court’s decision, however, was reversed by the California Court of Appeals, reasoning that Section 25402 and 25502.5 were not merely mechanisms to enforce fiduciary duties but rather were mechanisms to “subject intrastate securities transactions which take place in this state to California’s securities laws even if those securities are issued by foreign corporations.”\(^{404}\) The three-judge panel agreed to grant plaintiff’s writ of mandamus and to order trial.

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\(^{400}\) Because the litigation trustee is empowered to bring actions on behalf of the corporation, the derivative nature of the claim is not questioned or subject to further demand on the board of directors.

\(^{401}\) Friese, 134 Cal.App. at 700.

\(^{402}\) CAL. CORP. CODE § 2116 (DATE).

\(^{403}\) Restatement (Second) of Conflict of Laws § 309 (1971).

\(^{404}\) Friese, 134 Cal.App. at 709.
court to proceed with the insider trading claims in California state court.\textsuperscript{405} The decision was released on March 15, 2006.

The defendants in this case filed a petition of certiorari in the Supreme Court of the United States presenting two questions:

With respect to claim of breach of official duty to corporation, does commerce clause permit state to substitute its own substantive law for that of state of incorporation? (2) Does due process clause permit directors and officers of corporation incorporated in one state to be sued under substantive law of another state for breach of official duty to corporation?\textsuperscript{406}

The answers to these questions would have an impact not only on these cases but on other cases against corporations incorporated outside of California; however, the Supreme Court did not grant certification to this case.\textsuperscript{407}

Although finding cases in which officers have pleaded guilty in a criminal proceeding while shareholders’ civil actions have been dismissed, one can find cases in which the wheels of justice in the civil suit are moving at a vastly different degree of speed and facility than the criminal investigations. In the cases involving the officers and directors of Peregrine Systems, the shareholders must face almost insurmountable hurdles to bring claims involving the same facts that have allowed prosecutors to quickly bring indictments and obtain guilty pleas.

\textbf{IX. Is the System Broken? What is the Perfect Corporate Law Mousetrap?}

The reality of the presence of Type I errors in criminal prosecutions but Type II errors in private civil litigation can prompt various responses. First, one could

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{405} See \textit{id.} at 711.
\item \textsuperscript{406} Petition for Writ of Certiorari, Moores v. Friese, No. 05-1590, 74 U.S.L.W. 3704 (June 12, 2006).
\end{itemize}
\end{footnotesize}
accept the Type I errors in criminal prosecutions because they are a necessary
cost for the benefit of both the expressive and deterrent nature of criminalizing
corporate misconduct. See Bierschbach & Stein, supra note 28.

Second, one could bemoan the civil Type II errors and argue for a relaxation of procedural obstacles to civil lawsuits, creating more potential for some sort of liability for corporate crimes, which could lead to more deterrence. Third, one could argue that criminalization has gone too far and that a laissez-faire regime, both criminal and civil, benefits the U.S. capital markets by encouraging risk-taking. However, the position that the current state of affairs is preferable is fairly untenable.

This Article argues that a healthier private litigation system would alleviate any perceived need for excessive criminalization of corporate misconduct. Part of this argument rests on the assumption that the civil system is a superior arena for addressing the goals of responding to such misconduct.

A. Who Gains When Corporate Officers Meet the Criminal Law?

1. Monetary relief

The criminal system is not designed to compensate victims of wrongs. However, judges are required to order restitution in connection with convictions and guilty pleas regarding certain kinds of crimes, including fraud. Mandatory Victim’s Restitution Act, 18 U.S.C. §§ 3663A, 3664 (2000) However, because these payments will not be covered by insurance and are ordered knowing that the defendant’s ability to pay may be limited, restitution may never occur. See United States Attorney’s Office, Eastern District of Virginia, Victim Restitution, available at http://www.usdoj.gov/usa/oe/victimwitness_restitution.html (in response to a “commonly asked question” of how long it takes for victims to receive compensation, the site answers “Perhaps not for a very long time. . . .If the defendant is sentenced to prison, the U.S. Bureau of Prisons strongly encourages defendants to participate in the Financial Responsibility Program wherein half of what the defendant earns in prison is used to satisfy restitution obligations. Wages in prison can be as low as 11 cents per hour.”).

broad discretion, even taking into account the economic circumstances of the victims. In some instances, compensation to an individual may be capped. Moreover, because most circuit courts have characterized restitution as a penalty and not as compensation, any restitution award is abated should the defendant die while an appeal is pending. Even monetary penalties earmarked for restitution may have difficulty finding their way to investors who suffered losses from corporate misconduct.

The Global Settlement on Analyst Conflicts of Interest is a good example of how the criminal system has not fared well in compensating investors, and the civil system was not given a chance to try to do so. In one of the most publicized legal actions arising out of the bursting of the technology bubble, the New York Attorney General’s office, acting with the SEC and NASD and NYSE officials, investigated ten major New York investment banks and two prominent investment analysts, Jack Grubman and Henry Blodget. Although allegations of improper IPO allocation practices were included both in the lawsuit and in the

potential to make money may be unlikely to ever make meaningful restitution to the victims of a crime.

412 18 U.S.C § 3664 (i).


414 See Heidi M. Grogan, Characterizing Criminal Restitution Pursuant to the Mandatory Victim’s Restitution Act: Focus on the Third Circuit, 78 TEMP. L. REV. 1079 (2005) (explaining that only in the 7th and 10th Circuits will a restitution award survive the death of the defendant pending appeal).

Under this doctrine, Ken Lay’s conviction, including prosecutors’ request for $43 million in victim restitution, was vacated upon his death. Carrie Johnson, Enron’s Lay Dies of Heart Attack, WASH. POST., July 6, 2006, at A1.

415 18 U.S.C. § 3663A (c)(3)(A), (B) (“This section shall not apply in the case of an offense [against property, including fraud] if the court finds, from facts on the record, that the number of identifiable victims is so large as to make restitution impracticable; or determining complex issues of fact relating to the cause or the amount of victim’s losses would complicate or prolong the sentencing process to a degree that the need to provide restitution to any victim is outweighed by the burden on the sentencing process.”).

settlement against two of the defendants, this suit focused mainly on the conflicts of interest that arose between investment analysts, who were issuing research reports on issuer’s stocks with buy and sell recommendations, and the investment banking firms that employed them and served the same client-issuers. The lawsuits alleged that the investment banks were routinely authorizing and possibly requiring analysts such as Grubman and Blodget to give favorable ratings to clients when those ratings were not warranted. This practice was so pervasive that during 2000, analysts were giving “buy” recommendations for issuers whose businesses were plummeting into bankruptcy. All of the defendants entered into the Global Settlement of Analyst Conflict of Interest on April 28, 2003, pursuant to which each defendant signed a Letter of Acceptance, Waiver and Consent under NASD rules without admitting or denying the allegations or findings. Under the Global Settlement, the defendants agreed to pay $1.4 billion dollars, with $387.5 million of that sum to go to a fund to reimburse aggrieved investors. Grubman and Blodget were both barred from the securities industry by the SEC, NASD, and NYSE and ordered to pay fines of $15 million and $4 million, respectively.

Although the Global Settlement was agreed to on April 28, 2003, by September 2006, only about two-thirds of the $387.5 million fund had been

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Although the fund distribution website states that almost 100% of claims have been satisfied, the definition of claims is rather narrow. According to the distribution plan, even qualifying losses (from qualifying stocks bought through qualifying firms) are discounted by an “information” formula and a “proximity” formula. The information formula discounts losses generated by investments of over $25,000 under the theory that those investors consulted multiple sources of information prior to the investment and were not as impacted by biased research. In addition, net losses were also discounted by the number of days that elapsed between the issuance of the biased research and the date of purchase of the stocks. Other funds earmarked for “investor education” were also not used expeditiously.

2. **Deterrence as an investor benefit**

Criminal law deterrence may occur in two ways. First, if potential criminals are aware of harsh punishments for certain crimes, then those individuals may choose not to commit those crimes. Criminals are theorized to make rational cost-benefit analyses, and harsh punishments weigh into this formula. In addition, by criminalizing conduct and assessing a harsh penalty for commission

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423 Global Research Analyst Settlement Fund, Payments to Date, available at http://www.globalresearchanalystsettlement.com/payments.php (Substantial payments were made to eligible investors in the first phase of fund distribution. The average payment was $14,500 and most eligible investors received 100% of their eligible losses.) (last visited Feb. 5, 2007).
425 Id. at 3-5.
426 Id. at 4-5.
427 Id. at 3-4.
428 See Deborah Solomon, Investor Education Spurs Looming Duel Between U.S. States, WALL ST. J., May 26, 2005, at C1 (stating that of the $85 million earmarked for investor education by federal and state authorities, the federal agency had not spent its money and many states had spent the money on financial literacy curricula with glaring errors).
429 Whether or not most criminals make these types of rational decisions is disputed. See, e.g. David S. Lee & Justin McCrary, Crime, Punishment & Myopia, NBER Working Paper No. 11491 (July 2005) (studying teenagers before and after their 18th birthdays and concluding that harsher penalties upon turning 18 had no effect on their decisions to commit crimes).
of that conduct, the law signals to individuals that the conduct is wrong. Individuals may internalize this value and avoid the conduct.

Deterrence in corporate misconduct cases is hard to measure and hard to theorize. Unlike other crimes, white collar crimes are not “self-revealing”; that is, there is no dead body or other evidence whenever a corporate actor violates a law. Many such violations are undetected, especially during boom economic times when no one is being too critical or suspicious of corporate behavior. Although measuring rates of investigation, enforcement and conviction is possible; this analysis merely measures increases and decreases in investigation, enforcement and conviction, not in incidence.

Scholars have also had difficulty creating a theoretical framework for deterrence in the corporate crime arena. White collar crime involves individuals with education and resources who sometimes risk everything for very little. These executive officers of large public companies may be so self-confident that the threat of criminal prosecution seems improbable, if not impossible.430 Succeeding in the corporate world takes some amount of risk-seeking personality, and therefore those in a position to perpetrate corporate frauds may be the most risk-seeking of them all. If white collar criminals are so irrational, then what level of criminalization will force them to make rational calculations of risk of corporate punishment? Some scholars have argued that because corporate prosecutions are so selective and seem so random, white collar defendants may not consider the possibility of criminal punishment in the calculus and may respect the law even less. Unless prosecutors mean to continuously investigate companies on more than a random, spot-checking basis, then even Draconian sentences will have little effect. If the probability of even a high punishment is close to zero, then the expected punishment is still close to zero.

3. Investor confidence as an investor benefit

The rhetoric of overcriminalization is that prosecutors are restoring “investor confidence” to the market. Regulators understand that investor confidence

430 See Ribstein, supra note 5, at 4-5 (describing how someone as risk-seeking and overconfident as Jeff Skilling could not only believe that Enron was in better shape than the market thought it was but could also believe that any of his actions to counter that disconnect would go undetected).
creates stable capital markets. When investors have confidence in the information they receive about firms in the market, then they will put or leave their capital in that market, keeping prices stable and perhaps raising prices. When investors lose confidence, they sell shares and exit the market, causing prices to fall. Whether this confidence is rational or irrational, or whether we believe that the retail investor should be a part of this confidence game at all, prosecutors claim that criminal enforcement is necessary to maintain this investor confidence. Event studies are necessary to determine whether the high-profile convictions have an impact on the capital markets. If investors gain confidence in the market through indictments and convictions, then event studies may show that the market increases on days when those events are announced. However, event studies are problematic to some scholars because other economic forces may be affecting prices. Just as critics of overcompensating private plaintiffs point out that stock price movement may be unrelated to fraud or the revelation of fraud, stock price movement may be unrelated to perp walks, convictions, and sentencings.

4. Parallel prosecutions as an investor benefit

Although the existence of a criminal conviction may provide defendants with incentives to settle civil lawsuits, these parallel prosecutions do not benefit civil plaintiffs in other ways. For example, a conviction of a corporate defendant on solely second-order charges such as obstruction of justice, making false statements, or even tax evasion will not translate into valuable evidence in a civil lawsuit for securities fraud or breach of fiduciary duty. Courts have not been receptive to claims that directors breach duties when they do not monitor officers sufficiently to restrain them from making false statements. Therefore, these types of charges, while easier to prove by prosecutors, have little spillover effect to civil lawsuits. One could even theorize that defendants negotiating guilty

431 See Lynn A. Stout, The Investor Confidence Game, 68 BROOK. L. REV. 402 (2002) (“Suspicious and distrustful investors would refuse to exchange their hard-earned cash for such abstract and intangible goods as corporate securities.”).

432 Press Release, Fact Sheet: Corporate Fraud Task Force, available at http://www.usdoj.gov/opa/pr/2006/August/06_odag_521.html (citing as the goals of the Corporate Fraud Task Force (1) “restore confidence to the marketplace”; (2) “provide fair and accurate information to the investing public”; (3) “reward shareholder and employee trust”; and (4) “protect jobs and savings of hard-working Americans”).
pleas may prefer to plead to counts in an indictment that do not have a civil cause of action analogue. In addition, shareholder plaintiffs are not able to take the prosecutor’s case wholly as a template for their own. Although corporate defendants may be eager to waive attorney and work product privilege to provide prosecutors with corporate documents, civil plaintiffs will not be able to then use these “waived” documents to help build their own case. The Advisory Committee on Evidence has proposed amendments to Rule 502 at the request of the Senate Judiciary Committee. This rule will codify privilege rules in that it will define waiver of attorney-client privileges and work product privileges and it will create exceptions, including one when "the disclosure is made to a federal, state, or local governmental agency during an investigation by that agency, and is limited to persons involved in the investigation." This new rule will solve the dilemma of corporate firms who wish to cooperate with federal prosecutors but preserve rights in civil proceedings. In order to satisfy corporate defendants, the rule has to apply in both federal and state courts in order not to create an easy loophole for plaintiffs who file lawsuits in state court. To that end, the comments to proposed Rule 502 read "the Committee is well aware that a privilege rule proposed through the rulemaking process cannot bind state courts, and indeed that a rule of privilege cannot take effect through the ordinary rulemaking process. . . . It is therefore anticipated that Congress must enact this rule directly, through its authority under the Commerce Clause."

One recent example, however, of a guilty plea providing an investor benefit is the plea agreement between the DOJ and Andrew Fastow. Fastow had pleaded guilty early in the Enron investigation in exchange for a sentencing recommendation of ten years in prison. After testifying against Ken Lay and Jeff Skilling, Fastow was sentenced to only six years in prison based on his substantial cooperation in the Enron prosecution. As part of his cooperation,
Fastow volunteered to give a deposition to plaintiffs’ lawyers in the shareholder securities law class action against various Enron defendants, investment banks and Enron’s outside law firm.436

B. Arguments Against Corporate Prosecutions

1. Resources

Perhaps more so than private litigators, government actors have limited resources with which to enforce criminal laws.437 Following the scandals of the early 2000s, the media reported that the SEC, which often collaborates with the DOJ on investigations, had woefully inadequate resources to police industry participants and so had to purposefully choose which suspected firms to investigate.438 The DOJ also has a limited budget. Although these budgets have grown in the past few years due to the Corporate Fraud Task Force, those monies are subject to being reallocated to new, pressing enforcement issues.439 In exercising prosecutorial discretion, government agencies may make choices that may not affect the greatest number of affected investors.440 One might argue that

436 See Tom Fowler, Cooperation Could Pay Off for Fastow, HOUS. CHRON., Sept. 26, 2006, at __ (reporting that plaintiffs’ lawyers in the class action lawsuit had urged Judge Hoyt to reduce Fastow’s sentence in return for Fastow providing testimony to the plaintiffs, including a 175-page declaration of facts involving various defendants, including banks); Alexei Barrionuevo, Fastow Gets His Moment in the Sun, N.Y. TIMES, Nov. 10, 2006, at C1 (detailing Fastow’s multi-day deposition after his sentencing).

437 See Brown, supra note Error! Bookmark not defined., at 538-39 (“The government often remains at a substantial disadvantage in civil and regulatory enforcement, despite its invasive tools of discovery. This is because of severe limitations on enforcement budgets.”).

438 See Stout, supra note 431, at 434 (noting that the SEC’s budget has remained constant for a decade as caseload increased 80%).

439 For example, Attorney General announced in 2005 that combating pornography was a new priority for the DOJ and the FBI. See Julie Kay, U.S. Attorney’s Porn Fight Gets Bad Reviews, DAILY BUS. REV., Aug. 30, 2005, at __ (criticizing the anti-porn initiative, which targets adult pornography, for taking away resources necessary to investigate and prosecute more serious crimes); Barton Gellman, Recruits sought for Porn Squad, WASH. POST, Sept. 20, 2005, at A21 (chronicling employees at the DOJ and FBI’s bemusement of the anti-porn initiative and wondering how this priority fits in with the relative order of other priorities: terrorist attacks, foreign espionage, cyber-based terrorism, public corruption, civil rights, organized crime, white-collar crime, and other violent crimes).

440 See Heminway, supra note 262, at 267-68 (stating that although U.S. Attorneys follow the Principles of Federal Prosecution, which provide for the prosecution of all cases unless (1) the
prosecuting a research analyst like Frank Quattrone three times for obstruction of justice when not charged criminally or civilly for the underlying crime of spinning IPO shares may be the result of a flawed cost-benefit analysis. Likewise, prosecuting Martha Stewart on obstruction of justice charges when the uncharged underlying crime of insider trading, if committed, assisted her only in avoiding a $51,000 loss, may also be a strange way to spend taxpayer money.

Accordingly, prosecutors may commence prosecutions as a response to public outcry or administrative preference, not because of a true sense of the deterrent or remedial effect of such prosecutions. As prosecutors in high-profile cases then move on to lucrative jobs in the private sector, one wonders whether the principal-agent problems inherent in the relationship between plaintiff and contingency fee lawyer is any less in the relationship between citizen and Assistant U.S. Attorney.

2. Error Correction

The possibility of an inappropriately severe or even incorrect criminal conviction should urge caution when a civil alternative is available. Scholars warn against “death penalty” sanctions against corporate entities that may prove extremely detrimental to the ongoing business of the firm, which will affect

\begin{quote}
\textit{prosecution would serve no substantial federal interest; (2) the matter is being effectively prosecuted in another jurisdiction; or (3) an alternative to criminal proceedings exists, because the issues arising under this principles are so numerous, prosecutors are basically left with no guidance and able to selectively enforce laws without penalty).}
\end{quote}

\footnote{See Darryl K. Brown, \textit{Cost-Benefit Analysis in Criminal Law}, 92 CAL. L. REV. 323, 360 (2004) (citing “excessive interest group influence, shirking or self-regarding behavior, and lack of monitoring as improper but existing influences on prosecutorial discretion ). Prof. Brown also argues that those influencing prosecutorial discretion will be influenced by the availability bias and therefore think that highly publicized violent crimes need more attention than less publicized, nonviolent crimes such as white collar crime. See id. at 342. However, in light of recent publicity surrounding accounting scandals, one might argue that this availability bias may lead the public to overestimate the frequency and impact of white collar crime.}

\footnote{See Peter Lattman, \textit{High-Profile Prosecutor Anders to Take Post at Wachtell Lipton}, WALL ST. J., Dec. 2, 2005, at _ (describing the career path of David Anders, who earned $140,000 a year as an AUSA in the Southern District of New York convicting Bernard Ebbers and Frank Quattrone before leaving to join Wachtell Lipton for a salary estimated at over $1 million). The article also names other attorneys at Wachtell who were former prosecutors in the Manhattan U.S. Attorney’s office as well as reporting that prosecutors in the Martha Stewart and Quattrone cases have left for similarly lucrative jobs at Sullivan & Cromwell. See id.}
employees, vendors, pension holders, and even shareholder plaintiffs in civil lawsuits. Even a successful appeal cannot put the Humpty Dumpty firm back together, unwinding bankruptcy cases and restoring jobs and livelihoods. The classic example of this phenomenon is the conviction of Arthur Andersen LLP on obstruction of justice charges. Although that conviction was ultimately reversed by the U.S. Supreme Court, because Andersen lost the ability to conduct audits of public companies, the firm was literally decimated by the conviction.

These “market spillover” effects also occur when an individual is incorrectly indicted, convicted or sentenced. Potential defendants who find themselves in the prosecutor’s crosshairs are in far worse straits than a civil lawsuit defendant. Criminal defendants may have assets frozen, be held in custody or have to post bond to be free pending trial, be fired by firms wishing to be seen as “cooperating” with prosecutors, lose licenses and may be restricted from leaving a jurisdiction which is not their residence. Should charges be dropped, the defendant acquitted, or the defendant’s conviction reversed, the state does not put the defendant back where the defendant was before being indicted. Lost wages are not repaid, reputation cannot be restored, and trauma due to time spent in custody does not warrant compensation. Absent some sort of bias or evidence of malicious prosecution, the defendant will never by compensated for the damages caused by the Type I error.

444 See Moohr, Prosecutorial Power, supra note 261, at 174 (2004) (stating that even before Andersen’s trial started, the $9 billion company was basically defunct from loss of business); Kara Scannell & Jonathan Weil, Supreme Court to Hear Andersen’s Appeal of Conviction, WALL ST. J., Jan. 10, 2005, at C1. (reporting that a reversal would be a “hollow victory” for the former Big Five accounting firm, whose conviction derailed the employment of 28,000 people).
445 See Jamie Doward & Paul Harris, The Bankers, the Big Deal and the Taint of Scandal, OBSERVER (LONDON), July 16, 2006, at 1 (describing how the three bankers for Greenwich National Westminster were extradited to the United States to stand trial on charges of conspiring with Enron employees, were allowed to post bail, but must stay in Houston, Texas until their trial, set for September 2007).
446 See Joseph Grundfest, Over Before It Started, N.Y. TIMES, June 14, 2005 (arguing that for corporate defendants, being indicted sounds the death knell because “[t]he prosecutor’s decision to indict is largely immune from judicial review. The prosecutor acts as judge and jury. . . . The innocent can therefore be punished as though they are guilty, and penalties imposed in settlements need not bear a rational relationship to penalties that would result at a trial that will never happen.”).
3. **Incentives to Plead Guilty**

All criminal defendants who are tried, indicted or even merely investigated by federal prosecutors face “collateral consequences,” including business losses, market reaction, and social stigma. One could argue that these collateral consequences may be more severe for corporate actors whose careers are not terribly forgiving of criminal records. Generally, even a guilty white-collar criminal does not want to increase “street cred” by doing prison time, and most business people have led lives that did not prepare them for the realities of prison life. Although these collateral consequences may be unavoidable even in a perfect system for disciplining corporate conduct, the fear of these extreme collateral consequences gives prosecutors great power in extracting cooperation. However, that fear is real. Whether the defendant is a corporate actor or a participant in street crime, a trial or conviction will wreak havoc on the defendant’s marriage, family and future employment, and these costs should be considered when determining whether the benefits of criminal prosecution outweigh the costs.

Private litigation does not create the same collateral consequences. Because of the fear of prosecutorial overreaching and the knowledge that ultimate vindication may not reverse these collateral consequences, private litigation may be a more efficient model of disciplining corporate conduct.

**C. Who Gains When Corporate Actors Pay Civil Settlements or Judgments?**

1. **Monetary Relief**

One obvious benefit to shareholder plaintiffs in a civil lawsuit is the availability of monetary damages. To those who have incurred losses because of the misconduct of others with a fiduciary relationship to them, a remedy that makes them whole should be the goal of any system to discipline that

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447 See id. at 173.

448 See Bierschbach & Stein, supra note 28, at 1749-51 (defining this “market spillover” effect as an example of overenforcement of the law that cannot be abated without sending the message that market reaction to corporate fraud is punishment enough).

449 See Moohr, supra note 4.
misconduct. However, some cases, such as some fiduciary duty cases, do not result in monetary damage awards but in other types of remedies. These remedies may be just as valuable to a shareholder, even if the remedy does not directly increase wealth or even raise the stock price substantially.

2. **Deterrence**

Deterrence of private litigation is as hard to measure as the deterrence value of criminal punishment. Unlike criminal prosecutions, which seem to follow trends in public outcry and is not very predictable, private litigation is almost too predictable. Any securities law attorney can tell you what events prompt private litigation. Restatements of earnings, which are basically admissions of false reporting, prompt private litigation. Announcements of negative information that conflicts with earlier, positive information, will spawn private litigation. Disclosures of large amounts of selling by insiders before announcements of negative information will prompt private litigation. To avoid civil lawsuits, firms could pay attention to these areas and make greater efforts to be conservative in financial reporting, hewing close to accepted accounting practices, to monitor executive speech, and to monitor and control insider selling. Because the filing of civil lawsuits follow a more predictable path than criminal prosecutions, they give more valuable information to corporate actors that may help conform conduct.

3. **Proportionality**

One of the more hotly debated issues in the overcriminalization dialogue is whether the harms caused by white-collar crimes are sufficiently different than other crimes of theft or violence to warrant mere civil enforcement instead of

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450 See James D. Cox, *The Social Meaning of Shareholder Suits*, 65 BROOK. L. REV. 3, 8 (1999) (describing the compensability of a monetary harm the “sine qua non” of the shareholder suit because the suit will be dismissed without that element).

451 For example, Prof. John Coffee argues that private litigation has no deterrence value, but provides as evidence only that theory that “deterrence works best when it is focused on the culpable, but there is little evidence that securities class actions today satisfy this standard.” See Coffee, *Reform*, supra note 115.
criminal punishment. Many commentators vigorously argue that the harms done to investors (and in the case of Enron, employee-investors) are as deserving of criminal punishment, including incarceration, as violent criminals. Even commentators sympathetic to criminal defendants point out that although white-collar criminals may get sentences that seem harsh, so do first-time drug offenders under the Sentencing Guidelines.

This Article argues that the civil arena is a more appropriate arena for corporate misconduct in light of the disproportionate penalties required by the Sentencing Guidelines in the criminal system. Penal codes have long reflected the various values that society puts on certain types of liberties, rights and property. At the top of that list is the right to life and bodily integrity. Therefore, the common law meted out differing punishments for theft, theft in someone's home, theft with a weapon, and theft when someone gets killed. Murder has always been at the top of any list and is the only class of crime for which the death penalty currently can be assessed (and then only a subcategory of murder). From time to time, anomalous provisions will reflect an idiosyncratic value attachment, such as a Texas statute making it a felony to steal any part of a cow. The distinction between violent and nonviolent crimes is not an illusory distinction, but a very real one. For comparison, consider Skilling’s alleged misconduct under the laws of the State of Texas, the jurisdiction in which he lived and worked. Although the Sentencing Guidelines required a minimum

452 See Posting of Geoff Manne, Truth on the Market, http://www.truthonthemarket.com/2006/10/24/skilling-is-not-a-crack-whore-it-seems-to-me/ (Oct. 24, 2006) (arguing in a post entitled “Skilling is Not a Crack Whore It Seems To Me” that Skilling’s sentence was disproportionate in response to a post on a different blog).


455 TEX. PEN. CODE § 31.03(e)(4) (West 2004) (creating a state jail felony for theft of any part of one cow, but less than 10 head of cattle).
prison sentence of 24 years, no state crimes have that minimum according to the Texas Penal Code. In fact, no crime other than first degree felonies are punishable by more than 20 years.\footnote{\textsc{tex. pen. code} §12.32(a) (West 2004) (punishing first degree felonies with imprisonment “of not more than 99 years or less than 5 years); \textit{id.} §12.33(a) (punishing second degree felonies with imprisonment “of not more than 20 years or less than 2 years”).} Therefore, Skilling could not have been put in jail in Houston for over 20 years for such crimes as manslaughter, murder under the influence of passion, trafficking children under 14 or other humans where death results, or having sex with a child. He also could be sentenced to jail for as little as 2 years for any of those crimes and 5 years for murder.

Interestingly, critics of “vexatious” private securities litigation often downplay the financial harm experienced by investors due to corporate misconduct. Some scholars would argue that investors take these risks by investing in individual firms and have some duty to diversify their portfolios to minimize losses from corporate misconduct.\footnote{\textit{See} Coffee, supra note 8 (arguing that because most investors are diversified, and hence probably both plaintiffs and defendants in class actions generally, that compensating losses due to fraudulent misconduct is similar to moving money from one pocket to another in an otherwise unharmed individual) [hereinafter \textit{Causation}].} On the civil side, commentators argue that investors should not be compensated at all for the known risk of managerial misconduct, but in the criminal arena, commentators focus on the same harms as justifying harsh penalties.\footnote{\textit{See} Purva Patel & Anastasia Ustinova, \textit{Sentence Not Final Chapter for Some}, \textsc{Hous. Chron.}, Oct. 24, 2006, at ___ (quoting Judge Sim Lake as saying at Skilling’s sentencing “His crimes have imposed on hundreds, if not thousands, a life sentence of poverty”).}

\section{Arguments Against Private Litigation}

\subsection{Myth of Vexatious Lawsuits}

“Vexatious lawsuits,” “strike suits,” and “nuisance lawsuits” are phrases that evoke visceral responses from market participants and legislators. At the heart of this terminology is the concept that unscrupulous plaintiffs’ lawyers bring meritless lawsuits against undeserving companies because they know that the companies will realize that a small payout today will allow companies to avoid the much larger costs of litigation, including discovery and legal fees.\footnote{\textit{See} Coffee, \textit{Reform}, supra note 115, at 3 (arguing that the “strike suit” is as fictional as a unicorn, although other arguments against private securities litigation are more persuasive).} By
giving any shareholder the power to bring these lawsuits, we are giving that shareholder a bargaining chip with which to extort a settlement to make them go away. As discussed previously, the PSLRA was enacted to ensure that shareholders do not have this right to bring a lawsuit by default. Securities lawsuits are assumed to be frivolous until proven meritorious. In order for a lawsuit to go forward, the shareholder will have to plead, without discovery, facts amounting to a fairly strong case. The right to bring a lawsuit has now shifted back to the company, and the shareholder plaintiff has no bargaining power unless its pleadings can withstand a motion to dismiss.

If vexatious lawsuits are truly prevalent, however, this problem may not be due solely to the shareholder having the default right to bring a lawsuit. The problem is a product of many factors, including the fact that shareholders do not bear the cost of litigation until there is a positive settlement or judgment, creating an asymmetry of incentives between plaintiff and defendant. The plaintiff either does not pay legal costs or pays the costs as a percentage of its recovery whether the recovery comes early or late. Another problem may be that the firm is risk-averse to going to trial. The defendant firm may be rationally risk-averse because the costs of litigation are high, but the firm may be irrationally so. Insurance companies often litigate claims at a greater cost than settlement to deter lawsuits, and that approach can also be seen as rational. On the other hand, perhaps the cost of discovery in a corporate case is unreasonably high and creates a rational incentive for faultless defendants to settle. Before creating a default rule that shareholders have no right to bring a lawsuit, perhaps courts could try to reduce the costs of discovery either by streamlining or limiting discovery or allowing technology to reduce the costs of taking depositions and having court reporters transcribe them.

In the criminal context, prosecutors have the right to investigate and indict defendants. To induce witnesses to cooperate with prosecution and perhaps plead guilty, prosecutors threaten witnesses with indictment and prosecution.460

460 See Joseph A. Grundfest, The Class-Action Market, WALL ST. J., Feb. 7, 2007, at A13 (in an editorial arguing that criminal prosecution of corporate misconduct is superior to the “expensive, wasteful and unnecessary sideshow” of private litigation, Professor Grundfest glowingly describes the prosecutors’ big sticks: “The SEC and the Department of Justice now insist that any corporation suspected of a sufficiently serious fraud conduct an internal investigation that will finger the executives responsible. The corporation must also cooperate in prosecuting these executives. This enforcement technique is stunningly effective, if often overbearing. It eliminates the government’s need to conduct expensive and lengthy investigations and provides the authorities with extraordinary leverage over every executive suspected of wrongdoing. Private litigation doesn’t have an equivalent deterrent effect because it can’t threaten executives with jail and
This type of power has the same abusive tendency to create “vexatious investigations” or “vexation prosecutions.” In order to indict someone on federal charges, prosecutors have to seek a grand jury indictment. However, this procedural hurdle is fairly easy to surmount, leaving prosecutors with the ability to indict almost anyone. Because the collateral effects, or costs, of prosecution begin to be incurred at the investigation stage, criminal defendants have great incentive to plead early. This incentive to plead early to avoid the monetary and social costs of a trial and possible conviction is at least as great as the incentive of a company to settle private litigation early. However, legislatures have not rushed in to increase the evidentiary burden to prosecutors before they can investigate or indict defendants.

2. Intra-Shareholder Wealth Transfer

One argument against private litigation for securities law violations is that these lawsuits are nothing more than wealth transfers between two groups of equally nonculpable shareholders, former shareholders and current shareholders, giving the former shareholder group a "windfall." The basis of this argument is that a corporation is not a true "person" with its own bank account, but merely a vessel holding monies for the benefit of its owners, the shareholders. So, the first part of the argument is that it is problematic to hold those shareholders accountable for the misdeeds of the people running the vessel. This type of transfer may be unfair and, after transaction costs, may be inefficient. This part of the argument generates two responses. First, the law has minimized the impact of this concern by creating an entity with limited liability. Shareholders can be assured that they will not pay sums out of their own pocket and can easily diversify and invest in many different corporations, in

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461 See Segal & Stein, supra note 284, at 135-38 (noting that grand juries can indict by a bare majority on a standard of “probably cause” or “prima facie evidence” and that grand jury indictments are weak predictors of the probability of conviction).

462 See Coffee, Jr., supra note 8, at ___ (“[S]ecurities litigation in this context inherently results in a wealth transfer between two classes of public shareholders, neither of whom is necessarily culpable.”).

463 See id. at ___ (“[T]hese transfers seem likely to produce net losses in the real world, once the considerable transactions costs extracted by the legal profession are subtracted.”).
whatever dangerous entity they choose. So, to say that these shareholders should not see their capital diminished by a judgment in a lawsuit seems less sympathetic. We know that shareholders put their capital at risk; that's why common stock is more risky than preferred or debt. To treat current shareholders as worthy of capital protection in the form of super-limited liability seems odd. The second response is to then question how corporate conduct will ever be disciplined. Under this innocent shareholder argument, even a fine for the misconduct levied by the SEC or restitution ordered by the DOJ would be unfair as it diminishes the capital of nonculpable shareholders.

Perhaps this leads to the second part of the foundation of the argument against private securities litigation: the position of the suing shareholders. According to the argument, these shareholders are undeserving of a monetary judgment and to give them a judgment would be a windfall. These shareholders are also nonculpable, and have incurred a loss because of the wrongdoings of someone in a fiduciary position to them, wrongdoings which violated statutory law. Assuming we have a quantifiable loss caused by wrongdoing, then recovery to return the harmed shareholder to the status quo should not be a windfall. However, the argument stresses that the shareholder plaintiffs are diversified and take the risk of the loss, even though the loss was caused by wrongdoing. By placing capital at risk in a risk-seeking environment, shareholders understand that corporate misconduct is one of many foreseeable events that could affect the return on capital. However, the diversification and acceptance of risk argument just as easily explains why private securities law should not be concerned about the current shareholder of the judgment-paying firm.

The third basis of the argument is that the shareholders who profited from the corporate misconduct got off free and clear. The former shareholders bought too high from the nonculpable profiteers and then sold low to the current shareholders. One way to look at this problem is to recognize an equilibrium where the losses of one group equal the gains to another, and because those groups are fluid, the gains and losses will cancel out over time. In addition, the people who should pay restitution, if anyone should, are the profiteers, who are anonymous, invisible, and gone. Again, this argument seems to presume a market of repeat players who are diversified and so should not care about restitution or relief. And, again, this same rationale also supports having private litigation. If a

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464 See id. at ___ (arguing that civil judgments reward investors for their “irrational exuberance” and serve to insure diversified investors for their decisions, at a very high price).
shareholder is sometimes the windshield and sometimes the bug, then private litigation is as rational in a world of diversified shareholders as is no private litigation. However, in an environment with no private litigation, deterrence of corporate misconduct would likely be zero, while private litigation would afford some deterrence. At the very least, announcements of private lawsuits cause management to respond to shareholders in defense of the allegations and perhaps make personnel changes for the better, increasing value for current shareholders.

3. Difficulty in Measuring Damages

In cases such as *Dura*, measuring damages is difficult. In fact, some have said that to allow recovery for shareholders in a market with many other economic variables would constitute a “windfall.” If a stock price drops, the decrease may be due in whole or in part to other factors besides the underlying corporate misconduct. If recovery should approximate the loss, then calculating the loss as nearly as possible must be the goal.

However, the assessment of damages does not need to be perfect. In other areas of the law, the calculation of damages is equally difficult, if not more so. In tort law, juries must assess the price on a human life in a wrongful death action, whether that human life is an infant, a person in mid-life with a career trajectory, or a retired person with no income. In cases where death does not result, juries must also calculate the amount necessary to compensate for pain and suffering, the value of a lost limb or loss of mobility, and even the percentage of damages due to loss of chance of recovery. More analogous to securities fraud recoveries, juries must allocate fault among various defendants, causation among various negligent acts, and damages where there are pre-existing injuries. All of these damages calculations are extremely difficult to estimate, and any award will almost certainly either undercompensate or overcompensate the victim or victim’s family. However, we do not merely abolish negligence causes of action because the calculation of damages is too inexact.

Damages in securities cases, both before and after the PSLRA are not nearly as speculative. As in contracts cases, courts concern themselves with making the shareholder plaintiff whole and not in reimbursing them speculative lost profits. Shareholders are not allowed to argue that if the false statement had been true, then the stock price would have increased even more than it had. Likewise,
shareholders cannot argue that they lost the opportunity cost of investing in other companies without fraud. Shareholders must experience a net loss, and recovery is limited to that loss. If other economic forces combine to raise the stock price regardless of the fraud, then the shareholder plaintiff must be content, even if the stock increase should have been much higher. Although in some cases the shareholder plaintiff will be overcompensated, in some cases the plaintiff will be undercompensated or even uncompensated.

4. The Attorney Fee Conundrum

Another argument against private litigation is that it is not particularly effective in compensating shareholders, even if compensating shareholders is a worthy goal. Part of the problem of undercompensation lies with the contingency fee system. Because the costs of private litigation are so high and the probability of success so low, translating into a low expected value for each individual case, plaintiffs’ attorneys charge a contingency fee that is payable upon recovery. This system incentivizes the attorney to take the case on behalf of a class of plaintiffs, and finance the litigation, even though one individual plaintiff might not rationally make that choice alone. The attorney then must take a number of cases with differing expected values to create a portfolio of litigation investments. This system causes plaintiffs to be undercompensated in two ways.

First, any judgment for the plaintiff is reduced by a percentage more than zero to pay the attorney’s contingent fee. This recovery is not negligible and may be between 30 and 40%. Therefore, if a jury found that plaintiffs were harmed a total of $100 million, then plaintiffs would receive $60 million or so. In addition, settlement values will also be reduced by the same or similar fee. In settlement negotiations, attorneys may bargain separately for a fee, but the plaintiff will ultimately receive an amount less than the amount the paying firm was willing to pay because defendant firms will be concerned only with the total payout.

465 See Joseph A. Grundfest, The Class-Action Market, WALL ST. J., Feb. 7, 2007, at A13 (arguing that private litigation is wasteful compared to SEC civil actions because “[w]hen plaintiffs’ attorneys recover funds for the class, they collect contingent fees that can consume up to a third of any recovery”).
In addition to paying the attorney out of the amount meant to make the plaintiff whole, the plaintiff’s case may be settled at less than its expected value because the attorney has an incentive to settle quickly. The more time and resources that the attorney invests into a single case, the less the rate of return on that investment in his portfolio. Because of these transaction costs and agency costs inherent in the private litigation system, plaintiffs on average receive 2.8% of their stated losses.466

However, these are problems inherent in the representation system that is itself a product of the well-known shareholder collective action problem and the high transaction barriers to private litigation that require a central agent, the attorney, to collect, assess and finance claims. These agency problems can be ameliorated by either lowering the transaction costs of private litigation so that the expected value more nearly matches the inherent value of the claim or by creating a market for financing litigation that would align the incentives of shareholders and their agents.

X. Civilizing Corporate Law

Many commentators have urged correcting the “overcriminalization” half of the overcriminalization/undercivilization conundrum. However, once the overcriminalization has been corrected, the civil litigation arena needs to be strengthened to provide discipline for corporate managers. Therefore, the part of the debate that is missing is a call for reform of the private litigation system.

Suggestions for securities law reform range from repeal of the PSLRA to repeal of parts of the PSLRA to creation of an investor insurance market.467 Ideally, any reforms would be aimed at lowering barriers for merit-based lawsuits to proceed; i.e., eliminating Type II errors. For example, amending the PSLRA to loosen pleading standards as to specific intent until after at least some preliminary discovery had taken place would improve the system.

Another area of concern to attempt to remedy would be agency problems between plaintiffs and their attorneys. A significant portion of public disdain for

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466 See Coffee, *Causation, supra* note 457, at 542 (citing to a National Economic Research Associates study that tracks investor recoveries and stating that the highest rate of recovery was 7.2% in 1996).

securities law class actions seems to be based on the assumption that most lawsuits are driven completely by attorneys who watch for signs of alleged fraud, file lawsuits, then find plaintiffs. Because these attorneys have no losses, they do not have the proper incentives to be private attorneys-general as shareholder citizens were envisioned to be. Because of these misaligned incentives, the attorneys will be willing to settle for sub-optimum payouts for the individual plaintiffs in cases with both questionable likelihood for success and great likelihood for success.

One avenue for reducing the agency costs of the contingency-fee relationship is to have the litigation financed by a third party with no control over settlement. Third-party financing of litigation has become available in recent years, and this could lessen both pressures to settle on plaintiffs’ attorneys running out of cash and pressures not to settle on attorneys who have irrationally invested too much cash in the litigation. Even if third-party institutions required some consent mechanism for settlements, much as commercial banks may require consent for certain actions as conditions of loans, highly liquid institutions with large portfolios of loans would presumably gauge decisions to settle on the actual expected value of a lawsuit and not be influenced by internal financial pressures.

One additional area of inquiry for a different article would be whether a partnership between private individuals and their attorneys and the SEC would create a better system. The SEC would benefit from the additional resources of private attorneys, while the shareholders could benefit from a more objective agent such as the SEC to make settlement decisions. In addition, the SEC could act as a gatekeeper to ensure that frivolous litigation was not brought. Although this system would increase the SEC’s workload, the private cases could overlap and possibly inform the SEC’s traditional enforcement cases. In addition, the number of “classic” securities law class actions brought each year (excepting the

468 See, e.g., Alison Frankel, Helping Underfunded Plaintiffs Lawyers – at a Price, AM. LAW., Feb. 13, 2006, at __ (describing companies such as LawFinance Group Holdings, which provide financing for contingency fee litigation).

469 One such real-life example of both pressures is recorded in the nonfiction book A Civil Action. In his representation of plaintiffs suing W.R. Grace, Jan Schlichtmann and his firm spent inordinate sums on experts and scientific testing. When Beatrice offered a settlement during trial, Mr. Schlichtmann refused the offer, and readers are left to believe that the offer was rejected because it would not over the firm’s cost and save it from bankruptcy. The jury found for Beatrice, and that defendant was eliminated from the case altogether. Hovering near personal bankruptcy, Schlichtmann was then forced to accept a very low settlement offer from the remaining defendant, Grace, because he had no more funds to continue the litigation. JONATHAN HARR, A CIVIL ACTION (1995).
IPO allocation cases brought in 2001) typically do not number more than 200, and in recent years have fallen below 100.

XI. Conclusion

In any system that determines guilt or liability, participants in that system should want to reduce both Type I errors, in which a nonculpable party is found to be culpable, and Type II errors, in which a culpable party is found not to be culpable. Because no system will ever be perfect, eliminating these errors entirely is not feasible. Moreover, strong attempts to eliminate altogether one type of error may result in increasing another type of error. For example, if participants want to eliminate Type I errors and make sure that no nonculpable party is ever found to be culpable, then the protections and presumptions given to defendants will surely make Type II errors more likely, and vice-versa. However, in a bifurcated system of criminal proceedings and civil proceedings, participants would theoretically be less tolerant of Type I errors in criminal proceedings at the expense of Type II errors, and the opposite mindset would hold in civil proceedings. Because the stakes are so high in criminal proceedings, citizens should prefer a system that tends away from Type I errors. Because the purely monetary stakes are different in civil proceedings, and satisfying avenues of error correction fairly available, Type I errors should not be the primary concern, especially to the detriment of meritorious lawsuits being dismissed or never brought, Type II errors.

As this Article has shown, our current criminal system for prosecuting corporate misconduct commits an unacceptable number of Type I errors, and public outcry has shown that observers are becoming increasingly intolerant of that fact. Ironically, the civil system for prosecuting the same misconduct commits an inordinate number of Type II errors. The result is the overcriminalization and undercivilization of corporate law. This imbalance should be harmonized, not only by reforms in the federal criminal prosecution arena, but also in the private litigation arena. Should the system be altered by merely reforming criminal prosecutions, then shareholder investors will be left with a system with little or no power to discipline corporate conduct.