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The Impact on Director and Officer Behavior

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CRIMINALIZATION OF CORPORATE LAW
The Impact on Director and Officer Behavior

AS WE GO DOWN THE TABLE, I SUSPECT WE ARE ALL GOING to be reframing a lot of points already made rather than making new ones, and I confess that is what I am about to do.

I fall on the side of the skeptics about whether criminal liability in financial reporting cases is a healthy tool because I have doubts about whether judgments are likely to be proportionate. And proportionality is a very important measure in criminal law for two reasons. First, we expect the punishment to fit the crime as a matter of justice. Secondly, if we have disproportionately harsh treatment, then the behavior of officers and directors in response to over-deterrence is that they will pay too much attention to matters that are precautionary as opposed to profit-generating.[1] And the point of a business is to be entrepreneurial. That is a fairly familiar point, but worth emphasizing.

Why do I say proportionality is going to be problematic? I think there are three layers of ambiguity in any complex criminal trial that is likely to lead to judge or jury decision-making that imagines something rather than assesses it accurately. One is ambiguity as to the motive. It is very easy in hindsight to say "look at the stock options—that was the motive for the financial misreporting." That suggests greed, and so that is a very salient story about motive. But my sense is that there are often many motives. Looking at many of these scandals, the companies were in a desperate growth and/or survival mode during the times they engaged in financial misreporting.[2] Yes, the growth was fueled by options plans but, in fact, internally there was also a perception that there was going to be a shake out in their industry in three years, and if they were not one of the winners, they were not going to be around. They were in part, at least, doing it for their shareholders. That is a very

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1. *See* Frank Partnoy, *Barbarians at the Gatekeepers: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 511–12 (2001) (stating that officers/directors will expend resources to engage in monitoring practices to the extent the cost of such expenditures is less than the gain in terms of liability). The logical extension is that where over-deterrence exists, the officers/directors will spend more time and resources on precautionary measures.

2. *See, e.g.*, Kurt Eichenwald, *Audacious Climb to Success Ended in a Dizzying Plunge*, N.Y. TIMES, Jan. 13, 2002, § 1, at 1; Carrie Johnson & Christopher Stern, *Adelphia Founder, Sons Charged; Family Looted Sixth-Largest Cable TV Company, U.S. Says*, WASH. POST, July 25, 2002, at A1; Simon Romero, *Worldcom Facing Charges of Fraud: Inquiries Expanded*, N.Y. TIMES, June 27, 2002, at A1.

different motive, and far less venal. That would not excuse a crime, but it changes the emphasis, and hence one's assessment of what went wrong.

A second ambiguity relates to the so-called "badges of guilt."[3] That is a famous evidentiary point. Judges and juries look for certain things that tell them this was bad, this was evil—and the person accused of the crime obviously knew it. Concealment, secrecy, little bits of deception are traditional markers of fraud.[4] But, of course, in a highly competitive business environment, the way you compete is often by deceiving your competitors as to matters such as research and development and marketing plans. Business people make it a natural part of their strategy not to show all their cards all the time. More importantly, they believe that you win by not showing all your cards. In hindsight, then, lack of candor is often very easy to find. But this often just shows business norms at work, and does not necessarily prove fraudulent intent.

Finally, there is the ambiguity of harm. If we ever took seriously the notion that we want to see a proximate link between what the defendant did and the alleged harms (for instance, $30 billion of losses to Enron investors),[5] we would have to admit that there were many causes, and isolating any one is bound to be misleading. In fact, $30 billion may itself be a misleading way of looking at losses. But a number like that grabs a jury's attention.

I think when you put these three ambiguities together, the likelihood that you are going to have truly "proportionate" decision-making is minimal.

My final point just connects to Michael [Klausner's]. I think we have had a failure in the civil enforcement system, and that is what has put so much pressure on criminal law to respond. It is not because the law hasn't provided for good civil remedies. For forty years or so, the SEC has the power to seek disgorgement of any ill gotten gains from any individual wrongdoer.[6] It is not that they cannot, it is they have not always gone aggressively after the individuals as opposed to the company. One reason for this is because they settle their cases and, just as we talked about earlier, it is much easier to settle with other people's money, (i.e., the shareholders) than it is to settle based on an executive's real money out of pocket. It takes a politically committed prosecutor or plaintiff to say I am going to take a risk rather than pursing the path of least resistance. You did not always see that from the SEC. If the government had historically done a better job in the civil area I think a lot of the pressure would be taken off. The SEC is getting better about this, but it is a fairly recent phenomenon.

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3. *See* Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1997–99 (2006).

4. *See* Murphy v. Crater (*In re* Crater), 286 B.R. 756, 764 (Bankr. D. Ariz. 2002) (categorizing the traditional "badges of fraud" into three types—the first type being concealment and deception).

5. *Bank of America to Pay $69 Million to Settle Enron Suit*, N.Y. TIMES, July 3, 2004, at C2.

6. Matthew Scott Morris, Comment, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping Up With the Joneses, the SEC's Enforcement Arsenal is Modernized*, 7 ADMIN. L.J. AM. U. 151, 168 (1993).