Leverage, Sanctions, and Deterrence of Accounting Fraud

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The empirical evidence suggests that firms overpay for fraud liability and overspend on internal compliance mechanisms (which are not very effective at preventing fraud). Yet, insiders who commit fraud are rarely sanctioned for their wrongdoing, which produces moral hazard and individual underdeterrence.

Two factors explain the failure to sanction managers who commit fraud. First, managers control the information revealing who was involved in accounting fraud and, thus, can impede external investigations and sanctions. Second, managers also influence whether the firm will investigate and sanction accounting fraud internally. Managers' control over settlement and the availability of directors' and officers' insurance further reduce the likelihood that dishonest managers will be sanctioned.

Most proposals have focused on reducing the costs of fraud liability to firms by raising pleading standards or eliminating corporate liability for accounting fraud altogether, but have neglected the question of individual deterrence. Although these proposals might reduce the costs to firms, accounting fraud cannot be deterred effectively without shifting liability to those responsible. High levels of fraud are inevitable, so long as social costs of fraud exceed private costs.

To sanction dishonest insiders, private and public enforcers need to know their identities and their actions, which is often prohibitively costly to obtain without firm cooperation. This Article proposes using leverage against the firm to encourage disclosing private information, thereby lowering overall

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enforcement costs and increasing the probability that dishonest insiders will be sanctioned. At the same time, the proposal also reduces the risk that firms will overpay, because ex post *cooperation will reduce firms' liability.*

The Article develops the conditions for superiority of leveraged sanctions and proposes that their use be expanded to civil and regulatory actions, eliminating many of the concerns that leverage raises in criminal investigations. Improved deterrence is significant because it will reduce accounting fraud, producing more efficient capital markets.

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INTRODUCTION

Securities fraud and its most common variant, earnings manipulation,[1] have been the subject of academic study for decades, yet there is little agreement on the best mechanisms to prevent and sanction fraud.[2] Although markets, social norms, and *ex ante* regulation affect how firms behave, their effectiveness in preventing fraud is limited.[3] As a result, recent scholarship and policy-making has focused on liability to reduce the incidence of accounting fraud.[4]

Many have argued that current enforcement efforts by the Securities and Exchange Commission ("SEC"), prosecutors, and private plaintiffs, which focus largely on firms, are ineffective and costly.[5]

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[1] *See, e.g.*, *Securities Class Action Filings 2008: A Year in Review* 22, fig. 22, CORNERSTONE RESEARCH, *available at* http://securities.stanford.edu/clearinghouse_research/2008_YIR/20090106_YIR08_Full_Report.pdf/ (reporting that 82% of class actions allege misrepresentations in financial statements and 58% GAAP violations); *see also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 898-900 (2003). In part, this is the result of PLSRA's safe-harbor for forward-looking statements, i.e., the requirement that plaintiff prove that defendant had actual knowledge that the forward-looking statement was wrong, which lowers the relative share of securities frauds that are not accounting frauds. *See* Securities Exchange Act of 1934 § 21E, 15 U.S.C. § 78u-5(c)(1)(b) (1934).

[2] *See* sources cited *infra* note 5.

[3] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 450-52 (7th ed. 2007) (describing different mechanisms for preventing corporate fraud and finding problems with each). Although the number of large-scale accounting frauds has declined since 2002, accounting fraud remains common by any metric: measured by the number of restatements, filed lawsuits alleging accounting fraud, or initiated investigations. *See* Stephen Taub, *The State of Restatements: Sharply Falling*, CFO, Mar. 10, 2009, http://www.cfo.com/article.cfm/13270658 (reporting that in 2008 alone, 869 companies filed restatements, which represents 31.4% decline in financial restatements compared with 2007). Despite the decline, the number of restatements in 2008 still exceeds the numbers filed in 2001, 2002, and 2003. *See U.S. Financial Restatements Down Almost a Third in 2008*, SEEKING ALPHA (Feb. 18, 2009), http://seekingalpha.com/article/121298-u-s-financial-restatements-down-almost-a-third-in-2008/.

[4] For example, the Sarbanes-Oxley Act of 2002 vastly increased the maximum criminal penalties for securities fraud. *See, e.g.*, H.R. 3763, 107th Cong. § 1106 (2002) (increasing penalties for individuals from $1 million fine and maximum ten year prison sentence to $5 million fine and twenty year prison sentence, and for firms from $2.5 million fine to maximum $25 million).

[5] *See, e.g.*, Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1489-90 (1996) (arguing that damages in securities fraud class actions are inefficient); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEG. STUD. 833, 835-38 (1994) (arguing that vicarious liability for crimes committed by firm's employees may reduce firm's incentive to prevent wrongdoing); Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on*

Firms are vicariously liable (civilly and criminally) for intentional wrongs that their employees commit, even where the firm made every effort to prevent wrongdoing.[6] Vicarious corporate liability overdeters by holding firms liable for employees' wrongs that would have been inefficient to prevent, detect, and sanction,[7] while at the same time supplying firms with perverse incentives.[8] The better the firm's internal compliance mechanism, the more fraud it will detect, thereby increasing the firm's potential liability.

More problematically, while vicarious corporate liability causes firms to overpay for accounting fraud, it fails to deter responsible individuals.[9] Although the law imposes liability on individuals for the accounting fraud, individuals are rarely individually sanctioned.[10] With the exception of criminal prosecutions, firms (and indirectly

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Securities Markets: Theory and Evidence, 1992 U. ILL. L. REV. 691, 694-95 (1992) (arguing that vicarious liability for securities fraud transfers wealth from one group of innocent investors to another similar group without performing any useful social function); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1534-38 (2006) [hereinafter Coffee, *Reforming Securities Class Action*] (arguing that securities fraud class actions neither compensate victims nor deter wrongdoing); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 639-41 (1996) [hereinafter Langevoort, *Capping Damages*] (proposing capped damages for securities fraud because damages equal to out-of-pocket losses are grossly disproportionate to harm suffered); A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Securities Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 927-30 (1999) [hereinafter Pritchard, *Markets as Monitors*] (proposing to replace costly and ineffective securities fraud class actions with monitoring by stock exchanges); A.C. Pritchard, *Who Cares?*, 80 WASH. U. L.Q. 883, 883-84 (2002) (arguing that securities fraud class actions are poor deterrents for fraud).

[6] *See* Arlen & Carney, *supra* note 5, at 696 & n.22.

[7] *See* Langevoort, *Capping Damages*, *supra* note 5, at 657; Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1332-33 (2008).

[8] *See* Arlen, *supra* note 5, at 836 ("Increased enforcement expenditures reduce the number of agents who commit crimes by increasing the probability of detection . . . [but they] also increase the probability that the government will detect those crimes that are committed.").

[9] *See* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 305 (2007).

[10] Coffee reports that filing a securities fraud class action raises the likelihood of CEO turnover from 9.8% to 23.4%. Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1554 & n.77. Enforcement actions (SEC and DOJ) have a higher likelihood of resulting in termination, close to 90%, but a low probability of penalties beyond termination. *See* Jonathan Karpoff, D. Scott Lee & Gerald S. Martin, *The Consequences to Managers for Financial Misrepresentation*, 88 J. FIN. ECON. 195, 201 (2008) [hereinafter Karpoff et al., *Consequences to Managers*].

their shareholders) and their insurers bear almost the entire burden of liability for accounting fraud.[11]

The dominant argument in favor of holding firms vicariously liable for fraud is that vicarious liability lowers enforcement costs and serves as an indirect means to sanction dishonest employees.[12] Firms have superior information about fraud and, thus, can sanction dishonest employees at lower cost than external enforcers, such as the SEC or private litigants.[13] The argument assumes that liable firms will shift liability to those responsible.[14]

But, liability shifting for accounting fraud rarely happens[15] because sanctioning is costly for firms and because agency problems and legal restrictions impede internal sanctioning.[16] Top management is

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[11] *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1550-51; Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201 & tbl.3, 210 & tbl.8 (reporting that culpable employees identified in SEC or DOJ investigations lose their jobs, but most suffer no additional consequences other than cease-and-desist order). Criminal enforcement remains rare compared with the numbers of SEC enforcement actions or securities fraud class actions. *See* Jonathan Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 588 (2008) [hereinafter Karpoff et al., *Costs to Firms*] (reporting that between 1978 and 2006, SEC filed civil proceedings for accounting fraud against 429 firms and 1730 individuals and administrative proceedings against 297 firms and 815 individuals; in comparison, DOJ brought criminal proceedings against 41 firms and 558 individuals).

[12] *See, e.g.*, Arlen, *supra* note 5, at 835; Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity and Individual Liability*, 42 WAKE FOREST L. REV. 627, 630 (2007) [hereinafter Langevoort, *Naked, Homeless, and Without Wheels*].

[13] *See* Arlen, *supra* note 5, at 835.

[14] The firms can shift liability by requiring culpable individuals to indemnify the firm or by withholding employment-related benefits, including promotions. *See id.* at 835-36.

[15] The statement is entirely accurate for corporate management and less so for lower-echelon employees. But, no empirical studies to date have compared liability shifting within firms between different classes of employees. Karpoff and his collaborators find that culpable non-executive employees are more likely to lose their jobs than are executives. Furthermore, the authors do not report evidence on intrafirm sanctions other than termination. *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201-02; *see also* Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1254 (2003) [hereinafter Khanna, *Behavior of Top Management*] (observing that when transaction costs are positive and bargaining between management and corporation not at arm's length, firms cannot easily shift liability to management); Pritchard, *Who Cares?*, *supra* note 5, at 887 ("The settlement process [in securities fraud class actions] leaves us with a scheme of exclusively vicarious corporate liability.").

[16] *See* Arlen, *supra* note 5, at 835; Khanna, *Behavior of Top Management*, *supra* note 15, at 1254. By "legal restrictions," I mean statutory indemnification provisions and

involved in the vast majority of earnings manipulations. Top management, *ex officio*, also influences the firm's decision on whether to settle a claim or enforcement action, the content of that settlement, and the decision to sanction internally.[17] In addition, indemnification statutes and standard directors' and officers' ("D&O") insurance policies further insulate management from liability unless it is shown that they failed to "act[] in good faith and in a manner [they] reasonably believed to be in or not opposed to the best interests of the corporation."[18]

When the firm has no incentive to sanction management (because the firm is vicariously liable whether it sanctions culpable individuals or not, and sanctioning itself is costly to the firm), and when the responsible individuals participate in the process designed to determine the appropriate sanction, low rates of liability shifting to dishonest managers are not surprising.[19] This is problematic because without liability shifting or without external individual liability, moral hazard causes individuals, usually top managers, to engage in excessive wrongdoing. Ultimately, vicarious liability for accounting fraud does not require individual wrongdoers to internalize the costs of fraud and does little to reduce its incidence.

Proposals to modify the current liability regime — damage caps,[20] regulatory penalties instead of damages,[21] SEC screening of securities

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contractual limits on clawbacks, etc. By "agency problems," I mean the ability of insiders to influence the likelihood that they will be caught and sanctioned, including their ability to shape the substance of any settlement agreement with the SEC, private plaintiffs, or criminal prosecutors.

[17] Firms' efforts to recoup payments made to dishonest managers have been largely unsuccessful. *See* Phred Dvorak & Serena Ng, *Check, Please: Reclaiming Pay from Executives Is Hard To Do*, WALL ST. J., Nov. 20, 2006, at A1; Joann Lublin & Scott Thurm, *How To Fire a CEO: More Bosses Are Getting the Boot, But It's Harder to Sack Them Without Paying for the Privilege*, WALL ST. J., Oct. 30, 2006, at B1, B3.

[18] DEL. CODE ANN. tit. 8, §145(a) (2009). Although one would expect that insurers would effectively police fraud, this does not happen. Since the firm pays the policy premium, and not the managers, insurers profit by charging higher premia and reducing monitoring costs. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1800 (2007) (concluding that managers buy D&O insurance for self-serving reasons, and that coverage fails to control for moral hazard).

[19] Similarly, there is little evidence criminals often volunteer for detection and punishment.

[20] *See* Langevoort, *Capping Damages*, *supra* note 5, at 641.

[21] *See* Alexander, *supra* note 5, at 1508-14; Pritchard, *Markets as Monitors*, *supra* note 5, at 983 (proposing that exchanges impose penalties instead of private damages). Alexander proposes that both firms and individuals pay regulatory penalties and that penalties against individuals be made uninsurable. But, in order to sanction

class actions,[22] and, more radically, eliminating corporate liability for securities fraud altogether[23] — have largely ignored the deterrence disparity between firms and managers.[24] Although these proposals would reduce the perverse incentives for firms and alleviate the overdeterrence problem, none increases the probability that individual fraudsters will be detected and sanctioned.

This Article proposes an alternative regime that addresses both concerns, overdeterrence of firms and underdeterrence of managers: leveraged sanctions.[25] A leveraged sanction is a sanction that is threatened against the firm or a group of insiders. The firm (or the group) can reduce or avoid sanction by divulging information to external enforcers. The threat of sanction provides the leverage needed to overcome agency problems and increases the likelihood that the firm will share information with external enforcers, who will, in turn, sanction dishonest managers where appropriate.[26] Although firms can and do fire dishonest managers, they do it largely in response to a

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individuals, the regulator must know their identity and the nature of their involvement. Without the firm's cooperation, the regulator will likely be able to sanction only a few unlucky managers.

[22] *See* Rose, *supra* note 7, at 1301.

[23] *See* Arlen & Carney, *supra* note 5, at 720; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1582-84; Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 321 (1996) (concluding that corporate criminal liability in addition to corporate civil liability produces overdeterrence *ex ante* and excessive investment in litigation *ex post*); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does it Serve?*, 109 HARV. L. REV. 1477, 1493-96, 1532-34 (1996) [hereinafter Khanna, *Corporate Criminal Liability*] (concluding that corporate criminal liability serves no purpose).

[24] *See, e.g.*, Rose, *supra* note 7, at 1303 (mentioning deterrence dichotomy between firms and individuals, but ignoring it in rest of analysis).

[25] I am not the first to use the term "leverage" to describe the threat of liability imposed on groups for crimes committed by individuals within those groups. *See, e.g.*, Albert W. Alschuler, *Two Ways To Think About the Punishment of Corporations*, 46 AM. CRIM. L. REV. 1359, 1370 (2009) (noting that corporate criminal liability manufactures leverage of prosecutors over corporate managers); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1348-49 (1999) (arguing that prosecutors "leverage indictments" of individuals in exchange for civil and administrative actions against firms); Daryl J. Levinson, *Collective Sanctions*, 56 STAN. L. REV. 345, 378 (2003) (arguing that collective sanctions can "leverage" solidarity of groups to induce intra-group monitoring).

[26] *See* John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. ECON. PERSP. 91, 95 (2007) ("The ability of [the SEC] to raise the perceived odds of detection is also limited by information constraints."). In addition, more information will enable external enforcers to sanction managers more accurately and distinguish between honest mistakes and intentional fraud.

regulatory or criminal action.[27] But, termination is not an effective deterrent when managers commit accounting fraud to avoid being fired for poor performance.[28] External enforcers are able to sanction individuals more thoroughly than the firm, by imposing damages, fines, or restitution, by barring them from serving as officers or directors in the future, and by imprisonment. Leveraged sanctions will increase detection and individual sanctioning by combining the firm's cheaper access to information with external enforcers' superior sanctioning.[29]

The Article does not address optimal deterrence (impossible in any system where most actions settle), but is concerned instead with improving the effectiveness of liability for accounting fraud. By increasing the expected cost of fraud, leveraged sanctions reduce fraud without simultaneously increasing private costs of compliance for non-offenders.[30] Currently, federal prosecutors operate under a regime that is similar to leveraged sanctions, although criminal law potentially poses constitutional and policy problems absent from civil liability, such as the individual's right to remain silent.[31] But, criminal

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[27] Coffee reports that filing a securities fraud class action raises the likelihood of CEO turnover from 9.8% to 23.4%. *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1554 & n.77. Enforcement actions (SEC and DOJ) have a higher likelihood of resulting in termination, close to 90%. *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201 & tbl.3.

[28] *See* Arlen & Carney, *supra* note 5, at 702-03.

[29] Eliot Spitzer and Professors Frank Partnoy and William Black proposed public disclosure of A.I.G. internal correspondence both to determine if anyone should be held liable and to prevent a similar calamity from happening again. *See* Eliot Spitzer, Frank Partnoy & William Black, *Show Us the E-Mail*, N.Y. TIMES, Dec. 20, 2009, http://www.nytimes.com/2009/12/20/opinion/20partnoy.html?hp/.

[30] Since accounting fraud is an intentional crime, it is relatively easy for individuals to avoid. In addition, under a leveraged sanctions regime, firms can reduce or avoid liability *ex post*, simply by providing all pertinent information. *See also* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 878 (1984).

[31] *See* Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 855 (2007); *see, e.g.*, Brandon L. Garrett, *Coerced Confessions*, 30 CARDOZO L. REV. 917, 918-19 (2009) (arguing that confessions by corporations put individual employees in precarious position where they must decide between potentially inculpating themselves and discipline); Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 353-55 (2007) (arguing that deferred prosecution agreements for fraud jeopardize individual employee's constitutional rights). Although individuals are targeted significantly more often by criminal law enforcement than by civil enforcers, firm-level sanctions are rarely waived entirely under the deferred-prosecution regime. In addition to fines against firms, most deferred-prosecution agreements focus on implementing structural reforms and improving internal compliance.

prosecutions are much rarer than civil actions. Employing leveraged sanctions through private litigation and SEC regulatory actions is likely to produce higher levels of individual deterrence.

Part I supplies background information on the current liability regime for accounting fraud and the ongoing debate over its effectiveness. While all commentators address the overdeterrence problem, they fail to address adequately the problem of individual underdeterrence.

Part II explains how the characteristics of accounting fraud limit the deterrent effects of vicarious corporate liability, individual liability, and other proposals. In addition to raising maximum penalties, the Sarbanes-Oxley Act and recent enforcement efforts have largely focused on improving internal compliance systems, which only modestly reduce the frequency and duration of accounting fraud.[32] Some internal compliance measures are necessary to prevent easily avoided, plain-vanilla frauds. External audits will detect a few more accounting frauds. A better way to reduce the incidence of fraud is to increase the expected cost to culpable individuals by increasing the probability of sanctioning, and not the level of punishment.

Part III provides a theoretical model of leveraged sanctions. It explains why leveraged sanctions, either when threatened against the group with superior information or the firm, are likely to provide superior deterrence to the alternative liability regimes explored in Part II, and lists conditions under which a superior outcome is likely.

Finally, Part IV discusses practical implications of the leveraged sanctions model. It suggests how sanctions could best be implemented to deter cost-effectively accounting fraud, both by the SEC and by private plaintiffs.

I. CURRENT DEBATE

This Part begins by describing the effectiveness of current liability regimes and continues with an evaluation of the current debate about best mechanisms for sanctioning fraud. Commentators agree that current enforcement efforts are ineffective and costly and have proposed several changes.[33] While these proposals address the overdeterrence problem, all fail to address the problem of individual underdeterrence.

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[32] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002); Arlen & Carney, *supra* note 5, at 714-16; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1562-63 & n.103.

[33] *See* sources cited *infra* Part I.B.

A. Enforcement of Accounting Fraud

Currently, three major groups of external agents share enforcement:[34] private plaintiffs, the SEC, and federal and state prosecutors. Although all three groups can deter fraud, the defendants they target and the liability regimes they employ are somewhat different.

Individuals "almost never contribute personally to settlements"[35] in securities fraud class actions, even though they are often named as defendants.[36] Instead, the firm and the liability insurer pay the bulk of the settlement amounts.[37] The SEC targets individual defendants more frequently, but nevertheless settles most cases and imposes only minor, if any, sanctions on individuals.[38] While the efforts of private plaintiffs and the SEC focus on firms, prosecutors pursue both firms and individual wrongdoers within firms. Federal prosecutors usually avoid indicting corporations for accounting fraud and instead negotiate a deferred prosecution agreement ("DPA") or nonprosecution agreement ("NPA"). Agreements often require firms to cooperate in the investigation of individuals. Although individuals

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[34] Firms do "enforce" prohibitions against fraud internally by terminating culpable individuals. But, their efforts are sporadic and made overwhelmingly in response to an external enforcement action. Hence, internal enforcement without the threat of externally imposed sanctions plays only a minimal role in deterring fraud. *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201 & tbl.3 (reporting that firms terminated approximately one-third of dishonest employees before SEC began its investigation).

[35] Alexander, *supra* note 5, at 1499.

[36] *See* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1102-04 (2006) (explaining that plaintiffs have financial incentive to settle quickly and drop suits against individual defendants); Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1550-51 (pointing out that plaintiffs sue individual defendants to access their insurance coverage, and not to hold them individually liable).

[37] *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1550 (reporting that liability insurers pay on average 68.2% of settlement and defendant corporation pays 31.4%).

[38] *See* Donald Langevoort, *Criminalization of Corporate Law: The Impact on Director and Officer Behavior*, 2 J. BUS. & TECH. L. 89, 90 (2007) [hereinafter Langevoort, *The Impact on Director and Officer Behavior*] (observing that SEC has "not always gone aggressively after the individuals as opposed to the company" and has generally not sought disgorgement from individuals, even though it has ability to do so). In addition, the SEC is more likely to pursue small firms, even though accounting fraud is more prevalent among large firms. *See* Patricia M. Dechow, Weili Ge, Chad R. Larson & Richard G. Sloan, *Predicting Material Accounting Misstatements*, AAA 2008 FIN. ACCT. & REPORTING SEC. (FARS) PAPER 15, at 50 & tbl.2A, *available at* http://ssrn.com/abstract=997483.

are relatively more likely to be sanctioned for fraud in cases where there is a criminal investigation, individual criminal liability remains rare in absolute terms because criminal investigations overall are rare (compared to SEC enforcement actions and private securities fraud litigation).[39]

All three groups of external enforcement agents rely on vicarious or *respondeat superior* corporate liability for fraud committed by the firm's employees. The firm is liable regardless of its own "fault," as measured by ineffective internal monitoring, and regardless of what it has done to prevent, detect, or sanction fraud. Many commentators view criminal fraud prosecutions as a departure from vicarious corporate liability because firms can avoid indictment by cooperating with the prosecutors.[40] But, an examination of DPAs and NPAs suggests that the only sanction the firm avoids by cooperating is indictment. Most agreements include significant fines and require firms to conduct major structural reforms.[41] Indictment can mean the firm's liquidation, so firms will do almost anything to avoid it. Also, indictment produces significant collateral consequences to innocent shareholders, employees, creditors, customers, and communities.[42] Prosecutors often use the threat of indictment against the firm as leverage to obtain information about individual wrongdoers, lowering investigation costs and increasing the likelihood that culpable individuals are criminally sanctioned. Although criminal actions increase individual deterrence, they contribute to the overdeterrence of firms.

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[39] *See* James D. Cox & Randal S. Thomas with Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 763 (2003) (observing that fewer than 15% of firms that settle securities class action also face SEC enforcement action); Karpoff et al., *Consequences to Managers*, *supra* note 10, at 210 & tbl.8. (finding that of 2206 individuals identified in SEC enforcement actions 617 were also subject to criminal indictment).

[40] *See, e.g.*, Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1042-43 (2008) (proposing abolishing corporate liability for fraud and replacing it with insurance).

[41] *See, e.g.*, Garrett, *Structural Reform Prosecution*, *supra* note 31, at 853; Patrick J. Gnazzo, *Remarks on "The Challenge of Cooperation: Consideration of the Ethical and Managerial Implications or the Organizational Sentencing Guidelines, Thompson Memorandum, SOX, Etc,"* 44 AM. CRIM. L. REV. 1441, 1441-45 (2007) (describing costs of deferred prosecution agreement for Computer Associates, Inc. and compliance measures firm put in place after fraud — AEP Energy Services, Inc. DPA ($30 million fine); America Online, Inc. DPA ($150 million fine of which $60 million is penalty); Computer Associates DPA ($225 million payment to shareholders in addition to other fines); PNC ICLC Corp. ($90 million); KPMG DPA ($456 million)).

[42] *See* Griffin, *supra* note 31, at 319-20.

Both enforcement regimes, securities fraud class actions and criminal prosecutions, have been subject to much criticism. Those who study securities fraud class actions lament that securities litigation neither compensates the victims nor deters fraud.[43] Those who study criminal prosecutions for accounting fraud generally complain that criminal enforcement overdeters both individuals and firms and imposes significant costs on the shareholders without a corresponding benefit.[44] But, their proposed solutions — tweaks to vicarious corporate liability or a shift to individual liability alone — are unlikely to provide effective deterrence because they continue to rely on unrealistic assumptions about the causes of accounting fraud, or the ability of the firm to monitor, prevent, and sanction fraud.[45] However, specific characteristics of accounting fraud make it particularly difficult to prevent and sanction by relying on either of the two conventional liability regimes.

B. Current Debate About Liability for Fraud

The current debate on optimal liability for accounting fraud has several strands: some argue that the market itself will eliminate fraud, others argue that vicarious corporate civil or criminal liability are inefficient, and another group rejects any liability for fraud.

Judge Frank Easterbrook and Professor Daniel Fischel have famously argued that a rule against securities fraud is unnecessary.[46] Since investors can choose to invest in assets other than corporate stock, managers have the incentive to assure investors of their honesty and avoid fraud.[47] Although theoretically appealing, their market solution suffers from serious problems. There is far too much noise in capital markets for investors to be able to discern high-quality assurances of honesty from those of low quality.[48] Furthermore,

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[43] *See generally* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1545-56 and sources cited therein (arguing that securities fraud class actions do not compensate victims for fraud nor deter wrongdoers).

[44] *See* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 36-39 (2002) [hereinafter Ribstein, *A Critique of the Sarbanes-Oxley Act*] (arguing that executives will be overly cautious because of increased criminal liability); sources cited *supra* note 7 and accompanying text.

[45] *See infra* in Part II.

[46] *See* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 676 (1984).

[47] *See id.* at 673-76.

[48] *See* Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End*, 46 UCLA L. REV. 675, 696 (1999) (noting "low levels of direct information in the

Easterbrook and Fischel seem to have initial private offerings in mind and not the secondary market. Investors in an initial private offering are buying stock directly from the firm and its managers. Investors trading on the secondary market, on the other hand, do not communicate with management. In addition, managers do not benefit directly from trading among investors on the secondary market, except to the extent that share prices increase and their compensation is linked to share prices. They generally have little incentive to commit fraud, except when they fear they might be terminated for disappointing performance. In that period, managers do have an incentive to withhold accurate information about firm performance and, thereby, inflate the value of the firm to save their jobs this quarter (and hope the firm does well in the next quarter, thus, enabling them to conceal the misstatement).[49] Easterbrook and Fischel fail to anticipate this situation and, as a result, fail to address deterrence of individuals. Finally, there is evidence that investors do not accurately judge the honesty of managers and are prone to behavioral biases.[50] This further reduces the ability of markets to police accounting fraud. As a result, in a world without a rule against securities fraud, one would expect to see a lot more fraud, contrary to Easterbrook and Fischel's prediction.[51]

Professors Larry Ribstein[52] and Jonathan Macey,[53] similarly, have argued that regulation and fraud enforcement are not cost-effective and produce inefficient outcomes. They contend that market sanctions for fraud will deter fraud more efficiently than ineffective and costly regulation or enforcement.[54] Although markets sanction accounting

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marketplace about the performance of corporate managers").

[49] *See* Arlen & Carney, *supra* note 5, at 702-03. Managers benefit not only from higher stock prices that result from undiscovered fraud, but also enjoy continued job security because the firm appears healthier than it, in fact, is. *See* Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 825 (2006).

[50] *See* Patricia M. Dechow & Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners, and Regulators* 8 (Soc. Sci. Research Network, Working Paper, 2000), *available at* http://ssrn.com/abstract=218959; *see also* Prentice, *supra* note 49, at 825 & n.310.

[51] *Cf.* Coates, *supra* note 26, at 106 (reporting systemic effects of fraud before increased enforcement following accounting fraud scandals).

[52] *See* Ribstein, *A Critique of the Sarbanes-Oxley Act*, *supra* note 44, at 47-53.

[53] *See* JONATHAN MACEY, CORPORATE GOVERNANCE 50 (2008) (listing among effective corporate governance mechanisms market for corporate control, insider trading, and short selling, and among ineffective mechanisms, SEC enforcement and securities litigation). He does acknowledge that last period problems, for example, may justify some form of fault-based liability. *See id.* at 129.

[54] *See id.*; Ribstein, *A Critique of the Sarbanes-Oxley Act*, *supra* note 44, at 49-50.

fraud, most of the costs will be borne by investors and not by the individuals who commit fraud. Ultimately, investors may respond by taking their money out of the stock market and reducing capital formation.[55] Although Ribstein and Macey are correct that the costs of regulation and enforcement are nontrivial, empirical evidence does not support their assertion that enforcement of fraud is inefficient, i.e., that the marginal costs for enforcing accounting fraud generally exceed the marginal benefits of reduced fraud, nor do they explain how markets will effectively penalize individuals who commit fraud.[56]

A second group of commentators concedes that liability for fraud is necessary, but has argued that unlimited vicarious corporate civil liability imposes inefficient sanctions on firms and, thereby, overdeters firms.[57] To reduce the problem of overdeterrence, commentators have proposed capping damages in securities fraud class actions,[58] replacing damages with regulatory fines,[59] requiring an SEC screen before a securities class action can proceed,[60] shifting liability to auditors,[61]

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[55] *See* Prentice, *supra* note 49, at 825.

[56] Although many commentators have assumed that fraud is a zero-sum event, many empirical studies suggest that this is not the case. Not only does fraud have systemic financial-market effects, depressing returns for all firms, it produces real economic costs: inefficient production levels, short-term cost-cutting by competitors, etc. *See, e.g.*, Merle Erickson, Michelle Hanlon & Edward L. Maydew, *How Much Will Firms Pay for Earnings that Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings*, 79 ACCT. REV. 387, 389-90 (2004) (reporting that out of twenty-seven firms subject to SEC enforcement actions, fifteen paid taxes on overstated earnings; total amount of taxes paid represented 2.4% of firms' market value and 20% of pretax value of overstated earnings); Karpoff et al., *Costs to Firms*, *supra* note 11, at 581 (reporting that reputational sanctions that capital markets impose for fraud significantly exceed amount of fraud and conclude that financial honesty is particularly valuable asset for firms); Gil Sadka, *The Economic Consequences of Accounting Fraud in Product Markets: Theory and a Case from the U.S. Telecommunications Industry (WorldCom)*, 8 AM. LAW & ECON. REV. 439, 439-40, (2006) (showing that accounting fraud at WorldCom caused its competitors to make inefficient investment decisions); Oren Bar-Gill & Lucian A. Bebchuk, *Misreporting Corporate Performance* 4 (Harv. L. & Econ. Discussion, Paper No. 400, 2002), *available at* http://ssrn.com/abstract=354141 (reporting that accounting fraud has not only distributive effects, but gives rise to significant efficiency costs and distorts "allocative role of capital markets").

[57] *See* Alexander, *supra* note 5, at 1498; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1536-37; Langevoort, *Capping Damages*, *supra* note 5, at 641; Rose, *supra* note 7, at 1322-23.

[58] *See* Langevoort, *Capping Damages*, *supra* note 5, at 641-42.

[59] *See* Alexander, *supra* note 5, at 1508-14; Pritchard, *Markets as Monitors*, *supra* note 5, at 983 (proposing penalties instead of damages to be imposed by exchanges instead of individual plaintiffs).

[60] *See* Rose, *supra* note 7, at 1301.

[61] *See* John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of*

and, finally, eliminating corporate civil liability altogether and replacing it with individual liability[62] or insurance.[63] Although firms may be overdeterred, the penalties for fraud are not too large, just misplaced.[64] There is mounting evidence that the costs of fraud are significant and largely borne by third persons, not just the shareholders who bought shares during class period. Competitors[65] and employees,[66] for example, often bear some of the costs of accounting fraud, yet lack standing to recover. Instead, overdeterrence is the result of the firms' inability to prevent fraud and to shift liability to culpable individuals, usually top managers who benefit from accounting fraud.

Some commentators, including Professors Donald Langevoort and John Coffee, have advocated more frequent civil and regulatory sanctions for dishonest managers, instead of jail time. But, their proposals do not resolve the information asymmetries among the insiders, the firm, and external enforcers.[67] Without information about who did what (most of which the insiders control) external enforcers are usually unable to assign individual liability. As a result, Langevoort's and Coffee's proposals would, at best, only marginally increase individual deterrence.

A third group of commentators opposes vicarious corporate criminal liability. They argue that vicarious corporate criminal liability makes it

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Fashioning Relevant Reforms, 84 B.U. L. REV. 301, 349-53 (2004); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 540-46 (2001).

[62] *See* Arlen & Carney, *supra* note 5, at 720; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1582-84.

[63] *See* Baer, *Insuring Corporate Crime*, *supra* note 40, at 1035.

[64] *Cf.* Alexander, *supra* note 5, at 1498 ("Aggregate class trading losses are probably greater than either the true net social cost of the violation or the benefits received by the violator, both of which are speculative in nature and difficult to calculate.").

[65] *See* Sadka, *supra* note 56, at 439, 457-58. Sadka provides evidence that WorldCom managers lowered prices to give the appearance of financial health to conceal fraud. Because the telecommunications market was very competitive at the time, WorldCom's pricing strategy forced its competitors to lower their prices also, and squeezed their profit margins.

[66] *See id.* at 458 (reporting that AT&T made bad investment decisions and fired 20,000 employees to remain competitive with WorldCom's fraudulent financials). Karpoff and his collaborators report that a third of all fraudster firms enter bankruptcy, resulting in job loss. *See* Karpoff et al., *Costs to Firms*, *supra* note 11, at 593. Unless employees are also shareholders, they — under current law — do not have standing to sue for lost earnings.

[67] *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1572-83; Langevoort, *Naked, Homeless, and Without Wheels*, *supra* note 12, at 654-60.

too easy to convict corporations and propose eliminating corporate criminal liability,[68] implementing fault-based liability[69] for firms, or introducing affirmative defenses to corporate criminal liability.[70] Because corporate criminal liability is usually imposed in addition to civil liability, there is a risk of "overdeterrence ex ante, and an excessive investment of resources in litigation ex post."[71] In addition, Professors Assaf Hamdani and Alon Klement argue that corporate criminal liability that threatens the existence of the firm reduces deterrence by reducing incentives to monitor peers and by increasing incentives to engage in wrongdoing.[72]

Another line of argument addresses the balance between corporate criminal and civil liability,[73] arguing that criminal liability should be a "last resort," used only when civil liability is insufficient.[74] The argument has a lot of appeal. Civil liability is ordinarily cheaper to implement than criminal sanctions. It relies on private action (i.e., lawsuit by the injured individual) rather than government action. Private parties will not sue unless the expected benefit of enforcement exceeds the cost, so private enforcement may be more efficient (assuming no collective action problems, externalities, etc.). The

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[68] *See* John Hasnas, *The Centenary of a Mistake: One Hundred Years of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1329, 1357 (2009).

[69] *See* Geraldine Szott Moohr, *Of Bad Apples and Bad Trees: Considering Fault-Based Liability for the Complicit Corporation*, 44 AM. CRIM. L. REV. 1343, 1364 (2007) [hereinafter Moohr, *Of Bad Apples and Bad Trees*].

[70] *See* Ellen S. Podgor, *A New Corporate World Mandates a "Good Faith" Affirmative Defense*, 44 AM. CRIM. L. REV. 1537, 1543 (2007); Andrew Weissmann & David Newman, *Rethinking Corporate Criminal Liability*, 82 IND. L.J. 441, 449 (2007) (arguing that government should have burden of proving that firm failed to adopt effective procedures to prevent employee misconduct).

[71] Fischel & Sykes, *supra* note 23, at 321.

[72] Hamdani and Klement develop a game-theoretic model of expected outcomes. They conclude that a severe sanction which can be imposed only once can encourage insiders to engage in wrongdoing. This is so because the firm liquidates when a single individual commits a crime. If managers know that someone will eventually commit fraud and destroy the firm, each manager will want to commit fraud first. *See* Assaf Hamdani & Alon Klement, *Corporate Crime and Deterrence*, 61 STAN. L. REV. 271, 275 (2008).

[73] *See* Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361, 445 (2008) (concluding that there exists "imbalance" between criminal and civil enforcement in corporate law); Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459, 1462 (2009) [hereinafter Moohr, *Balance*].

[74] Fischel & Sykes, *supra* note 23, at 321 (arguing that "the case for corporate criminal liability must rest on the need to correct some deficiency in the system of civil liability"); Moohr, *Balance*, *supra* note 73, at 1462.

reasoning is appealing, and this Article adopts the preference for civil sanctions over criminal, but the commentators do not focus on the disparity between deterrence of firms versus deterrence of individuals who commit fraud.[75]

Finally, commentators object to the (ab)use of corporate criminal liability to secure criminal convictions and plea bargains by individual wrongdoers.[76] They argue that enlisting the firm to prosecute its employees violates the employees' rights against compelled testimony and undermines their right to counsel.[77] Professor Samuel Buell convincingly rejects their arguments.[78] He explains that suppressing employees' statements made during internal investigations would enable both the firm and its employees to avoid liability.[79]

As currently employed, however, corporate criminal liability combined with DPAs and NPAs is the only effective means to deter managers from committing accounting fraud. This Article grants that relying on criminal sanctions to deter fraud is both unpredictable and costly, and proposes leveraged civil and regulatory sanctions against firms or insiders as a preferred alternative.

II. LIMITATIONS OF CORPORATE AND INDIVIDUAL LIABILITY

Currently, vicarious corporate liability is the dominant form of liability in private and public enforcement actions. In addition, most proposals detailed above, including capped damages, regulatory fines, or SEC screening of private lawsuits, rely on vicarious corporate liability.

Because of its dominance, this Part begins with a detailed analysis of justifications for vicarious corporate liability and explains why each of them is unpersuasive when applied to accounting fraud. This Part then explains briefly why individual liability, without attendant corporate liability, and most fault-based corporate liability regimes will underdeter accounting fraud.

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[75] *See* Hurt, *supra* note 73, at 444 (discussing replacing criminal enforcement with more private securities litigation, but failing to address at all how private lawsuits will "provide discipline for corporate managers"); Moohr, *Balance*, *supra* note 73, at 1462.

[76] *See* Baer, *Insuring Corporate Crime*, *supra* note 40, at 1045-48; Griffin, *supra* note 31, at 329-31.

[77] *See* Griffin, *supra* note 31, at 361. *But see* Samuel W. Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1646-50, 1655-57 (2007).

[78] *See* Buell, *supra* note 77, at 1645.

[79] *Id.*

A. Incomplete Justifications for Vicarious Corporate Liability

Imposing liability on the firm for harm caused by its employees, in theory, provides superior deterrence of employee misconduct because it lowers the combined costs of misconduct and enforcement.[80] Firms that are liable for their employees' misconduct have the incentive to monitor and sanction their employees and may be able to do so at lower cost than external enforcers.[81] To the extent firms are able to monitor, vicarious corporate liability can deter wrongdoing better than individual liability.

However, vicarious corporate liability, particularly for intentional acts, is efficient only if firm liability does not reduce employee incentives to shun wrongful conduct.[82] This requires the firm to deter wrongdoing *ex ante* through incentives directed at employees, to discover efficiently and stop wrongdoing by monitoring employees, or to sanction dishonest employees at lower cost than the government.[83]

The following sections argue that vicarious corporate liability for accounting fraud does not satisfy any of these requirements: it underdeters managers and thereby produces inefficiently high levels of wrongdoing.[84] Specifically, the *ex ante* incentives that firms can provide their managers will rarely be effective when accounting fraud is most likely to occur, and may increase managers' incentives to commit fraud.[85] Although an effective system of internal controls will reduce the incidence of run-of-the-mill fraud, it will rarely catch the most pernicious frauds and those involving the highest levels of management. Similarly, the firms' ability to sanction managers is very

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[80] *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 692 (1997).

[81] *Id.* at 696.

[82] Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 588 (1988). Although the failure to shift liability for negligence will also reduce employees' incentives to take care, intentional acts present a more serious problem. Employees who commit intentional wrongs have the opportunity to decide whether to commit the act and perform an actual cost-benefit analysis, not just an implicit one, as is the case with negligence.

[83] *See* Arlen, *supra* note 5, at 836; Arlen & Carney, *supra* note 5, at 707.

[84] *See generally* Arlen & Carney, *supra* note 5, at 734 (arguing that firm-level liability will fail to deter fraud by managers who fear they will lose their jobs anyway for poor performance).

[85] Stock options, a common form of compensation, provide a good example. Options are usually awarded annually and must vest within a specified period of time. They provide powerful incentives to managers to increase the stock price (either through good performance or fraud).

limited. Firms can terminate managers who commit fraud,[86] but agency problems prevent firms from imposing additional sanctions necessary to deter fraud effectively. Risk shifting, another rationale for vicarious liability, borrowed from the law of negligence, also does not justify corporate liability for accounting fraud. If the firm is liable for fraud, but cannot shift liability to dishonest managers, vicarious corporate liability creates moral hazard. Managers manipulate earnings because they benefit from it. Unless the managers are forced to internalize the costs of their own wrongdoing, they will commit more fraud than socially desirable.

1. Bundled Incentives

Commentators have assumed that vicarious corporate liability will reduce individual wrongdoing because firms are able to provide superior *ex ante* incentives to employees, which can reduce the upside of wrongdoing.[87] It is necessary to distinguish the incentives which the firm can provide to rank-and-file employees and managers. Firms can provide managers long-term incentives like restricted stock awards, which are believed to align managers' incentives with those of the shareholders. Firms offer honest managers the potential for advancement and continued affiliation with the firm's reputation. They also can fire dishonest managers, terminating the benefits of continued employment, both monetary and reputational.

The problem with *ex ante* incentives and incentive compensation, however, is that it is difficult to tailor them to target specifically accounting fraud, without undermining other goals of executive compensation. Most managers will not manipulate earnings, but some will. Professors Jennifer Arlen and William Carney identified the "last period" problem as an important cause of accounting fraud.[88] Managers are more likely to manipulate earnings when the firm's results are disappointing and they fear their job is at risk.[89] Those caught might lose their job (e.g., nine out of ten managers named in SEC or Department of Justice ("DOJ") enforcement actions for fraud did indeed lose their jobs), but not all fraud is discovered, and not all discovered fraud is subject to an enforcement action.[90] Although

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[86] *See supra* note 27 and accompanying text.

[87] Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1563 & n.103.

[88] Arlen & Carney, *supra* note 5, at 702-03.

[89] *Id.* at 703. But, that also means that 10% kept their jobs even after the SEC or DOJ investigated and sanctioned them for fraud.

[90] *See* Karpoff et al., *Costs to Firms*, *supra* note 11, at 586 (reporting that 40.2% of restatements are followed by enforcement actions, and suggesting that although

termination is a serious penalty, the threat of job loss provides limited deterrence when the individual deciding whether to commit fraud believes that her job is on the line anyway.[91] The same is true for potential job advancement.

Incentive compensation like stock options or restricted stock can increase managers' appetite to engage in accounting fraud because "[n]ecessarily, the manager acts within a shorter time frame than the firm."[92] Unless the firm pays its top managers nearly unlimited cash salaries[93] (enabling them to live comfortable lives without having to sell stock),[94] restricted stock and stock options must vest, usually every year. The more options the firm grants its managers, the greater the incentive to boost the stock price and the greater the incentive to misrepresent earnings. Every vesting period thus becomes an opportunity for accounting fraud.[95] "[C]ompensation contracts contingent on reported earnings cannot provide managers with the incentive both to maximize profits and to report those profits honestly."[96] Unless firms award incentive compensation after the manager has lost the ability to control the firm's actions, there will always be a period during a manager's employment when the manager will have an incentive to boost results artificially.[97]

Even if the size of the manager's compensation package is unrelated to firm performance (an unlikely scenario), a manager of an ailing firm has an incentive to commit fraud to preserve his job-specific monetary and reputational benefits. Reporting disappointing earnings

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number of firms that get "caught . . . is not negligible," not all firms do).

[91] *See* Arlen & Carney, *supra* note 5, at 702-03.

[92] John C. Coffee, *"No Soul To Damn, No Body To Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 394 (1981).

[93] Note that only $1 million of nonperformance based compensation is deductible on the firm's taxes. *See* 26 U.S.C. § 162(m)(1) (2006).

[94] *Cf.* Paul Sullivan, *At Bonus Time, Less Appetite for Toys*, N.Y. TIMES, Jan. 23, 2010, http://www.nytimes.com/2010/01/23/your-money/23wealth.html/ (describing financial planning for bankers who will receive most of their compensation in form of restricted stock).

[95] *But see* Coffee, *Reforming Securities Class Action*, *supra* note 5, 1563 & n.103 (arguing that incentive compensation and stock options in particular can reduce managers' incentives to engage in fraud).

[96] Keith J. Crocker & Joel Slemrod, *The Economics of Earnings Manipulation and Managerial Compensation*, 38 RAND J. ECON. 698, 700 (2007). *But see* Chris Armstrong, Alan D. Jagolinzer & David F. Larcker, *Chief Executive Officer Equity Incentives and Accounting Irregularities*, 48 J. ACCT. RESEARCH 225, 227-28 (2010) (arguing that high levels of equity incentives slightly reduce frequency of accounting irregularities).

[97] *See* Arlen & Kraakman, *supra* note 80, at 705 (observing that compensation designed to reward performance also rewards profit-enhancing misconduct).

would result in an immediate and certain harm to the manager's job security and reputation. Although managers can and do hint to analysts when earnings will disappoint, usually the market penalty for missing an earnings target is significant.[98] Fraud, although risky, delays the harm to the manager and may avert it altogether if the fraud is never discovered. Depending on the duration of fraud, the manager's discount rate, her appetite for risk, and the perceived likelihood of apprehension, accounting fraud may be appealing.[99]

Clawback provisions requiring managers to return any compensation based on earnings later restated can reduce the incentive for fraud.[100] But, managers who knowingly overstate earnings will also have advance warning of possible clawback. They can hide or spend their compensation, effectively making themselves judgment-proof if they are caught.[101]

Alternately, firms that vest most of the compensation after the manager leaves the firm can reduce the incentive to commit fraud.[102] If conditioned on faithful service, compensation awarded after employment with the firm (such as pensions) could induce managers to stay honest. But, these post-employment payments also create moral hazard problems of their own. A manager who expects to receive most of her compensation after she leaves the firm will have an incentive to

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[98] *See* Dechow & Skinner, *supra* note 50, at 8.

[99] Dechow and her collaborators report "there are long-term benefits to building reputations for providing reliable and timely disclosures. Yet the sample of firms investigated . . . chose to risk (and ultimately lose) these benefits for the prospect of short-term gain." Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, 13 CONTEMP. ACCT. RES. 1, 31 (1996); *see also* Yair Listokin, *Crime and (With a Lag) Punishment: The Implications of Discounting for Equitable Sentencing*, 44 AM. CRIM. L. REV. 115, 115 (2007) (arguing that because criminals discount ultimate sentence because of pre-conviction delays and proposing that sentence terms be discounted to reflect delays).

[100] Clawbacks have generally been used to describe "any action for recoupment of a loss." Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 410 (2009); *see* Sarbanes-Oxley Act, § 304(a), 15 U.S.C. § 7243(a) (2006) (requiring CFOs and CEOs to reimburse any bonuses received during twelve month period preceding restatement for fraud, regardless of their own fault).

[101] For example, managers in Texas with unlimited homestead exemptions may sink their compensation into large houses. Sarbanes-Oxley exempts fines imposed by the SEC or criminal prosecutors from bankruptcy discharge, but creditors (like the firm) cannot foreclose on the primary residence. *See* TX. PROP. CODE ANN. §§ 41.001, 41.002 (West 2000).

[102] Firms already provide severance packages and executive pensions. But, these payments are a relatively small portion of executive's total compensation.

engage in activities that are more likely to result in termination.[103] In addition, severance payments and large pensions are frequently the source of shareholder ire, dubbed "payments for failure."[104] Justifying even larger pensions or severance payments as an incentive for managers to avoid committing accounting fraud is unlikely to be popular with investors and policymakers alike.

As a result, the ability of the firm to lower the likelihood of accounting fraud by tailoring employee incentives is very limited.

2. Limited Monitoring

Vicarious corporate liability may nevertheless be desirable if firms can monitor employee behavior more cheaply than external enforcers.[105] But, the firm's ability to monitor accounting fraud is limited.[106]

Earnings manipulations overwhelmingly result from a decision by top managers to fabricate results in order to satisfy and exceed analysts' expectations[107] (i.e., expectations that may have become untethered from reality)[108] or to hide deteriorating performance.[109] Dishonest managers fear that if they report disappointing earnings, investors and stock analysts will closely scrutinize their

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[103] MACEY, *supra* note 53, at 25. Ideally, managers should strive to increase long-term value of the firm, rather than try to get terminated.

[104] *See, e.g.*, Jason Nissan, Clayton Hirst & Heather Tomlinson, *Payments for Failure at 17 FTSE 100 Firms*, INDEPENDENT, May 25, 2003, http://www.independent.co.uk/news/business/news/payments-for-failure-at-17-ftse-100-firms-539048.html/ (discussing shareholder proposals to ban golden parachutes at top U.K. firms).

[105] *See* Arlen & Carney, *supra* note 5, at 715; Khanna, *Corporate Criminal Liability*, *supra* note 23, at 1495.

[106] *See* Arlen & Carney, *supra* note 5, at 715.

[107] *See* COMMITTEE OF SPONSORING ORGANIZATIONS, FRAUDULENT FINANCIAL REPORTING: 1987-1997, at 19-20 (1999), *available at* http://www.coso.org/publications/FFR_1987_1997.PDF/; Dechow, Ge, Larson, and Sloan, *supra* note 38, at 22; Prentice, *supra* note 49, at 782 & n.34 (2006) (citing study by Committee of Sponsoring Organizations which found that in frauds disclosed between 1987 and 1997, CEO, CFO, or both were involved in five out of six cases).

[108] Consider that Enron's peak valuation of $68 billion (in August 2001) effectively required the company to increase its cash flow at 91% annually for the next six years, (and then to grow at the average rate for the economy) — a pace that required it continuously to come up with what were, in effect, one-time-only innovations. *See* Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, 14 J. APPLIED CORP. FIN. 41, 43 (2002).

[109] "A consistent theme among misstating firms appears to be that they have shown strong performance prior to the misstatements and that the misstatements are made to hide deteriorating performance." Dechow, Ge, Larson, and Sloan, *supra* note 38, at 5.

performance.[110] Managers might lose their jobs and associated financial and reputational benefits.[111] Many accounting frauds are accompanied by allegations of insider trading, suggesting that managers manipulate reported earnings in order to "unload their holdings at inflated prices."[112]

Managerial over-optimism may also play a role in accounting fraud.[113] Believing that past success predicts future success, top managers will risk accounting fraud, perhaps rationalizing it as "income smoothing."[114] For example: "Enron's accounting games were never meant to last forever . . . . The goal was to maintain the impression that Enron was humming until Skilling's next big idea kicked in and started raking in real profits."[115]

Managers who recognize revenue on products that have yet to be manufactured,[116] or capitalize expenses instead of expensing them immediately,[117] usually know that what they are doing is illegal.[118]

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[110] *See* Pritchard, *Markets as Monitors*, *supra* note 5, at 931.

[111] *See* Arlen & Carney, *supra* note 5, at 702-03; Gulati, *supra* note 48, at 697-99 (arguing that high prestige associated with top managerial posts provides incentive for managers to commit fraud).

> If termination is the only sanction, and that sanction is applied in only a percentage of cases, fraud may still be a gamble worth taking for the corporate manager — she would likely find herself out of work, even if she did not commit the fraud . . . . the threat of a class action lawsuit does little to deter those wrongdoers . . . .

Pritchard, *Who Cares?*, *supra* note 5, at 887.

[112] Pritchard, *Markets as Monitors*, *supra* note 5, at 932-33.

[113] *See* Douglas C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, *in* BEHAVIORAL LAW AND ECONOMICS 144, 149-50 (Cass Sunstein ed., 2000).

[114] Opinions on income smoothing vary, but the most innocuous define the practice as making systematic choices within GAAP rules which produce reported earnings that are smoother than underlying cash flows. *See* Dechow & Skinner, *supra* note 50, at 4. Although income smoothing has become an accepted practice, it distorts market prices. In finance theory, the price of stock is determined by the net present value of future cash flows discounted by the firm's level of risk. Income smoothing lowers income volatility and perceived risk (but does not lower actual risk) and thereby artificially increases the market valuation of the stock. More perniciously, the step from income smoothing to outright accounting fraud is very small. *See id.* at 5-8 (discussing managerial intent as crucial element that distinguishes income smoothing from outright fraud).

[115] BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 171 (2003).

[116] *See* SEC v. Henke, 275 F. Supp. 2d 1075, 1079 (N.D. Cal. 2003).

[117] *See In re* WorldCom, Inc., Sec. Litig., 346 F. Supp. 2d 628, 635 (S.D.N.Y 2004).

[118] *See id.* at 635; *Henke*, 275 F. Supp. 2d at 1079; Miriam H. Baer, *Linkage and the*

Indeed, managers frequently go to great lengths to cover up their crimes. They lie to their accountants,[119] threaten dismissal to those who resist,[120] reduce their prices to convey to competitors the appearance of superior performance,[121] and even pay taxes on nonexistent earnings.[122]

Vicarious corporate liability is usually justified as incentive for firms to implement effective internal compliance systems to prevent and detect fraud. But it is unclear that internal compliance efforts can deter accounting fraud that involves top management,[123] because managers control compliance.[124] Although financial statements sometimes raise red flags (or should have raised them), smart managers are often able to hide problems, particularly in industries with difficult-to-value assets.[125]

More importantly, internal compliance systems are ordinarily designed to alert *management* of their subordinates' wrongdoing, not to discover management's own wrongdoing.[126] In fact, Sarbanes-Oxley requires management to implement internal control systems and to

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Deterrence of Corporate Fraud, 94 VA. L. REV. 1295, 1311 (2008). And, if they do not know that, they are not qualified to be managers.

[119] *See, e.g.*, MCLEAN & ELKIND, *supra* note 115, at 128, 157-58 (describing examples of deals where Enron executives misrepresented facts to its accountant, Arthur Andersen).

[120] Sherron Watkins and Cynthia Cooper, accountants at Enron and WorldCom, respectively, brought accounting problems to the attention of management. Both were threatened with termination and Watkins was reassigned. *See* Kathleen F. Brickey, *From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L.Q. 357, 362-63, 369 (2003).

[121] *See* Sadka, *supra* note 56, at 439, 457-58 (arguing that WorldCom fraud caused price competition and not vice versa).

[122] *See* Erickson et al., *supra* note 56, at 389-90 (reporting that out of twenty-seven firms subject to SEC enforcement actions, fifteen paid taxes on overstated earnings; total amount of taxes paid represented 2.4% of firms' market value and 20% of pretax value of overstated earnings).

[123] *See* Miriam Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 950 (2009) (reporting that despite increased use and spending on internal compliance systems, "employee malfeasance . . . is on the rise").

[124] *See* Fischel & Sykes, *supra* note 23, at 324-25 (observing that monitoring senior management might be far more costly than monitoring rank-and-file employees).

[125] *See In re* Cendant Corp., Admin. Proc. No. 3-10225, 54 S.E.C. 673, 677-78 (June 14, 2000); Partnoy, *supra* note 61, at 532 (observing that "accounting fraud can be virtually impossible to detect").

[126] *See* Toby J.F. Bishop & Frank E. Hydoski, *Mapping Your Fraud Risks*, 87 HARV. BUS. REV. Oct. 2009, at 76 ("Senior executives and directors need to be aware of their companies' vulnerability to serious fraud, yet they may be out of the loop because risk assessment is frequently handled further down the chain of command and captured in voluminous, hard-to-penetrate spreadsheets and databases.").

certify their effectiveness.[127] While internal control systems may catch lower-level fraud, there is little reason to believe that compliance improves monitoring of top management itself.[128]

In effect, the board of directors is the ultimate monitor of top management, yet it usually lacks the time, skill, and resources to monitor and sanction fraud. Modern boards are overwhelmingly independent. Formal independence reduces potential conflicts of interest among board members and the firm, but also reduces the quantity and quality of information available to the board. Virtually all independent boards of directors rely largely on top executives, who are often also co-directors, for information. It is usually top management that presents the information to the board of directors after reported wrongdoing. Management controls what information is presented and how. It can withhold relevant information from the board and present information in a favorable light to obtain the necessary board cooperation.[129]

Some studies have found that firms with independent boards of directors are less likely to manipulate earnings, suggesting that boards of directors can provide some monitoring, but the effect is not strong.[130] In addition, because management usually hand-picks board members, managers who are more likely to commit fraud will be more likely to select lower-quality directors (assuming that managers themselves know their own propensity for fraud). Finally, the effect of vicarious corporate liability on monitoring over and above requiring

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[127] The Sarbanes-Oxley Act also requires firms to implement effective internal controls over financial reporting.

> [E]ach annual report . . . [must] contain an internal control report, which shall — (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment . . . [by management] of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

The Sarbanes-Oxley Act of 2002, Pub. L. 107-204, § 404(a), 116 Stat. 745 (2002).

[128] *See* Kimberly Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 491-93 (2003).

[129] For example, the Enron board approved self-dealing transactions between Andrew Fastow and off-the-books partnerships.

[130] For a literature review, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921-22 (1999) (reporting that independent boards do not improve performance); Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is Received Wisdom?*, 95 GEO. L.J. 1843, 1869-70 & nn.127-28 (2007).

independent boards and imposing individual director liability for wrongdoing is unclear.

After Enron and WorldCom, audit committees were also redesigned and empowered to investigate fraud. But, even the best audit committees are ill equipped to catch willful accounting fraud. Although audit committees usually have one or more experienced auditors (or financial analysts) as members, their time is severely limited. Some audit committees will coordinate their work with external auditors, but most are not able to investigate the veracity of financial statements or detect fraud before it has been exposed. To date, few studies have found a positive correlation between the independence of the audit committee and the incidence of accounting fraud.[131]

Even if vicarious corporate liability cannot guarantee better monitoring by directors, it might be superior to individual liability if it provides managers with superior incentives to monitor their peers. One should expect this result if managers' pay is tied to corporate performance. But, performance-linked pay is unlikely to produce superior monitoring. Overstated earnings can lead to larger-than-deserved bonuses for all managers and reduce the managers' incentive to monitor their peers. The effect is particularly strong when the firm cannot clawback bonuses paid to "innocent" managers if the accounting statements are later restated.[132]

Even if we assume that senior managers will monitor their peers despite the incentive to do otherwise, there is little evidence that their efforts are effective: fraud is usually committed by people who control

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[131] *See, e.g.*, Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1531-33, 1604-06 & tbl.4 (2005) (collecting data from sixteen empirical studies on correlation between audit committee independence and financial restatement, and reporting that eleven find no such correlation); April Klein, *Audit Committee, Board of Director Characteristics, & Earnings Management* (N.Y.U. Law & Econ. Research, Paper No. 06-42, 2006), *available at* http://ssrn.com/abstract=246674 (finding no positive correlation between majority independent audit committee and earnings manipulation).

[132] Under investor and government pressure, some of the nation's largest banks changed their clawback policies from 2008 to 2009. In its 2009 proxy statement, Citigroup disclosed that it can recover any bonus or incentive compensation that is based on earnings that are later "shown to be materially inaccurate," whether by misconduct or mistake. CITIGROUP, INC., 2009 PROXY STATEMENT 39 (2009). A year earlier, Citi disclosed that it could only recoup compensation if there was a restatement and the "executive engaged in intentional misconduct that caused or partially caused the need for the restatement." CITIGROUP, INC., 2008 PROXY STATEMENT 47 (2008).

the relevant information and checking the accuracy of that information is near to impossible.[133]

Empirical studies have undermined the assumption that internal monitoring effectively deters accounting fraud. Professor Alexander Dyck and his collaborators report that internal governance mechanisms detect 34.3% of disclosed fraud, while external actors detect nearly more than twice as often (65.7%).[134] They do caution, however, that it is empirically impossible to analyze whether internal monitors catch accounting fraud early, without having to file a restatement, because that information is not disclosed to the market.[135]

The available evidence does not support the conclusion that firms are better able to monitor and control top management than external enforcers. It does, however, suggest that the return on monitoring costs will likely be small or negative in the case of accounting fraud. In addition, while vicarious liability may induce firms to create better monitoring mechanisms, it is difficult to disaggregate the effect of liability from the regulatory mandate that firms put in place an effective internal controls system and a fully independent audit committee.

3. Inferior Sanctioning

Vicarious corporate liability can provide superior deterrence if the firm is better able to sanction dishonest employees than external enforcers.[136] If so, vicarious corporate liability is merely an indirect way of sanctioning individual wrongdoers.[137] The firm is better at sanctioning if any of the following is true: (1) it is able to sanction individual wrongdoers more accurately than external enforcers; (2) it can impose a sanction on individuals more cheaply; or (3) it can impose sanctions that are unavailable to external enforcers, provided that those sanctions deter individuals more effectively (e.g., control over wages and terms of employment, indemnification, or the possibility of future advancement and compensation).[138]

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[133] Arlen & Carney, *supra* note 5, at 716.

[134] *See* Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?* 52 & tbl.2 (CRSP Working Paper No. 618, 2007), *available at* http://faculty.chicagobooth.edu/finance/papers/who%20blows%20the%20whistle.pdf.

[135] *See id.* at 10-11.

[136] *See* Arlen, *supra* note 5, at 835.

[137] *Id.*

[138] *See id.*; Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 570 (1988) [hereinafter Sykes, *Boundaries of Vicarious Liability*].

None of these three conditions is satisfied in accounting fraud. Available evidence suggests that firms do not sanction managers more accurately than external enforcers.[139] If firms impose a sanction for fraud at all, the sole sanction employed is termination.[140] Although the firm may have a right to be indemnified, it is usually inefficiently costly for the firm to sue individual wrongdoers or pursue sanctions beyond termination.[141] Additional sanctions for individuals are, therefore, rare and are virtually always imposed by the government (i.e., the SEC or prosecutors), not the firm.[142] Finally, the firm's ability to sanction top management is limited because the firm cannot control the individual's post-termination employment, nor can it impose nonmonetary sanctions.[143]

Professor Vikramaditya Khanna suggests that in situations involving top management, such as accounting fraud, agency problems and statutory limitations on indemnification are the cause of inferior sanctioning by firms.[144] Top management controls the appointment and tenure of directors, which reduces directors' incentives to oversee management and sanction them.[145] Furthermore, revealing fraud and sanctioning dishonest employees requires "directors to take actions that will decrease share price without offering *any* prospect of an offsetting future increase in share price."[146] As a result, directors may be reluctant to act.

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[139] *See* Arlen, *supra* note 5, at 860 & n.79 (noting that firms' sanctioning tools are limited to termination, while state's toolbox also includes future and nonmonetary sanctions, among other sanctioning mechanisms); Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201 & tbl.3 (noting that more than 90% of employees identified in securities fraud class actions are fired, but omitting any reference to additional employer-imposed sanctions).

[140] *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 201 & tbl.3.

[141] *See* Baer, *Insuring Corporate Crime*, *supra* note 40, at 1035.

[142] *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 210 & tbl.8, 212 & tbl.9 (reporting that fraud-committing managers are disbarred in about 30.0% of cases, indicted in 27.5% of cases, imprisoned in 11.7% of cases, fined in less than half of cases and when fined, median fine equaled a mere $100,000).

[143] In addition, Sykes notes if the firm's only available device to maintain employees' incentives is an indemnification action (and firing), then imposing liability on the firm will not deter employee wrongdoing. *See* Sykes, *Boundaries of Vicarious Liability*, *supra* note 138, at 570.

[144] *See generally* Khanna, *Behavior of Top Management*, *supra* note 15, at 1254-55 (suggesting that inferiority of corporate sanctions may be due to agency costs and statutory limitations).

[145] *See* Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1685 (2007).

[146] *Id.* at 1684.

Recent reports suggest that boards may have become more willing to investigate wrongdoing independently, but the mere fact of investigation does not translate into sanctions.[147] The boards can fire dishonest managers, but the firm may have to pay severance and forego indemnification to avoid proving intentional wrongdoing in court. A court battle would not only be costly for the firm, but may expose board members themselves to the risk of liability (or perceived risk thereof) and would likely harm the firm's reputation.

It is not surprising that firms rarely require dishonest managers to indemnify the firm for fraud-related losses.[148] Because top management controls the firm's actions and because external sanctioning is uncertain and costly, management can ordinarily avoid sanctions by settling the case on behalf of the firm early, before much evidence of wrongdoing is discovered. Managers' indemnification agreements (requiring the firm to indemnify agents for job-related costs and liability)[149] and D&O insurance put additional pressure on firms to settle to avoid adjudication of dishonesty.[150]

Holding the firm, but not individual wrongdoers, liable is, thus, likely to have little effect on preventing accounting fraud. Even if managers are held liable along with the firm, many courts and the SEC have held that it is against public policy for a co-defendant to seek indemnification from another when both have been held liable.[151] And if the firm settles, which it nearly always does, dishonest managers avoid sanctions altogether.[152] The only managers who contributed

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[147] *See generally* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1029-32 (2010) (reporting that boards have become more powerful vis-à-vis CEO, and are more willing to monitor and replace CEO today than they were ten years ago).

[148] However, full liability shifting is often not necessary. Even modest proportional liability imposed on culpable agents is likely to provide some deterrence. *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1579-80. This is because it increases the costs of securities fraud to the agents and reduces their moral hazard. In addition, individuals are loss-averse, and losses loom larger than gains. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 288 (1979).

[149] DEL. CODE ANN. tit. 8, § 145(a) (2009); United States v. Stein, 435 F. Supp. 2d. 330, 339 n.25 (S.D.N.Y. 2006) (citing defendant's employment agreement that provided if he were named as defendant in any action based on his activities with firm, firm would indemnify him, except as to "wilful or intentional unlawful acts").

[150] Pritchard, *Who Cares?*, *supra* note 5, at 885-86.

[151] Arlen & Carney, *supra* note 5, at 711.

[152] Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1566-70.

personally to a settlement have done so as part of a plea agreement or settlement with the SEC.[153]

4. Risk Shifting

Even if vicarious corporate liability does not deter employee wrongdoing better than individual liability, commentators have argued that the former is efficient because it shifts the risk of liability from risk-averse managers to risk-neutral diversified shareholders, who can bear liability more cheaply.[154] Relying on this logic, Professor Reinier Kraakman argues that individual liability is only appropriate where corporate liability is exhausted and where the gravity of the offense warrants additional deterrence.[155]

The firm can bear the risk of unintentional wrongs better, but is not better positioned to bear risk for intentional wrongdoing of top management.[156] Risk-shifting creates moral hazard, like any form of insurance. If managers can shift the risk of liability to someone else, they are likely to commit more fraud.[157] Where the firm is unable to monitor effectively its employees — like in accounting fraud where managers control the information, and agency problems frequently prevent the firm from sanctioning them — corporate liability "generally reduces the level of precautionary behavior."[158]

In addition, accounting fraud harms the firm and its shareholders, rather than third parties, as is common for many other corporate wrongs.[159] Imposing liability for accounting fraud on the firms' shareholders requires "the victims of the violation [to] pay an

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[153] *See id.* at 1551. In *Cendant* accounting fraud, the securities fraud class action was settled in 2001 for $2.85 billion without any individual contribution. *In re* Cendant Corp. Litig., 264 F.3d 286, 288, 291 (3d Cir. 2001). Later, the company's founders Kirk Shelton and Walter Forbes were indicted and convicted of securities fraud and were required to pay back more than $3 billion that the fraud cost Cendant.

[154] Arlen & Carney, *supra* note 5, at 719. The same argument has been made in support of the business judgment rule. If directors were held liable even for negligent wrongs, they would exercise excessive caution and err on the side of doing less, which would reduce the levels of efficient business risk-taking. Since the amount of potential liability in the context of firms is huge, the business judgment rule is used to counteract directors' risk aversion.

[155] Kraakman, *supra* note 30, at 885.

[156] Khanna, *Behavior of Top Management*, *supra* note 15, at 1254; *see also* Alan O. Sykes, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168, 183-84 (1981) [hereinafter Sykes, *Efficiency Analysis*].

[157] *See* Khanna, *Behavior of Top Management*, *supra* note 15, at 1254-55 & n.173-75.

[158] Sykes, *Efficiency Analysis*, *supra* note 156, at 186-87.

[159] "Shareholders are victims, not beneficiaries, of their agents' misstatements motivated by entrenchment." Pritchard, *Markets as Monitors*, *supra* note 5, at 932.

additional penalty for their own victimization."[160] Furthermore, some empirical evidence suggests that vicarious corporate liability for accounting fraud spreads losses from a risk-neutral group of investors to one that is more risk-averse.[161] Securities fraud class actions require shareholders who bought shares outside the class period to compensate those who bought during the class period. Retail investors are more likely to buy and hold their stock than to trade actively. As a result, securities class actions "transfer wealth systematically" from retail investors (who bought shares on average outside the class period) to more sophisticated and more rapidly trading investors (who are more likely to have bought shares within the class period) — like hedge funds — and their lawyers.[162]

Finally, even if we assume that investors as a group are able to diversify their portfolios to reduce their exposure to fraud, that assumption is not true for each individual diversified investor, as Professor Alicia Evans has demonstrated.[163] In fact, she observes that "many investors, not just a few outliers" suffer net losses (and others enjoy net gains).[164]

5. Cost Internalization

A final argument in favor of vicarious liability is that it induces firms to internalize the cost of wrongdoing. If the firm is held liable, its shareholders will have the incentive to elect a board of directors that is more likely to select honest managers and implement optimal precautions. Even where the firm's precautionary measures are not effective, the shareholders should bear the cost of the firm's activity to the extent that they benefit from it.

For example, firms ought to be vicariously liable for evading taxes. If only individual wrongdoers were held liable, firms (and their shareholders) would have an incentive to hire dishonest and

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[160] SEC v. Bank of America, 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009).

[161] *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1559-61.

[162] Arlen & Carney, *supra* note 5, at 719; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1560.

[163] *See* Alicia Davis Evans, Are Investors' Gains and Losses from Securities Fraud Equal Over Time? Some Preliminary Evidence 31-32 (Univ. of Mich. L. Sch., Empirical Leg. Stud. Ctr., Working Paper No. 09-002, 2009), *available at* http://ssrn.com/abstract=1121198.

[164] *See id.*; *see also* Jason Zweig, *The Intelligent Investor: More Stocks May Not Make a Portfolio Safer*, WALL ST. J., Nov. 26, 2009, at A11 (reporting that although on average diversification reduces risk, "[t]hirteen percent of the time, a 20-stock portfolio generated by computer will be riskier than a one-stock portfolio" while human-selected portfolios are "even more fallible").

judgment-proof managers, reaping the benefits of tax evasion but few of the costs.

But the assumption that vicarious corporate liability is superior to individual liability holds only to the extent that the firm benefits from employees' wrongdoing. When the firm does not benefit from wrongful activity, as in the case of insider trading and, usually, accounting fraud, vicarious corporate liability will not deter wrongdoing.[165] It also "offends social norms, . . . sense of fairness, to punish the victim for conduct it did not cause."[166] Consequently, vicarious corporate liability for accounting fraud increases the cost of investing and shrinks equity markets.

B. Additional Problems with Vicarious Corporate Liability

In addition to overdeterrence, vicarious corporate liability also provides firms perverse incentives. Arlen observed that vicarious corporate liability can reduce the firm's incentives to implement an effective system of internal controls designed to prevent and detect employees' wrongdoing.[167] An effective mechanism will discover more employee wrongdoing, which, under a vicarious corporate liability regime, will increase the firm's expected liability.[168] In response, Arlen proposed negligence liability for firms and liability mitigation where the firm has implemented an effective system of internal controls.[169] Her proposal assumes that the firm is a better *ex ante* monitor than are external monitors. If, however, the firm's *ex ante* monitoring efforts are unlikely to be effective, her proposed solutions will not deter wrongdoing any better.[170]

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[165] Sometimes, accounting fraud can benefit the shareholders in the short-term: the firm might be able to borrow at lower cost. *See, e.g.*, Baena v. KPMG, 453 F.3d 1, 7 (1st Cir. 2006) (stating that fraud, like price fixing, "profits the company in the first instance"); Cenco v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982) ("the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud"); AIG v. Greenberg, 965 A.2d 763, 827 (Del. Ch. 2009) (citing cheap acquisitions, tax evasion, and higher stock price as benefit). But over the long term, accounting fraud harms the shareholders as a class. In a market of low information (including the stock market and accounting fraud), investors will assume all firms are lemons, which depresses all stock prices.

[166] Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1562.

[167] Arlen, *supra* note 5, at 836.

[168] *Id.*

[169] *See id.* at 862-66.

[170] If the court determines that the firm was not a negligent monitor *ex ante* because it could not do anything to prevent fraud, the individual will be held liable, while the firm will not. In that case, the result is the same whether corporate liability

In a subsequent article, Arlen and Kraakman extend Arlen's observations to the credibility of the firm's enforcement efforts.[171] Internal sanctioning is costly for firms.[172] Unless the firm benefits from imposing a sanction on wrongful employees, employees should assume that the firm will not sanction them. Since vicarious corporate liability is imposed regardless of the firm's "fault," employees will perceive sanction risk as not credible and will not be deterred.[173]

C. Problems with Individual Liability

High litigation and investigation costs, limited resources available to investigate, litigate, and punish fraud, substantial agency costs as well as statutory limitations on internal sanctioning, result in low rates of personal liability and, therefore, low rates of individual deterrence under vicarious corporate liability. For similar reasons, Arlen and Carney conclude that vicarious corporate liability should not be applied in fraud cases.[174] They argue in favor of individual civil and criminal liability, positing that it will provide superior deterrence.[175] Coffee, too, has proposed eliminating corporate liability for securities fraud to reduce the ability of insiders to "pass[] the costs of the litigation onto the shareholders."[176]

However, there are several reasons to be skeptical. First, private plaintiffs are significantly less likely to pursue actions against individual agents whose limited wealth (and insurance coverage) will yield a much smaller recovery.[177] Although managers are usually named defendants in securities class actions, private plaintiffs rarely insist that they contribute personally to the settlement because the expected return on such insistence is negative. Moreover, D&O policy limits are usually sufficiently high to cover a satisfactory settlement.[178]

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or individual liability is used. If the court holds the firm liable for failing to prevent fraud even where the firm could not have prevented it (i.e., the court makes an error), the firm will be forced to bear the additional liability cost, while the individual might escape liability entirely or bear less than the full cost of her wrongdoing. In that scenario, corporate liability is inferior to individual liability.

[171] Arlen & Kraakman, *supra* note 80, at 712.

[172] *Id.* at 693.

[173] *Id.* at 714.

[174] *See* Arlen & Carney, *supra* note 5, at 720.

[175] *See id.*

[176] Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1584.

[177] *Id.* at 1564.

[178] *See* Black, Cheffins & Klausner, *supra* note 36, at 1098-1102; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1578 (reporting that highest D&O policy limit in 2006 was $300 million).

If plaintiffs pursued culpable managers, managers will litigate aggressively, spending their D&O insurance coverage on legal fees and leaving little to compensate the victims of fraud. Professors Bernard Black, Brian Cheffins, and Michael Klausner report that individuals have been required to contribute out-of-pocket only thirteen times over the last twenty-five years.[179] In all but two of those cases, individuals were required to contribute because the firm was insolvent (and, therefore, unable to indemnify agents), and its D&O insurance policy limit was too low or the policy itself was invalid.[180]

Second, accounting fraud is notoriously difficult to investigate.[181] The difficulty of investigation increases with the size and sophistication of the firm.[182] Although the SEC[183] and federal prosecutors[184] tend to target smaller firms, studies have found that accounting fraud may actually be more common among large firms.[185] Analyzing all restatements filed between 1982 and 2005, Patricia Dechow and her collaborators found that the largest 10.0% of firms by market capitalization filed 14.7% of all restatements.[186] Although the disparity could be due to the largest firms' greater visibility, it also indicates that despite greater market scrutiny, large firms are not immune to accounting fraud. Presumably, larger firms can hire the

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[179] *See* Black, Cheffins, & Klausner, *supra* note 36, at 1056.

[180] *See id.*

[181] Buell, *supra* note 77, at 1625; Neal K. Katyal, *Conspiracy Theory*, 112 YALE L.J. 1307, 1326-27 (2003); *see* Darryl K. Brown, *The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement*, 1 OHIO ST. J. CRIM. L. 521, 536 (2004) (discussing difficulties of detecting fraud when actors are specialized).

[182] *See* Buell, *supra* note 77, at 1625.

[183] Cox & Thomas, *supra* note 39, at 765 (reporting that average market capitalization of firms targeted by SEC is nearly three times smaller than that of firms named in securities class actions); *see* Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers* 34 (Harv. L. & Econ. Discussion Paper No. 27, 2009), *available at* http://ssrn.com/abstract=1333717 (observing that SEC pursues smaller broker-dealer firms more frequently than large firms and imposes more severe sanctions on smaller firms).

[184] In 2008, only 13.7% of firms sentenced under the federal guidelines had 200 or more employees. *See* U.S. SENTENCING COMM'N, SOURCEBOOK OF FEDERAL SENTENCING STATISTICS 2008, at tbl.54, *available at* http://www.ussc.gov/Data_and_Statistics/Annual_Reports_and_Sourcebooks/2008/SBTOC08.htm. The report does not disaggregate statistics for fraud nor include deferred prosecution agreements with firms.

[185] *See, e.g.*, Cindy R. Alexander & Mark A. Cohen, *New Evidence on the Origins of Corporate Crime*, 17 MANAGERIAL & DECISION ECON. 421, 432 (1996) (attributing increased likelihood of fraud to weaker monitoring and control by shareholders and greater opportunities to commit fraud).

[186] Dechow, Ge, Larson, and Sloan, *supra* note 38, at 18 tbl.2A.

very best accountants, internally and externally, so fraud should be less common, and not the reverse.

Top managers, particularly in larger firms, can reduce their likelihood of capture by delegating overt acts of fraud to lower-level employees.[187] Securities class actions or SEC enforcement actions against individuals cannot proceed without knowing their identity. Limited resources and high procedural burdens further reduce the ability of private plaintiffs and public investigators (e.g., the SEC) to gather evidence against dishonest managers without the firm's cooperation.[188] Fraud cases against firms can easily involve "hundreds of witnesses, millions of documents, and years of investigation."[189] Firms, whose resources are (for all practical purposes) unlimited, can stonewall investigations by making broad assertions of attorney-client privilege and work-product doctrine and conceal the activities of their managers.[190] Their ability to deflect requests for information increases with size.[191] Without the threat of corporate liability, relevant witness and documentary evidence may be very difficult to obtain from the firm. As a result, individual liability has a limited reach in deterring accounting fraud.

D. Problems with Fault-Based Corporate Liability

Characteristics of accounting fraud — complexity, involvement of top management, and shareholders as victims of fraud — undermine the effectiveness of both vicarious liability and individual liability alone.

In response, commentators have proposed fault-based corporate liability.[192] Although fault-based liability reduces the overdeterrence problem, it creates problems of its own. First, most fault-based proposals have been made by criminal law scholars and propose a single measure of corporate fault: whether the firm had in place an

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[187] *See* Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 266-70 (2004) (describing complex prosecution strategy used to convict elusive WorldCom chief executive Bernie Ebbers, who was very fond of delegating dirty work to his subordinates); Kraakman, *supra* note 30, at 860 ("[T]op manager's most powerful risk-shifting tool [is] delegating legally risky policies to subordinates.").

[188] *See* Brown, *supra* note 181, at 536-37. "The more sophisticated the fraud, the more difficult it is to identify as fraud." Buell, *supra* note 77, at 1627.

[189] Buell, *supra* note 77, at 1625.

[190] *Id.*

[191] *See* Brown, *supra* note 181, at 528.

[192] *See* Moohr, *Of Bad Apples and Bad Trees*, *supra* note 69, at 1364; Podgor, *supra* note 70, at 1543; Weissmann & Newman, *supra* note 70, at 449 (arguing that government should have burden of proving that firm failed to adopt effective procedures to prevent employee misconduct).

effective mechanism of internal controls.[193] As discussed above, internal compliance is unlikely to catch accounting fraud, particularly those instances where top management is involved. In addition, these proposals are uniquely prone to hindsight bias — the fact that fraud occurred will be used as evidence that internal compliance failed and that the failure was avoidable. Anticipating hindsight bias, firms will either overspend on compliance, or alternatively, implement "cosmetic" (and cheap) compliance to give the appearance of compliance, while accepting the risk of liability.[194]

Second, even if the measures of the firm's "fault" are broadened to include *ex ante* incentives provided to managers to avoid fraud, fault-based liability is unlikely to produce deterrence superior to vicarious liability because incentive compensation is not effective at preventing accounting fraud.[195] Similarly, because firms cannot sanction individuals for fraud at lower cost than the government or private plaintiffs, fault-based liability that depends on *ex post* sanctioning will be inefficient.

But, firms control access to relevant information or can obtain such access at lower cost than external enforcers. Fault-based liability that depends on *ex post* reporting of fraud and cooperation can lower enforcement costs, increase the likelihood that dishonest individuals will be sanctioned and, thereby, produce superior *ex ante* deterrence of individual wrongdoing. In addition, firm action is more easily observable after the fact than before, reducing the risk of over- and underinvestment in cooperation. Finally, only firms where fraud occurred are exposed to liability, vastly reducing the potential costs. Because liability depends on the firm's conduct after fraud has occurred, it is useful to distinguish it from liability that depends on the firm's conduct before the fact also by using a different label. This Article employs the term "leveraged sanctions."

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[193] *See* Pamela H. Bucy, *Corporate Criminal Liability: When Does It Make Sense?*, 46 AM. CRIM. L. REV. 1437, 1442 (2009); Podgor, *supra* note 70, at 1537-38; Andrew Weissmann, *New Approach to Corporate Criminal Liability*, 44 AM. CRIM. L. REV. 1319, 1335-36 (2007).

[194] *See* Krawiec, *supra* note 128, at 487. Given the uproar that corporate indictments create because of the collateral harm, it is unlikely that firms whose compliance systems were judged ineffective would be indicted, even if effective compliance were an affirmative defense. Instead, prosecutors would continue to rely on DPAs and *ex post* cooperation to determine the firm's ultimate sanction.

[195] *See supra* Part II.A.1.

III. LEVERAGED SANCTIONS AND IMPROVED DETERRENCE OF ACCOUNTING FRAUD

Vicarious corporate liability and individual liability provide limited deterrence of accounting fraud. Even though *ex ante* incentives and internal monitoring are unlikely to be effective, several other possible ways to reduce the incidence of accounting fraud exist.

One way is secondary liability imposed on outsiders entrusted with *ex ante* monitoring (often called "gatekeepers"): parties who are not the primary actors or beneficiaries of the misconduct, but are in the position to prevent it, that is, lawyers and accountants.[196] If accountants or lawyers are liable for failing to prevent fraud, they will have an incentive to monitor carefully. But, gatekeepers have failed to prevent Enron and other accounting frauds.[197]

Yet, deterring accounting fraud cannot rest on improved external monitoring and better *ex ante* regulation alone, because sophisticated managers often produce few discoverable signs of wrongdoing, particularly in the early stages of accounting fraud. Although it is better to prevent harm than to sanction it *ex post*, improved *ex post* reporting and sanctioning will prevent harm *ex ante* because managers will remain honest if the risk of discovery and sanctioning is greater. Changed perceptions about the likelihood of apprehension and sanctioning affect behavior of potential wrongdoers *ex ante* and should result in less accounting fraud.[198]

The perceived likelihood of sanctioning depends on two factors: (1) how likely is it that fraud will be discovered, and (2) how likely is the dishonest manager to be sanctioned. External audits of accounting statements are required to increase the likelihood of discovery. Whistleblowers are in some cases promised bounties if they report fraud.[199] Offers of bounties could be expanded to those who blow the whistle for accounting fraud, including firms who self-report accounting fraud, though the effectiveness of such rewards is difficult to assess *ex ante*. It could be that only firms whose accounting

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[196] *See* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. LAW. ECON. & ORG. 53, 53 (1986).

[197] *See* Sarbanes-Oxley Act of 2002, tit. I-II, VIII, IX, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 5, 11, 12, 15, 18, 28, 29, 49 U.S.C.).

[198] *See* Arlen & Kraakman, *supra* note 80, at 693; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1579 (suggesting that shifting some liability in securities fraud class actions to individuals will likely improve deterrence of accounting fraud).

[199] The False Claims Act gives individuals who file a *qui tam* action on behalf of the federal government against government contractors for fraud against the government a right to a portion of any recovered damages. *See* 31 U.S.C. § 3730(d) (2006).

practices have already raised red flags would report wrongdoing. In that case, bounties may only marginally expedite discovery of fraud, without increasing overall reporting rates.[200]

Another way to increase the perceived likelihood of sanctioning is to increase the odds that dishonest managers will be sanctioned.[201] As described above, asymmetric information among firms, private and public enforcement agents, limited resources of private plaintiffs and public enforcers, agency costs, and bargaining restrictions significantly lower sanctioning rates for managers. This Part proposes leveraged sanctions against firms or groups of insiders with access to relevant information as a mechanism to overcome sanctioning impediments, lower enforcement costs, and increase individual deterrence of accounting fraud.

A. Collective and Leveraged Sanctions

Leveraged sanctions are a type of collective sanction. Collective sanctions, unlike individual sanctions, are sanctions against a group when an individual within the group commits a wrong.[202] They include, among other examples, vicarious liability and liability of parents for wrongs their children commit. Professor Daryl Levinson describes collective sanctions as "an indirect way of controlling individual wrongdoers."[203] He argues that collective sanctions, whether leveraged or not, provide superior deterrence where "[g]roup members . . . are in an advantageous position to identify, monitor, and

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[200] *Cf.* Louis Kaplow & Steven Shavell, *Optimal Law Enforcement with Self-Reporting of Behavior*, 102 J. POL. ECON. 583, 601-02 (1994) (arguing in favor of providing rewards to criminals who self-report, but noting that rewards must be adjusted accurately for likelihood of apprehension to provide optimal deterrence). Expedited discovery may reduce the social cost of fraud marginally. Since most accounting frauds are not discovered until they become too difficult to hide, few firms will report fraud before very late. As explained above, internal monitoring systems will rarely alert firms to accounting fraud early.

[201] It is the perception of sanctioning that affects individual behavior. One way to change perceptions is by increasing the actual rates of sanctioning; another is by making sanctioning more visible. *See* Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1538-39 (1998). However, given the current fascination with "perp walks" for executives arrested for accounting fraud and the high level of journalistic interest in convictions and long prison sentences for fraudulent managers, it is unlikely that visibility of sanctioning could be increased appreciably. Actual sanctioning rates, on the other hand, could be increased and reported as such to change individuals' perceptions of the likelihood of sanctioning.

[202] *See* Levinson, *supra* note 25, at 348.

[203] *Id.* at 349.

control responsible individuals, and can be motivated by the threat of sanctions to do so," even where they do not benefit from the wrongdoing.[204]

Collective sanctions can be either unconditional or conditional. Unconditional collective sanctions are imposed regardless of the group's behavior, while conditional collective sanctions are threatened against the group and used as leverage to increase the likelihood that the condition will be satisfied. Unconditional collective sanctions will likely be superior to individual sanctions when the group subject to the sanction is better able to determine who is the culpable individual within the group and can sanction her more effectively than can the external enforcer. Collective sanctions merely give the group the incentive to use its superior information for sanctioning purposes. Vicarious corporate liability, for example, assumes that firms have both better information and superior means to monitor and sanction individuals.[205]

Conditional collective sanctions, or leveraged sanctions, on the other hand, are imposed only when the group fails to satisfy the condition set by the sanction, for example, by exposing the wrongdoer to external enforcers. Leveraged sanctions are more effective than unconditional collective sanctions whenever the group has better information than external enforcers about the identity of the culpable individual, but external enforcers are better able to sanction that individual. Three reasons are possible: because external sanctions are cheaper, because they are more frequent, or because they are more effective. If the group chooses to withhold information, the group is sanctioned. If, however, the group discloses information, only the individual is sanctioned, while the group escapes sanctioning. Assuming that groups respond to incentives, a leveraged sanction increases the probability that the culpable individual will be sanctioned.

In particular, collective sanctions are effective when information constraints would otherwise preclude sanctioning altogether or would make sanctioning prohibitively costly.[206] For example, in *Ybarra v. Spangard*, a patient underwent an appendectomy and woke up with an

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[204] *Id.* at 348.

[205] This is not to suggest that individuals are not jointly and severally liable with firms for the wrongs they commit. But when a firm is vicariously liable for an employee's tort or crime, plaintiffs rarely pursue the individual in addition to the firm. *See, e.g.*, Black, Cheffins & Klausner, *supra* note 36, at 1098-99 (explaining how settlement dynamics in securities fraud class actions shift liability away from individuals).

[206] *See* Levinson, *supra* note 25, at 379.

injured shoulder.[207] No one on the surgery team would identify the guilty party. Instead of dismissing his lawsuit, the California Supreme Court allowed the patient to recover damages from the entire group collectively.[208]

The collective group-level sanction in *Ybarra* increased the cost of noncooperation and, thus, the likelihood that in subsequent cases, the group will either cooperate with external enforcers or demand that culpable individuals within the group indemnify the innocent for their share of the imposed sanction. Assuming no agency costs or impediments to bargaining, wrongdoers will pay the same sanction in an unconditional collective sanction regime, whether or not the group cooperates with external enforcers, because group members will demand to be indemnified or compensated.[209]

Imposing a collective sanction in cases of accounting fraud is more complicated than in *Ybarra*. First, only conditional or leveraged collective sanctions are likely to be effective.[210] Second, the identity of group members with private information about accounting fraud is difficult to ascertain *ex ante*. A leveraged sanction for accounting fraud could be threatened against the board of directors or top managers. Instead of trying to identify individuals with the best information, which is by itself costly, the leveraged collective sanction could also be imposed against the firm. Firms as collections of employees and agents possess private information about accounting fraud. Hence, assuming that firms can investigate at lower cost than external enforcers, the costs of discovering information can be reduced by encouraging firms to cooperate with external enforcers and divulge relevant information.[211] Although some firms will cooperate voluntarily, many will not. Noncooperative firms can be persuaded to disclose information if the legal regime rewards disclosure. A sanction imposed

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[207] Ybarra v. Spangard, 154 P.2d 687, 688 (Cal. 1944).

[208] *See* Levinson, *supra* note 25, at 379. Although the sanction in *Ybarra* is structured as unconditional, effectively it was a conditional collective sanction that would not have been imposed if any member of the group cooperated with the authorities.

[209] This assumes no contractual (or other) restrictions that would limit the ability to require indemnification. In addition, Levinson notes that "[a]bsent any group solidarity, an individual group member will have little incentive to avoid sanctions because she will enjoy all the benefits of misconduct while expecting to pay only a fractional share of the cost of sanctions." *Id.* at 378.

[210] *See supra* Part II.A.3.

[211] If firms were able to sanction effectively wrongful employees, the step requiring disclosure of relevant information would not be necessary. Since firms' sanctioning is severely impaired, we need to rely on external enforcement agents to sanction individual wrongdoers. *See also supra* Part II.A.3.

unless the firm fully cooperates in the investigation will reward cooperation.[212]

Leveraged sanctions broaden the focus of the current debate from sanction optimality to superior deterrence, when a theoretically optimal liability regime is unworkable.[213] In other words, leveraged sanctions will result in more sanctioning for the same cost by enabling external enforcers to "make an extra effort to subject culpable individuals within the firm to liability."[214]

At first blush, leveraged sanctions appear similar to fault-based, mixed and composite corporate liability that Professors Arlen and Kraakman propose.[215] In both proposals, theirs and mine, a vicariously liable firm or group can lower its expected liability by reporting fraud and by cooperating with external enforcers.[216] Leveraged sanctions differ from their proposal in several ways.

First, leveraged sanctions as proposed here expand the list of possible targets of liability. While Arlen and Kraakman assume that only the firm can be vicariously liable for fraud, this Article suggests that leverage could also be used against knowledgeable insiders who can discover the identity of the wrongdoers and the nature of wrongdoing at lowest cost.

Second, Arlen and Kraakman develop a framework for corporate liability for all types of intentional wrongdoing; this Article proposes using leverage against the firm in cases of accounting fraud to reward after-the-fact reporting and cooperation. Accounting fraud differs from other types of intentional corporate wrongdoing in a number of ways. Most importantly, top managers are involved much more often than in other corporate crimes, rendering the firm's compliance efforts largely ineffective.[217] Thus, sanctioning the firm for accounting fraud should not depend on the firm's internal compliance, so long as the firm

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[212] Levinson calls this the "information-forcing feature" of collective sanctions. Levinson, *supra* note 25, at 379.

[213] *Cf.* Garrett, *Structural Reform Prosecution*, *supra* note 31, at 881-82 (observing that DOJ has "now firmly rejected an optimal deterrence approach to organizational punishment"); Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 217-22 (1993) (describing Sentencing Commission's departure from optimal deterrence model because of its inability to estimate probability of detection of particular crimes with any accuracy).

[214] Hamdani & Klement, *supra* note 72, at 304.

[215] *See* Arlen & Kraakman, *supra* note 80, at 687-88.

[216] *See id.* at 693, 726-30 (describing two-tier composite liability, which combines baseline vicarious corporate liability and large fault-based liability that can be avoided if firm discharges its policing duties).

[217] *See supra* Part II.A.2.

complies with regulation regarding internal controls, as mandated by the Sarbanes-Oxley Act and New York Stock Exchange ("NYSE") rules.[218] Determining the effectiveness of internal compliance mechanisms after the fact is costly both for the firm and external enforcers and is likely to produce hindsight errors.[219]

Third, Arlen and Kraakman's proposal requires a careful selection of the best liability regime, a precise calculation of the optimal sanction, and assumes judicial involvement. They concede that liability regimes they propose are difficult to administer,[220] prone to error,[221] and costly.[222] Leveraged sanctions, on the other hand, focus on the relationship between the firm and external enforcers, and assume a high likelihood of settlement with very limited judicial oversight, as is the case for all but a handful of accounting fraud suits and enforcement actions today.[223]

Finally, leveraged sanctions are primarily designed to increase individual deterrence, and not as an optimal corporate liability regime, which is difficult to do where most actions, public and private, settle. In addition, the usual rationales for vicarious corporate liability — internal monitoring, sanctioning, and providing employees with

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[218] For example, a majority independent board of directors, an independent audit committee, regular external audits, and internal audits.

[219] Meaning, the fact that fraud occurred proves, in hindsight, that internal compliance mechanisms were not effective.

[220] *See* Arlen & Kraakman, *supra* note 80, at 725, 730 (duty-based regime "would impose a significant administrative burden on courts . . . composite liability always forces a heavier informational burden on courts, and hence imposes larger administrative costs"); *see also* Baer, *Insuring Corporate Crime*, *supra* note 40, at 1051 (concluding that Arlen and Kraakman's proposal is costly and difficult to administer, because it assumes that court and enforcers' budgets can be increased, that courts and enforcers can develop clear performance standards and apply them transparently, and that courts can cheaply acquire accurate information about social costs of wrongdoing and likelihood of apprehension in each case).

[221] *See* Arlen & Kraakman, *supra* note 80, at 721 (conceding that strict liability coupled with evidentiary privilege for firms that adequately police wrongdoing over-sanctions those unlucky firms that get caught before they can come clean).

[222] *See id.* at 723 (conceding that duty-based "regime does impose a higher informational burden [than traditional strict liability]").

[223] It is true that judges approve settlement proposals, but the court's review is highly deferential. *See, e.g.*, Hester Indus., Inc. v. Tyson Foods, Inc., 160 F.3d 911, 916 (2d Cir. 1998); SEC v. Worldcom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003). Judge Rakoff's recent refusal to approve the settlement between the SEC and Bank of America and Merrill Lynch about pre-merger disclosure of bonuses to be paid to Merrill Lynch employees is a rare exception. *See* SEC v. Bank of Am. & Merrill Lynch, 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009).

incentives to avoid fraud — are weak in accounting fraud.[224] Rewarding firms for reporting wrongdoing after the fact and cooperating, on the other hand, has the ability to increase significantly deterrence of individual wrongdoing *ex ante* and produce efficiency gains through lower enforcement and sanctioning costs. The shareholders will bear *ex post* cooperation costs, but only if fraud has been committed. So long as spending is efficient,[225] diversified shareholders will directly benefit from the lower likelihood of accounting fraud that increased individual deterrence will produce.

B. Conditions for Superiority of Leveraged Sanctions

Leveraged sanctions should produce higher detection and sanctioning rates of individual wrongdoing than direct sanctions against individuals or firms in accounting fraud. Sanctions against individuals alone are inefficient when, for example, sanctions are imposed so infrequently that the aggregate sanction cannot reflect the social costs of the harm multiplied by the likelihood of sanctioning.[226] The death penalty or even life imprisonment for large scale accounting fraud are not acceptable sanctions in modern American society.[227]

In accounting fraud, leveraged sanctions can reduce the barriers to sanctioning. Although a leveraged sanction does not change the ability of dishonest managers to influence the decision on whether or not the firm will cooperate, it does change the cooperation calculus for the group making the decision on whether to cooperate. Because firms can

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[224] *See supra* Part II.A.

[225] Efficient spending in this context means spending in fraudulent firms divided by all firms. Although spending in a particular case of fraud might appear inefficiently high, it may be efficient across all firms because diversified shareholders benefit when the incidence of fraud falls.

[226] The social cost of accounting fraud is generally measured in the hundreds of millions, but few defendants have the resources to reimburse the losses, let alone multiply the losses by the likelihood of sanctioning. *See generally* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 210 & tbl.8 (reporting average financial penalties levied against individuals of $5.7 million); Karpoff et al., *Costs to Firms*, *supra* note 11, at 593 & tbl.6 (reporting median losses in firms that experience fraud of $380 million).

[227] Arguably, the 150-year sentence levied against the 72-year-old Bernard Madoff for defrauding investors in the largest Ponzi scheme to date is a life sentence. Some have argued that sentences in excess of 20 years imposed on Jeffrey Skilling and Bernie Ebbers amount to life imprisonment. *See* Moohr, *Of Bad Apples and Bad Trees*, *supra* note 69, at 1345 & n.12. Although sentenced individuals would spend the rest of their lives in prison, these sentences do not constitute life imprisonment per se. Also, it is unclear what moral justification exists for reducing the sentences of older offenders to avoid them dying behind bars.

obtain relevant information more cheaply, leveraged sanctions lower overall investigation costs.[228] Assuming at least some cooperation and disclosure, leveraged sanctions will lower the costs of sanctioning individuals.

The following sections describe in more detail the conditions under which leveraged sanctions will deter accounting fraud better than alternative regimes. They analyze the best target for leveraged sanctions, the type and size of sanction imposed, what constitutes cooperation, and the identity of the enforcer.

1. Target of Leveraged Sanction

When the enforcers can choose between several possible targets of leveraged sanctions, a number of considerations can affect the best choice of the target of liability. They include: (1) who is the person or group with the best information, and (2) what are the costs of threatening a leveraged sanction against that person or group. The discussion below will compare different potential targets for leveraged sanctions — the audit committee, the board, top management, or the firm.

Ideally, a leveraged sanction should be threatened against the individual or group that possesses private information about wrongdoing. The cost of acquiring and disclosing information is the lowest for the group that already possesses it. Alternately, a leveraged sanction can be threatened against a group that is in the position to obtain relevant information most cheaply.

One such group is the audit committee, which usually investigates allegations of reported accounting fraud, and has the skill and the ability to do so. Alternately, the entire board could be threatened with a leveraged sanction. Such a sanction could put significant pressure on individual committee or board members to investigate diligently, but there are several reasons that make adoption of an audit-committee or a board-level leveraged sanction less appropriate.

First, both groups will spend the firm's money, and not their own resources, to conduct the internal investigation. If individual board members are held liable for failure to cooperate, they have strong incentives to spend as much of the firms' money as necessary to remove the threat of their own liability, even when those expenses are excessive.

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[228] In addition to lowering investigation costs, leveraged sanctions shift those costs from external enforcers to firms. *See infra* Part III.C.3.b.

Even if we normatively believe that all wrongdoers deserve to be punished, it is usually inefficient to do so.[229] Although accounting fraud is socially costly, the marginal cost of investigation and enforcement expenses will eventually exceed the marginal benefit. At that point, any additional expenses will not efficiently increase deterrence levels. In addition, spending on internal investigation will be shifted to the shareholders, who do not benefit when the level of spending is inefficiently high. One caveat is in order. In the model that this Article develops, the investigation does not take place until after accounting fraud has been discovered and firms, thus, bear investigation costs only if their managers committed fraud. For diversified shareholders, the cost of an *ex post* internal investigation of fraud will also be diversified. Spending significant amounts in individual cases may not be socially wasteful because discovery and reporting individual wrongdoing deters fraud elsewhere, and it reduces moral hazard.

Second, leveraged sanctions, particularly criminal sanctions, against board members conflict with normative notions that sanctions should apply only to the morally blameworthy. While just desserts is less important in civil liability, it nevertheless strikes many as wrong to impose a sanction on an individual or a group that committed no transgression. It would raise concerns that leveraged sanctions are often imposed in error, on directors who are unable (instead of unwilling) to cooperate as demanded by external enforcers.

Finally, from a practical point of view, leveraged sanctions against the board or audit committee require legislative action and have a low likelihood of being adopted. These sanctions conflict with state-level indemnification and insurance provisions that compel firms to indemnify directors for any damages except those arising from a breach of good faith.[230] In addition, since competent independent directors or audit committee members are already in limited supply, subjecting them to leveraged sanctions for accounting fraud would further reduce their willingness to serve. Of course, firms could compensate them for the additional risk of liability.[231] Compensation demands by audit committee members could be useful since they would signal to the market how likely audit committee members

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[229] *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 207-09 (1968) (developing law and economics model of criminal sanctioning).

[230] *See* 8 DEL. CODE ANN. § 145(a) (2009).

[231] Note that the risk of liability is low. Targets of leveraged sanctions could avoid liability by disclosing information.

believe the firm is to engage in accounting fraud. But, risk-averse individuals will demand excessive payments.[232] Furthermore, increasing director compensation is politically problematic, particularly when executive compensation is a major political issue.[233] Finally, although only a fraction of audit committees would be subject to leveraged sanctions, compensation would likely increase in all firms, not just in those that commit fraud, so the market signal of compensation demands would be attenuated.[234]

Alternately, leveraged sanctions could be threatened against the top management team. Managers are involved in the overwhelming majority of cases of accounting fraud.[235] A leveraged sanction threatened against the top management team will likely include some individual wrongdoers and operate similarly as the *Ybarra* decision. If the group chooses to cooperate, individual culpable managers will be sanctioned. If, however, the group chooses not to cooperate, all top managers would be sanctioned. Innocent managers who remain silent would privately demand indemnification from those who were involved in fraud, producing higher levels of individual deterrence for accounting fraud. Agency problems and legal limits on bargaining that impede internal sanctioning when firms are liable for their employees' wrongdoing do not exist in private settlement negotiations among top managers.

Although threatening sanctions against top management would likely produce superior deterrence, they raise fairness concerns. To have bite, a leveraged sanction should not be indemnifiable. In that

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[232] *See* Black, Cheffins & Klausner, *supra* note 36, at 1055-56 (observing that outside directors are very rarely held liable to shareholders and that they overstate their exposure to liability).

[233] The Dodd-Frank Act of 2010, for example, included a number of corporate governance reforms aimed at curbing executive pay. *See* Jeremy L. Goldstein, *Some Dodd-Frank Executive Compensation Items*, HARV. L. SCH. F. ON CORP. GOV. & FIN. REG., (Aug. 12, 2010, 9:12 AM), http://blogs.law.harvard.edu/corpgov/2010/08/12/some-dodd-frank-executive-compensation-action-items/ (listing pay-related reforms directed at curbing executive pay, including say on pay, compensation consultant independence, compensation committee member independence, pay disparity disclosure, pay vs. performance, and clawbacks).

[234] *Cf.* Kraakman, *supra* note 30, at 865 (theorizing that managers will "demand a very large risk premium if they are simply paid outright for enduring even a small probability of catastrophic personal liability").

[235] *See* Prentice, *supra* note 49, at 782 & n.34. Karpoff and his collaborators report that in 788 enforcement actions they analyzed, 515 chief executive officers were involved, 723 of the top 3 executives, 1433 executives (including chief executives and other top 3 executives), and 773 other employees. Their findings suggest that top management is indeed virtually uniformly involved in accounting fraud. *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 210 & tbl.8.

case, requiring innocent managers to pay a substantial sanction because they cannot identify the wrongdoer (but the enforcer does not find their inability to disclose to be credible) may strike many as unfair. An additional concern is that the potential for threatened sanctions in the future will undermine the group solidarity necessary for effective management.[236] But group cohesion after members of the group committed fraud is hardly worth protecting. Threatening a leveraged sanction may produce superior *ex ante* monitoring among group members, which is not an undesirable outcome, given the limitations on internal monitoring.

Because top management is not a category with a set membership, managers will try to re-characterize themselves as middle management. Any such disputes are likely to increase the costs of sanctioning without improving the outcome. But the most serious disadvantage is that leveraged sanctions against management would require legislative action, both to extend liability for fraud to innocent managers and prevent indemnification or insurance from defeating leveraged sanctions. If managers who refuse to cooperate could shift liability to the firm (through indemnification) or their insurance company, the sanction will not deter.

Finally, the firm could face leveraged sanctions. In all cases of accounting fraud, someone at the firm will possess private information about the wrongdoing.[237] Threatening a sanction against the firm and its shareholders can induce the firm to search for that person. Leveraged sanctions against the firm will produce better results than vicarious liability, although several concerns should be addressed.

During an investigation of accounting fraud, the board or the audit committee will oversee the firm's response. They will hire outside

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[236] Levinson notes that leveraged sanctions can both undermine and solidify group solidarity. Levinson, *supra* note 25, at 378. Either result may be undesirable in a group of managers who must trust each other to work together effectively, but also question each other's moves to prevent excessive risk-taking. In addition, enhanced group solidarity will enhance the group's ability to pursue collective goods, not all of which may be desirable. *See id.* at 388-91.

[237] Most criminal fraud trials relied on cooperating witnesses to prosecute high-level managers. *See generally* Brickey, *Enron's Legacy*, *supra* note 187 (describing trial techniques in Enron and WorldCom trials). Another recent example includes the Lehman Brothers' use of Repo 105 transactions. The examiner's report tracks in painful detail what information even high-level managers had when they entered into fraudulent transactions. The report relied largely on cooperating witnesses and internal documents, e-mails, etc., to piece together the picture of fraud. *See* Report of Anton R. Valukas, Examiner, *In re* Lehman Brothers Holdings, Inc., et al., No. 08-13555(JMP) (S.D.N.Y. Mar. 11, 2010), *available at* http://lehmanreport.jenner.com/VOLUME%203.pdf.

attorneys and accountants to investigate, who will rely on insiders for information. To induce insider cooperation, outside investigators may need the help of the regulator such as providing immunity to lower-level participants in the fraudulent scheme. In addition, the board's incentives are not perfectly aligned with shareholders' interests. If a leveraged sanction is threatened against the firm, the shareholders benefit if the board cooperates, unless the cost of cooperation exceeds the benefit. When top management is suspected of wrongdoing, directors are faced with the choice of punishing their colleagues or doing nothing. If the firm is liable no matter what directors do, they have an incentive to do nothing. But if the firm can escape liability by cooperating with the government, or if the firm's liability is reduced, then the board has an incentive to cooperate. This incentive is limited to the extent that directors' net private benefit from cooperation exceeds the net private benefit of noncooperation. Cooperation may expose the board or individual board members to liability, while noncooperation does not when the sanction is threatened against the firm. If the board believes that they are vulnerable, they will not cooperate unless the alternative is worse. An example of "worse" is the "corporate death penalty" that might follow a criminal conviction (or indictment). In that case, if they cooperate, directors may be sued; if they refuse to cooperate, they lose their jobs and may be indicted themselves.

The risk of liability is generally overstated, and rational directors should understand that their personal risk of liability is very low, unless they were personally involved in fraud.[238] Refusing to cooperate may, in fact, expose directors to greater liability and will certainly communicate a disturbing signal to external enforcers and the firm's shareholders.

2. Type and Size of Sanction

In a leveraged sanctioning regime, there will ordinarily be two sanctions: one that is threatened against the firm and imposed if the firm does not cooperate, and a significantly lower sanction that is imposed if the firm does cooperate. This section argues that the sanction that is threatened should be substantial to be credible. The size of the sanction that is imposed if the firm does cooperate should be substantially smaller, but the ultimate size would depend on both the level and the cost of cooperation, and the benefit that the firm received from fraud.

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[238] Black, Klausner & Cheffins, *supra* note 36, at 1055-56.

Sanctions, leveraged or not, generally can be grouped into several categories: monetary and nonmonetary, civil and criminal, positive sanctions (i.e., rewards) and negative sanctions (i.e., penalties). Monetary sanctions are believed to be more efficient than nonmonetary sanctions because they are more easily tailored to optimal deterrence and do not require continued oversight for compliance.[239] Once the sanction is paid, enforcement ends, which is not generally the case with nonmonetary sanctions.

Leveraged sanctions can be civil or criminal. The differences include the attendant process, the frequency with which sanctions are imposed, and the collateral consequences of the sanction.[240] Criminal sanctions usually result in longer-term costs than civil sanctions, including imprisonment, disbarment, and the inability to conduct audits of public companies.

Leveraged sanctions need not be punitive. Although sanctions impose a cost on the wrongdoers or — in the case of leveraged sanctions — on noncooperative groups, sanctions could also be structured as rewards for those who cooperate.[241] For a leveraged sanction to be effective, the net benefit of cooperation must exceed the net benefit of noncooperation. If the benefit for cooperation takes the form of a reward (or bounty), the calculation of the net benefits to be compared can be difficult since many of the inputs — benefit of noncooperation, cost of cooperation — are not easily observable for external enforcers (who determine the size of the reward). If the reward is too small, it will fail to induce cooperation. If it is too large, external enforcers will overpay for cooperation. Since the group that is deciding whether to cooperate controls information about their private costs and benefits, it will selectively disclose those costs to increase the reward if the bounties are variable. But there is a more fundamental problem with rewards: the source of funding.

Better if the benefit for cooperation takes the form of a cost avoided, in other words, a leveraged penalty.[242] An excessively large leveraged penalty will induce the same level of cooperation as one that is less

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[239] *See* Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409, 410 (1980) (arguing that sufficiently large fines deter as well as imprisonment and are cheaper to administer).

[240] *See generally* Fischel & Sykes, *supra* note 23, at 330-33 (describing why civil entity sanctions are usually preferred to criminal entity sanctions).

[241] *See* Hamdani & Kraakman, *supra* note 145, at 1678-80.

[242] Although economists usually treat financial benefits equally with avoided costs, individuals making the decision are loss averse and are subject to diminishing marginal utility of money. *See* Kahneman & Tversky, *supra* note 148, at 288 (demonstrating that individuals are risk averse).

severe (but still large enough to induce cooperation).[243] In contrast to the oversize bounty, an overlarge penalty is not inefficient because the firm will cooperate to avoid the penalty. A threatened leveraged penalty that is too small, however, will fail. When threatened with a sanction that is too small, the board of directors might opportunistically accept the "settlement offer," but fail to investigate fraud or shift the sanction to those responsible.[244]

The conclusion that an outsize leveraged penalty will produce the same level of cooperation and deterrence as a closely fitted leveraged penalty assumes that cooperation is binary, which may be unrealistic. Some firms may prefer to cooperate as little as possible, choose a scapegoat to blame, and reap the benefits of cooperation.[245] To some extent, external enforcers are able to control strategic cooperation. Enforcers are usually able to compare independently the quality of cooperation by comparing information that is already available with information provided by the firm. In addition, external enforcers can find out whether the scapegoat feels himself to be wholly responsible. Federal prosecutors, for example, have used immunity agreements and proffers to build cases against higher-level employees involved in fraud.[246] Finally, external enforcers can condition the sanction avoidance on continued cooperation, or withhold their blessing until later in the investigation.[247]

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[243] Expected benefit from cooperation is reduced by the cost of cooperation, i.e., conducting an internal investigation, reviewing internal accounting documents to discover wrongdoers, interviewing employees. *See* discussion *infra* Part III.C.1.

[244] In that case, a leveraged sanction will merely replicate the problem with vicarious corporate liability for accounting fraud. *Cf.* Hamdani & Klement, *supra* note 72, at 298 (arguing that lawmakers should limit entity-level penalties to "monetary fines that would not trigger firms' demise"). Hamdani and Klement assume that the firm will always be sanctioned when its employees commit crime on the job. The assumption is unrealistic because federal prosecutors rarely impose firm-level sanctions. More problematically, the assumption leads them to propose that lawmakers limit the conditions under which firms could be held criminally liable. The analysis in this Article suggests that firms should be subject to liability quite often: not only for wrongdoing that they could prevent and sanction, but for wrongdoing that they cannot prevent nor sanction, provided that they can obtain relevant information more cheaply than can external enforcers. *See id.* at 298-99.

[245] *See* Brown, *supra* note 181, at 534-36.

[246] *See, e.g.*, Brickey, *Enron's Legacy*, *supra* note 187, at 268-70 (describing how federal prosecutors offered WorldCom's former chief financial officer Scott Sullivan plea agreement in exchange for cooperation against WorldCom's chief executive Bernie Ebbers).

[247] Deferred prosecution agreements often condition lowered or waived firm-level sanctions on continued cooperation. *See, e.g.*, Garrett, *Structural Reform Prosecution*, *supra* note 31, at 881, 889-90, 899 (identifying Thompson Memorandum as example

One concern with outsize leveraged penalties is that the external enforcer can use them opportunistically and demand excessive cooperation. In accounting fraud, the group paying for investigation, the shareholders, is not the same group deciding whether to cooperate.[248] If the external enforcer threatens the firm with liquidation, the board of directors may decide to overspend on cooperation, depending, of course, on the discount offered for cooperation. The greater the discount and the lower the cost of cooperating, the more valuable is the decision to cooperate. In a civil regime with civil sanctions, the problem is smaller than in a criminal regime, and there are fewer collateral consequences. In addition, since a firm would spend on compliance only after fraud was discovered, high spending in an individual investigation does not imply overdeterrence for diversified shareholders. So long as the marginal benefits of reduced accounting fraud across all firms exceed the marginal cost of spending in firms that are victims of fraud, even very high levels of spending on cooperation will be efficient.

Another concern is that if a board of directors perceives the leveraged penalty as overly severe and if the sanction would produce significant collateral consequences, a risk-preferring board of directors might act strategically and call the perceived bluff. Then, the external enforcer would have to choose whether to impose the threatened sanction (which harms many innocent corporate stakeholders) or to settle for a lesser sanction with fewer collateral consequences. But, boards are unlikely to wager the firm's future. Boards will face intense pressure from innocent managers and employees to fold.[249] A board that wagers the firm and loses will face lawsuits. A board willing to risk the firm's continued existence must have a lot to hide, suggesting that wrongdoing is pervasive. If the firm is rotten through and through, then it should be liquidated.[250]

3. Cooperation and Waiver

Cooperation will generally require disclosing private information about accounting fraud. Information will include internal accounting documents, memoranda, e-mails and other messages, and minutes of

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of conditioning sanction avoidance on cooperation with investigators).

[248] This is true whether sanctions are threatened against the board of directors, top management, or the firm. *See* discussion *supra* Part III.B.1.

[249] This assumes that individuals know the extent of collateral consequences that the sanction will cause. It is hard to imagine that external enforcers will allow this ignorance to persist.

[250] *See* discussion *infra* Part III.C.1.

meetings. It will often also require the firm to identify individuals who were involved.

Although candid cooperation will be cheaper than stonewalling and obstruction,[251] it is not costless. Therefore, a leveraged sanction regime for accounting fraud will need to adjust for the increasing marginal costs of cooperation and waive the sanction before those costs become excessive. Waiving the sanction sufficiently early will produce other desirable consequences. Because external enforcers have mechanisms that lower individuals' cost of cooperation (i.e., immunity, pleas, and settlements), they may be better able to induce cooperation by individuals identified in the internal investigation than the firm. For example, while the firm can persuade employees to cooperate with the investigators by threatening job loss, external enforcers can offer immunity, plea bargains and settlements, bounties, and so forth. As a result, the optimal level of cooperation from the external enforcers' perspective will not be unlimited cooperation, but rather cooperation to the point where external enforcers can continue with the investigation more cheaply than can the firm. Often, the level of cooperation needed to start an investigation against individuals will be relatively small.

4. Identity of External Enforcer

The Article assumes that the external enforcer will pursue superior deterrence of accounting fraud but not maximum recovery. Public enforcers, not private plaintiffs, are best suited to be the external enforcer, despite the risk of capture. Superior deterrence in accounting fraud results from increased liability shifting to dishonest employees. Private litigants pursue maximum recovery and as a result usually settle with the firm alone as the deep pocket. If firms forced dishonest managers to internalize the cost of their own wrongdoing, then private litigation pursuing maximum recovery would also produce optimal deterrence. But, as shown above, liability shifting to individual fraudsters is a rare exception to the general practice of no individual liability (beyond the sanction of termination).[252]

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[251] Effective stonewalling usually requires hiring clever and expensive legal counsel.

[252] *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 209-10, 210 tbl.8 (showing that most fraudulent managers identified in SEC and DOJ enforcement actions were fired, but small minority were criminally sanctioned or paid out-of-pocket fine).

Private plaintiffs usually pursue the maximum damage award at the lowest litigation cost.[253] They are not concerned with deterrence and enforcement policy.[254] Under a vicarious liability regime for accounting fraud, private plaintiffs and their lawyers have the financial incentive to settle with the firm and have the firm (and its insurer) pay.[255] Private plaintiffs are likely to recover more and to recover faster if they settle the case with the firm alone, instead of insisting that dishonest managers contribute to the settlement.[256]

Closer judicial scrutiny of settlement agreements (akin to scrutiny of fraud settlements with the SEC) could improve the capacity of securities litigation deter individuals, but may require legislative reform to implement.

Alternately, Professor Amanda Rose has proposed an "oversight approach" to securities litigation, that would allow the SEC to screen which class actions should proceed and against whom.[257] This approach could be used effectively with leveraged sanctions not only to "mut[e] the overdeterrence threat of private litigation,"[258] but also to increase deterrence of individual wrongdoing. Similar to allowing firms to reduce their liability by identifying the wrongdoers, the SEC screen would require legislative action.

Without legislation that would replace vicarious corporate liability in securities fraud class actions with leveraged civil liability, leveraged sanctions for accounting fraud require involvement of public enforcers. Public enforcers are primarily interested in maximizing deterrence, while recovery is less important. The SEC, for example, has recovered billions of dollars in disgorgements and fines for securities violations, yet none of the money has been added to its budget.[259] Instead, it is

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[253] *See* Rose, *supra* note 7, at 1337-38.

[254] *See* Richard A. Bierschbach & Alex Stein, *Overenforcement*, 93 GEO. L.J. 1743, 1777 (2005).

[255] *See* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1550 (reporting that secondary defendants, including individual wrongdoers, contribute only 0.4% of securities fraud class action settlement amounts).

[256] *See* Black, Cheffins & Klausner, *supra* note 36, at 1102-04; Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1549-50.

[257] *See* Rose, *supra* note 7, at 1305-06.

[258] *Id.*

[259] *See* Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* 14 (Georgetown Law Research Paper No. 1475433, 2009), *available at* http://ssrn.com/abstract=1475433 [hereinafter Langevoort, *Three Narratives*]. In 2008 alone, the SEC obtained orders against securities violators to disgorge $774 million and pay additional $256 million in fines. SEC, SELECT SEC AND MARKET DATA 2 (2009), *available at* http://sec.gov/about/secstats2008.pdf/. Although not all of the disgorgement orders and fines were successfully collected (collection rates ranged

paid to the Treasury and included in the general fund. As a result, the SEC has no direct financial incentive to forego pursuing individuals to increase the fine paid by the firm.[260] Public enforcers also are better able to adjust the leveraged sanction to fit the offense. The SEC can engage in "discretionary nonenforcement" against those who commit accounting violations in letter but not in spirit.[261]

Although public enforcers are better able to deter, commentators have identified several problems with public enforcement. Public enforcers have limited budgets, and Congress (or state legislatures) control those budgets. Langevoort observes that until after the scandals in 2000–2002, the SEC had been underfunded for years.[262] The underfunding was the product of "a government-wide, anti-regulatory philosophy."[263] Furthermore, public enforcers are more likely to be captured by the groups they regulate than dispersed private enforcers. But Professor Matthew Stephenson argues that concerns about capture have been overblown and that "public interest" considerations play an important role in public agency decision-making.[264] Finally, in order to appear tough on fraud, the SEC has in the past focused on the company instead of the individuals. "If you want to get the company to sign on the dotted line and show how quickly you are moving, you go for the company," said Edward Fleischman, a former SEC commissioner, adding that the SEC "will get more pushback if [it] go[es] after the individual."[265]

Despite the problems with public enforcement, employing leveraged sanctions should produce better deterrence of individual wrongdoing.

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from 40% in 2003, 82% and 86% in 2006 and 2004, to 96% in 2005). SEC, FY 2008 PERFORMANCE BUDGET 157 (2009), *available at* http://sec.gov/about/2008budgetperform.pdf. SEC's 2008 budget totaled $906 million while its 2009 budget was $913 million. SEC, IN BRIEF: FY 2009 CONGRESSIONAL JUSTIFICATION 2 (2008), *available at* http://sec.gov/about/secfy09congbudgjust.pdf.

[260] The SEC could use large recoveries as a bargaining chip for a budget increase, but there is no evidence to support this contention. SEC's limited enforcement resources are usually cited as the reason why the agency so rarely investigates and sanctions dishonest managers in large firms. *See* Langevoort, *Three Narratives*, *supra* note 259, at 8-9.

[261] *See* William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 38 (1975).

[262] *Cf.* Langevoort, *Three Narratives*, *supra* note 259, at 14 (describing underfunding of SEC as result of belief in self-correcting abilities of market).

[263] *Id.*

[264] *See* Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 131 (2005).

[265] Michael Corkery & Susanne Craig, *Judge Forces SEC to Defend Its Tougher Tack*, WALL ST. J., Aug. 7, 2009, at C3.

Moreover, since leveraged sanctions reduce enforcement costs, and then shift some of those costs to firms, public enforcers can pursue significantly more wrongdoing without increased budgets.

C. Rebuttable Limitations

Several objections are likely. Management shills aside, some might argue that it is unjust and inefficient to allow the firm to avoid liability by "ratting out" its employees after fraud has been discovered. Fraud might be pervasive in the firm, so the firm should be sanctioned. In addition, where fraud is not pervasive, it may appear unfair for some individuals to be sanctioned but not the masterminds. Finally, some may contend that leveraged sanctions are costly, produce errors, and deter managers from pursuing desirable business activities to avoid the risk of liability. The following sections elaborate on the objections and reject them.

1. Pervasiveness of Wrongdoing

One common objection to reducing corporate liability is that sometimes firms should be punished, and I agree.[266]

Hamdani and Klement argue, using the lens of game theory, that imposing a severe penalty against the firm will improve deterrence when wrongdoing is pervasive, but not otherwise (assuming that shareholders cannot monitor individual employees).[267] If individual employees are unable to monitor effectively each other to prevent fraud, and if the penalty for fraud of one individual is firm dissolution, then individual employees will have an incentive to commit fraud themselves (to the extent that private benefits of fraud exceed costs). So imposing firm dissolution on all firms (without excuse) will increase the likelihood that any individual employee will commit fraud. If, however, dissolution is limited to those cases of fraud where fraud is pervasive, then the pervasive effect of the sanction is eliminated.[268] Pervasive wrongdoing suggests that the firm completely neglected its duty to monitor and police employees. In effect, the firm

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[266] *See, e.g.*, Lawrence Friedman, *In Defense of Corporate Criminal Liability*, 23 HARV. J.L. & PUB. POL'Y 833 (2000) (arguing that retribution is important goal for imposing criminal liability on corporations); William S. Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability*, 37 AM. CRIM. L. REV. 1285 (2000) (arguing that moral blame should play role in deciding whether corporations should be held criminally liable).

[267] *See* Hamdani & Klement, *supra* note 72, at 293-94, 302.

[268] The authors concede that "pervasiveness" may be difficult to define. *Id.* at 302-03.

encouraged and rewarded their wrongdoing.[269] When wrongdoing is pervasive, the firm — as well as the culpable individuals — should be punished without the opportunity to eliminate liability for cooperation, and leveraged sanctions should be employed with caution (or not at all).

2. Institutional Influence

Another argument against shifting the bulk of liability from the firm to individual employees is that "[i]nstitutions influence people in ways that sometimes make it rational to blame institutions for what people do."[270] Professor Lisa Griffin adds that "[i]t is not clear . . . that the converse is true."[271] Division of labor within a firm diffuses responsibility, so it would be unjust to hold "select midlevel employees accountable for widespread practices within the institution."[272] Griffin's concern about holding individual employees liable for wrongdoing that involved others who will not be similarly sanctioned is well taken. Ideally, all individuals involved would be sanctioned with sanctions calculated relative to their level of culpability and involvement in wrongdoing. But, superior deterrence can also be achieved by singling out some individuals and punishing them severely, deterring others from engaging in similar conduct. Moreover, there is little evidence that DOJ and SEC target mid-level employees while letting top managers escape without any sanction.[273]

The purpose of leveraged sanctions for accounting fraud is to increase the likelihood that dishonest managers will be sanctioned. For top management, the argument that institutional pressure caused

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[269] *Id.* at 302.

[270] Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 491 (2006). William Laufer has written extensively about the moral culpability of corporations and the ability of firms to have criminal intent. *See, e.g.*, Laufer, *supra* note 25, at 1351-52 (tracing historical progression of corporations as individuals with moral culpability and ability for criminal intent); Laufer & Strudler, *supra* note 266, at 1287-88 (proposing for corporations "constructive standard of liability and culpability" that captures moral fault of actor); *see also* Friedman, *supra* note 266, at 833 (noting that society thinks of corporations as real corporeal persons and, thus, should be held to similar standards of action with imposition of criminal liability).

[271] Griffin, *supra* note 31, at 332-33.

[272] *Id.*

[273] Professor Karpoff's research is useful: SEC and DOJ fraud enforcement actions targeted 2,206 individuals. Of those, about one third occupied one of top three positions within the firm (CEO, Chairman or President), and only about one third were non-executive employees. Karpoff et al., *Consequences to Managers*, *supra* note 10, at 210 & tbl.8.

them to misrepresent earnings is frivolous: they are the institution. Incentive-based compensation may have increased the potential benefit of fraud, but top management can always choose honesty.

Although managers devise the accounting fraud scheme, they usually delegate at least some of the tasks. Their subordinates, who complete those tasks, may not know that they are participating in fraud because they believe the figures are accurate. On the other hand, subordinates who are pressured into committing accounting fraud are not innocent of fraud. Like the managers, they responded to incentives, even if the reward was small. We may feel sympathy, but a subordinate who commits fraud as a result of superior's pressure has made an economic calculation of the costs and benefits of her actions and decided that the perceived benefits exceed the perceived costs.

To reduce scapegoating of lower-level employees, the external enforcers should try to distinguish misled mid-level employees from those who chose to participate in the scheme, by closely questioning those involved and comparing testimonies with other available evidence. Even where the mid-level employee was involved, greater authority should require greater punishment. In addition, the external enforcers should stay focused on the most likely source of fraud: managers, not mid-level employees. But, public enforcers look for the kingpin, so this risk is small.

3. Costs: Of Errors, of Overdeterrence, of Cooperation

a. Errors

The most common critique against the use of leverage in criminal law suggests that it produces errors.[274] The firm may pursue individual wrongdoers (over)zealously after fraud has been reported. In addition to overspending on compliance, the firm's zealousness, reinforced by a leveraged sanction, might also produce identification errors: the hapless clerk who input cooked numbers can be reported to external enforcers as a member of the scheme. Ordinarily, the individual could exonerate herself by coming clean, but her access to relevant sources of information and documents to support her statements may be limited.

In addition, when sanctioning of individuals identified as fraudsters is severe, the accused individuals may be more willing to settle for a lower sanction than risk a much higher sanction at trial.[275]

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[274] *See* Levinson, *supra* note 25, at 386-87.

[275] *Cf.* Ronald F. Wright, *Trial Distortion and the End of Innocence in Federal Criminal Justice*, 154 U. PA. L. REV. 79, 93-94 (2005) (observing that defendants plead

Commentators have expressed concern about errors in accounting fraud criminal trials.[276] They claim that juries convict managers of crimes carrying a punishment of decades in prison for presiding over companies that went bust and not for having engaged in accounting fraud. To avoid that fate, they claim, innocent individuals plead guilty to accounting fraud to avoid a worse fate at trial.[277]

There is only modest anecdotal data suggesting that many errors occur.[278] Individuals' perception of their own guilt or innocence affects their willingness to accept a plea bargain. Innocent defendants tend to reject plea offers that guilty defendants accept, and that "the concern over the innocence problem may be exaggerated."[279] In accounting fraud cases in particular, very few individuals will share the usual characteristic that increases the pressure to accept a plea: a prior criminal record.[280]

In addition, this Article proposes leveraged sanctions as a *superior* alternative to vicarious liability and not as an *optimal* sanctioning regime. Vicarious corporate liability produces large errors, namely that culpable agents avoid sanctioning. Under the existing regime, few dishonest managers are sanctioned. A shift to a leveraged sanctions regime would vastly reduce the number of false negatives (wrongdoers who are not sanctioned) at the cost of perhaps some false positives (innocent who are sanctioned).[281] While the ratio is not clear *ex ante*,

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guilty to avoid severe sentencing at trial even when evidence supporting plea is thin).

[276] *See, e.g.*, Sarah Ribstein, Note, *A Question of Costs: Considering Pressure on White-Collar Criminal Defendants*, 58 DUKE L.J. 857, 858-59 (2009) (describing case of Jamie Olis, executive of Dynegy, who, convinced he had done nothing wrong, refused to plead guilty, but was found guilty at trial based on his boss's testimony and sentenced to twenty-four years in prison). Olis successfully appealed his conviction, and his sentence was reduced to six years on remand. *See* United States v. Olis, No. H0321701, 2006 WL 2716048, at *13 (S.D. Tex. Sept. 22, 2006).

[277] *See* Ribstein, Note, *supra* note 276, at 858-59.

[278] *See id.* at 858. It is also possible that individuals only claim to be innocent, or that they should have known that they were involved in accounting fraud, but turned a blind eye or refused to learn that their actions constituted accounting fraud. As the Latin saying goes, *Ignorantia iuris nocet.*

[279] Avishalom Tor, Oren Gazal-Ayal & Stephen M. Garcia, *Fairness and the Willingness To Accept Plea Bargain Offers*, 7 J. EMPIRICAL LEGAL STUD. 97, 113 (2010).

[280] *See* Josh Bowers, *Punishing the Innocent*, 156 U. PA. L. REV. 1117, 1121 (2008) (observing that "most innocent defendants are probably recidivists").

[281] Although Karpoff and his collaborators conclude that guilty managers do not walk free — the vast majority lose their jobs — their study does not suggest that guilty managers do not, on net, benefit from accounting fraud. This is so because the authors do not include benefits from accounting fraud in their model, only costs that discovered guilty managers suffer. *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 213.

experimenting with leveraged sanctions on a smaller scale may yield a satisfactory answer. Finally, although normatively we might prefer that no innocent individual will be sanctioned, in fact the legal system allows for sanctioning errors.[282] The burden of proof to prevail at trial is not certainty, but beyond a reasonable doubt, clear and convincing evidence, or preponderance of the evidence, depending on the nature of the suit. The lesser burdens of proof are employed precisely because of our shared belief that culpable or guilty individuals should be sanctioned. The legal system is willing to risk some erroneous sanctioning in order to reduce the number of culpable individuals who avoid sanctioning.

Finally, the concern about sanctioning errors can undermine the credibility of a sanctioning regime. If errors threaten to undermine the sanctioning system's credibility, there are a number of ways to reduce the likelihood and costs of errors. First, the *scienter* requirement for finding of liability in court could be increased.[283] If it is more difficult for external enforcers to prevail at trial, they will be less likely to play hardball at the settlement stage.[284] Second, guilty pleas and settlements with individuals could be subjected to more searching judicial review when the product of a leveraged firm-level sanction. Third, employing leveraged firm-level sanctions in a civil instead of a criminal regime would likely reduce the sanctions on individuals (albeit coupled with increased likelihood thereof). A public civil enforcer is more likely to employ civil sanctions against identified individuals than is a federal prosecutor, who operates with the criminal toolbox in mind. When the stakes are lower, innocent individuals are also less likely to be coerced into settling.

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[282] We even allow for error in death penalty cases. Although death-row inmates have a right to virtually unlimited appeals of their case, our legal system sometimes puts to death innocent individuals. The most recent alleged example is the case of Cameron Todd Willingham, who was sentenced to death for arson. An independent investigator tested trial evidence and concluded that the evidence was misrepresented, finding it more indicative of arson than reasonably could be determined. *See* David Grann, *Trial by Fire: Did Texas Execute an Innocent Man?*, NEW YORKER, Sept. 7, 2009.

[283] The U.S. Supreme Court has defined *scienter* for the purposes of 10b-5 class actions as "a mental state embracing intent to deceive, manipulate, or defraud." Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 (2007); *see* Arlen & Carney, *supra* note 5, at 705 & n.72.

[284] *See* Robert Cooter & Stephen Marks with Robert Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 246 (1982).

b. Overdeterrence

Because leveraged sanctions increase individual sanctioning, risk-averse managers could shy away from not only fraud, but also productive activities that might expose them to risk of liability.[285] Particularly if the threatened sanction is imprisonment and loss of livelihood, risk-aversion would affect managers' behavior.[286]

Unlike overly optimistic statements about future performance of the firm, earnings misstatement, the most common type of accounting fraud, involves making false statements about historical facts. It requires that the defendants know the truth and misstate it.[287] Because firms already employ accountants, risk-averse managers can easily confirm *ex ante* that their actions are lawful.

In addition, there is no social value in aggressive accounting. Economic value comes from productive activity, while accounting merely describes that activity. *A fortiori*, accounting fraud, such as moving liabilities to off-balance-sheet entities, does not create real economic value.[288] It merely gives the appearance of financial health. The appearance of financial health will attract capital, depriving worthier projects of funding. If increased expected liability of managers produces risk-averse accounting, this is not an undesirable outcome.

If accounting is transparent to capital markets, then the style of accounting, whether aggressive or meek, has no impact. A number of empirical studies indicate that capital markets poorly interpret

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[285] Alberto Gonzales, the former Attorney General, stated in an address to general counsel that "overreaching exercise of investigatory and prosecutorial powers — in addition to being unjust — can create its own problems, through overdeterrence." Alberto R. Gonzales, Attorney General, Prepared Remarks at the National Legal Center General Counsel Conference (May 10, 2005), *available at* http://www.justice.gov/archive/ag/speeches/2005/051005aggeneralcounsel.htm.

[286] *See* Hurt, *supra* note 73, at 369; Larry E. Ribstein, *The Perils of Criminalizing Agency Costs*, 2 J. BUS. & TECH. L. 59, 61 (2007) ("Cautious managers will want to stay very far away from conduct that has even the slightest chance of landing them in jail."); Richard A. Epstein, *The Deferred Prosecution Racket*, WALL ST. J., Nov. 28, 2006, at A14 (arguing that deferred prosecution agreements often read like "confessions of a Stalinist purge trial"). Brown observes that critics of the current criminal enforcement regime likely "conflated potential criminal liability with actual practice." Brown, *supra* note 181, at 525; *see also* Arlen & Carney, *supra* note 5, at 705-06, 705 n.72 ("[O]verdeterrence is less of a concern in fraud cases (particularly where the firm is concealing bad news) because the social value of the grey region separating the legal from the illegal is dubious.").

[287] *See* Arlen & Carney, *supra* note 5, at 705 & n.72.

[288] *See id.* at 705 ("Fraud on the Market produces substantial social costs and yields no social benefit.").

accounting.[289] Thus, aggressive firms will attract capital at the expense of meek firms. Even if aggressive accounting does not indicate recklessness more generally, this allocation of capital is inefficient. Any reduction in aggressive accounting will produce more efficient capital markets. Additionally, the extra cost of creating misleading financial statements will be saved, increasing returns at firms that would have used aggressive accounting. Hence, increasing the liability for accounting fraud will reduce internal costs, investor research costs, and produce more efficient capital markets.

c. Cooperation

A final concern is that the regime would produce overspending on cooperation. It would require firms, and indirectly their shareholders, to spend resources after already having suffered losses from accounting fraud. While the concern should not be dismissed lightly, this Article argues that improved deterrence of fraud would lower the overall costs of fraud and ultimately benefit diversified investors.

From a social point of view, leveraged sanctions reduce enforcement costs in individual cases because firms can discover relevant information about accounting fraud more cheaply than can external enforcers. If the number of investigations increases, then the total social cost of investigation will rise, but that cost will be offset by lower social costs of fraud, produced by improved deterrence of individuals.

Leveraged sanctions would redistribute some enforcement costs from external enforcers to firms, thereby reducing those shareholders' returns. However, so long as marginal benefits of reduced fraud exceed the marginal costs of additional enforcement, individual shareholders will benefit from leveraged sanctions. Because fraud is very costly and because diversified shareholders will pay for cooperation only when fraud has occurred (and not *ex ante*), overall leveraged sanctions should increase return on capital by reducing the incidence of fraud.[290]

Finally, the firm's cooperation is efficient only to the point where it is cheaper than external investigation. Often, after obtaining initial

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[289] *See* Dechow & Skinner, *supra* note 50, at 9-13 (including empirical studies cited therein and demonstrating that investors respond irrationally to firms that miss earnings targets).

[290] Studies after Sarbanes-Oxley suggest that shareholders' returns improved after regulation that, among other things, increased sanctions for accounting fraud. *See, e.g.*, Coates, *supra* note 26, at 92-93, 107-08 (including works cited therein and explaining that costs are declining over time).

information about the identity of wrongdoers and documentary evidence about their involvement, external enforcers should be able to take over and continue the investigation at lower cost than the firm. This is so because external investigators usually have at their disposal tools unavailable to firms, including the subpoena power.

IV. IMPLICATIONS

Vicarious corporate liability, as employed by private plaintiffs and the SEC, severely underdeters individual wrongdoing and increases the pressure on federal prosecutors to pursue zealously individual wrongdoers criminally.[291] This Article proposes leveraged sanctions as a means to improve civil liability, instead of continued reliance on criminal enforcement, and suggests that the SEC should be the primary agency to deploy leveraged sanctions. This Part proposes a roadmap for implementing leveraged sanctions through the SEC. Some aspects of leveraged sanctions would require legislative action, such as threatening sanctions against the board of directors or management, but modest yet effective reforms do not require a change in the law.

The SEC rarely uses leverage, though there exist no legal impediments.[292] Section 36 of the Securities Exchange Act allows the SEC to "exempt any person . . . from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."[293] The SEC already has at its disposal a variety of monetary and nonmonetary sanctions to threaten firms and has the authority to waive or reduce sanctions against firms to secure their cooperation.

To test this regime, the SEC could employ leveraged sanctions where it appears that the firm had proper monitoring and compliance systems in place, yet accounting fraud nevertheless occurred. Careful selection would shift the focus of the investigation from structural reforms (the effectiveness of which is unclear) to cooperation.[294]

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[291] *See* Langevoort, *The Impact on Director and Officer Behavior*, *supra* note 38, at 90; *see also* Fischel & Sykes, *supra* note 23, at 321.

[292] *Cf.* Coffee, *Reforming Securities Class Action*, *supra* note 5, at 1582-84 (discussing that SEC need not find firm liable under Rule 10b-5; it can use its discretion to assign liability).

[293] Securities Exchange Act of 1934 § 36(a)(1), 15 U.S.C. § 78mm(a)(1) (2006).

[294] *Cf.* Baer, *Governing Corporate Compliance*, *supra* note 123, at 949-50 (observing that compliance efforts have not reduced incidence of fraud); Garrett, *Structural Reform Prosecution*, *supra* note 31, at 860-61 (arguing that structural reform

Where the conventional rationale for sanctioning the firm is absent (i.e., failed monitoring), the SEC could threaten a significant leveraged firm-level sanction, like a sizeable fine, deregistration, or a trading suspension, unless the firm cooperates. While some firms will cooperate without prodding, leverage will persuade additional firms to cooperate. The SEC could then use the information obtained to sanction the individuals.

A few words of caution. The public enforcer must understand the underlying dynamics of a leveraged sanctioning regime. First, culpable management will try to scapegoat lower-level individuals as the sole wrongdoers. The investigator should take such claims with a grain of salt. Second, the SEC should impose the threatened sanction if the firm fails to cooperate. While a trading suspension, for example, is a serious sanction, the collateral consequences of the sanction are likely to be relatively minor, particularly compared to criminal sanctions, and the shareholders rather than the employees will largely suffer from such consequences. In addition, a trading suspension can be lifted as soon as the firm remedies the problem. Third, some fraud will require the involvement of criminal investigators and the SEC should defer when appropriate. Fourth, achieving an effective level of individual deterrence may require increasing the SEC's budget and staffing levels. Currently, the SEC pursues only a small percentage of accounting frauds.[295] This is not the product of capture or institutional incompetence, but of the SEC's limited enforcement resources and understaffing.[296] The SEC's budget and staffing increases over the last three decades have not kept pace with the increase in the number of public companies the agency oversees, or the incidence of accounting fraud.[297] Although leveraged firm-level sanctions will reduce enforcement costs in individual cases, if the number of cases the SEC investigates increases dramatically (and it should), then its enforcement budget must likewise increase. Finally, leveraged sanctions are most effective and less costly for those wrongs that do not benefit the firm. Where the firm benefits from employee wrongdoing or fails to implement effective compliance measures, the sanction should be reduced, but not waived completely.

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prosecutions are abusive).

[295] *See* Cox & Thomas, *supra* note 39, at 763 (reporting that SEC pursued only 37 out of 248 of settled — not dismissed — securities fraud cases between 1990 and 2001).

[296] *See* Langevoort, *Three Narratives*, *supra* note 259, at 14-16.

[297] *See* Karpoff et al., *Costs to Firms*, *supra* note 11, at 586 & tbl.1 (reporting that number of restatements increased from 2 in 1978 to 246 in 2002).

Critics will argue that unrestrained discretion by the SEC results in overdeterrence and chills desirable business activities. But this Article shows that overdeterrence in accounting fraud is largely illusory. Increased likelihood of individual liability for accounting fraud will also cause individuals and firms to engage in less aggressive accounting, which is not *per se* an undesirable outcome.

Since corporate fraud is very costly with significant collateral consequences,[298] criminal sanctions, including imprisonment, must be available, in particular for the most serious frauds. Corporate fraud offends deeply held moral beliefs of the community. It is an intentional act or series of acts that usually lasts a long period of time[299] and has serious collateral consequences for the firm and often the economy.[300] It is committed by "talented, bright, highly educated, successful people, who have 'made it,' "[301] motivated by greed, opportunity, a sense of entitlement, and arrogance.[302] The victims' expectation that fraudulent managers will be found guilty and imprisoned is not irrational, as one commentator implied;[303] rather, it is consistent with the normative nature of law.

CONCLUSION

The empirical evidence of accounting fraud suggests that firms overpay for liability and overspend on internal compliance mechanisms that are generally ineffective at preventing fraud. On the other hand, individuals who commit accounting fraud are rarely sanctioned for their wrongdoing, which produces moral hazard and individual underdeterrence.

Most proposals have focused on reducing the costs of fraud liability to firms, but have neglected individual deterrence. Yet, accounting fraud cannot be deterred effectively without liability shifting to responsible individuals, usually the managers.

To sanction dishonest managers, private and public enforcers need information about their identity, which may be prohibitively costly to

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[298] That is, fraud itself produces severe collateral consequences, not just enforcement of fraud.

[299] *See* Karpoff et al., *Consequences to Managers*, *supra* note 10, at 202 (reporting average violation period of 27.4 months).

[300] *See* Karpoff et al., *Costs to Firms*, *supra* note 11, at 581.

[301] Pamela H. Bucy, Elizabeth P. Formby, Marc S. Raspanti & Kathryn E. Rooney, *Why Do They Do It?: The Motives, Mores, and Character of White Collar Criminals*, 82 ST. JOHN'S L. REV. 401, 401 (2008).

[302] *Id.* at 406-07.

[303] *See* Ribstein, *Perils of Criminalizing Agency Costs*, *supra* note 286, at 64.

obtain without the cooperation of the firm. This Article proposes using leverage against the firm or insiders who possess private information about fraud to lower enforcement costs and increase the probability that dishonest managers will be sanctioned. The Article develops a model for leveraged sanctions to improve deterrence of accounting fraud more broadly in regulatory actions and securities litigation.

Improved deterrence is significant because it will reduce the incidence of accounting fraud and produce more efficient capital markets. The increased likelihood of individual sanctioning should cause managers to avoid aggressive accounting practices and instead pursue projects that create real economic value.

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