PUBLIC VERSUS PRIVATE ENFORCEMENT OF SECURITIES FRAUD

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More than ten years after the Private Securities Litigation Reform Act of 1995, the debate continues over whether private shareholder suits should be used to help enforce law prohibiting securities fraud. Many argue that securities fraud enforcement should be left entirely to public enforcers. Others argue that private actions should be permitted because public enforcers often are unable or unwilling to pursue all the actions needed to deter fraud. Both sides of the existing debate tend to share the assumption that the same rules should govern the right to bring private actions against the managers who commit fraud that governs private actions against the firms that employ them.

This Article shows that the scope of private authority to sue for securities fraud should depend on the nature of the defendant. Private actions against managers should be permitted in order to ensure that managers are deterred from committing fraud. By contrast, shareholders should not have unfettered authority to sue corporations for damages resulting from fraud. Private actions against corporations should be restricted because, although private against individuals who commit fraud helps deter fraud, private actions against the wrongdoers corporate employers may not. Corporate liability deters fraud when it provides firms with an incentive to help the government detect fraud and sanction wrongful managers. Securities fraud laws can induce firms to report and cooperate by subjecting firms that do not report and cooperate to greater expected total sanctions than are imposed on those that do report and cooperate. Since reporting and cooperation subjects the firm to an immediate market penalty, securities fraud laws can ensure that firms benefit from failure to report and cooperate only if the law imposes a substantial financial penalty on firms that breach this duty, but imposes no penalty at all on firms that do not. This is best accomplished by permitting public and private suits against corporations for their managers’ fraud if the corporation did not report detected wrongdoing or cooperate. Private actions should not be permitted against firms that public enforcers conclude have satisfied their duties to report detected wrongdoing and cooperate, however. Private plaintiffs nevertheless should be able to proceed against the wrongful managers using information that public authorities obtain from firms through their investigations.


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Securities fraud is a potentially momentous event in the life of a firm, potentially subjecting the firm and its managers to a host of penalties. The magnitude of the combined penalties for fraud is enormous. First, a corporation caught issuing fraudulent financial statements is subject to a market penalty, which takes the form of a substantial stock price reduction that exceeds the adjustment warranted by revelation of the firm’s accurate financial picture. One recent study found that firms with disclosed fraudulent financial statements suffer an average loss of market value of almost $400 million. The average loss is even greater (almost $600 million) for those firms that were able to survive the enforcement process.1 In addition, firms with fraudulent financial statements can be subject to civil, criminal, and administrative enforcement actions by public authorities, such as the Securities and Exchange Commission (SEC) and Department of Justice (DOJ). They also are subject to private actions by shareholders for damages. The average monetary penalty imposed by federal enforcers on those firms subject to such penalties was almost $60 million;2 the average private settlement imposed on firms also subject to a public enforcement action was $25.5 million.3 Often, the firms subject to public sanctions also are subject to private liability. In addition to these corporate level penalties, managers who commit fraud also face a risk of sanction through both private and public actions. Public sanctions include not only monetary penalties, but also non-monetary penalties such as being precluded from serving as an officer or director of a registered firm. As with corporations, the imposition on a manager of a public sanction does not preclude private actors from obtaining redress as well, and vice versa. The combined effect of these sanctions can be ruinous.

For decades, a debate has raged about whether these parallel public and private securities fraud actions are necessary or even advisable. This debate has resulted in repeated Congressional intervention over the last decades to alter the scope of both public and private authority to sanction securities fraud.4 Probably the most well known legislation in this area is the Private Securities Litigation Reform Act of 1995 (PSLRA), which restricted private plaintiff's ability to sue for damages resulting from the issuance by a firm of fraudulent financial statements, and the Sarbanes-Oxley Act which, among other things, increased public sanctions for securities fraud. Yet debate continues about whether private actors have too much

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2 This is the average penalty excluding the $2.28 billion penalty imposed on WorldCom. When this is included the average penalty rises to approximately $107 million. WorldCom’s sanction was reduced to $750 million by a bankruptcy court. Id., at 14.
3 This average settlement excludes the $2.83 billion class action settlement against Cendant Corporation for 12 years of systematic accounting manipulation. The average settlement against firms with public enforcement actions is $37.7 when the Cendant settlement is included. Id., at 14.
4 See infra Section I.
(or too little) authority to sue.\textsuperscript{5} To date, neither Congress nor the SEC has presented a clear and coherent policy concerning the appropriate scope of private and public authority to pursue securities fraud actions.

A central limitation of both the current debate and of Congress’ activity in this area is that it applies a common analysis or rule to all securities fraud actions against primary wrongdoers for fraudulent statements affecting the value of its traded shares.\textsuperscript{6} Specifically, standard accounts of public versus private enforcement generally focus on the issue of whether private actions provide a useful supplement to public sanctions, assuming that liability should be imposed on all those who commit wrongs (and not on those who do not). Yet, this approach overlooks the fact that securities frauds cases generally involve two different actions: one against the managers who committed the fraud and the other against their corporate employer. Analysis of the optimal scope of liability for fraud must attend to this distinction between individual and corporate defendants because individual and corporate liability serve different purposes and have different effects. In turn, the question of whether, and when, private parties should be permitted to sue for securities fraud also depends on whether the action is against a wrongful manager or the corporation.

This Article examines the question of what allocation of enforcement authority between public and private actors best operates to deter managers of publicly held firms from issuing fraudulent material misstatements affecting the value of shares on secondary markets, focusing on the distinction between actions against individuals and those against corporations.\textsuperscript{7} This Article shows that both the scope of liability for fraud, and the allocation of authority to private actors to sue, must depend on whether the defendant is the wrongful manager or the corporation.

In the case of individuals who commit securities fraud, this Article shows that both public and private actors should be permitted to bring securities fraud actions against managers who make fraudulent statements on behalf of their firms. In this situation, securities fraud laws promote deterrence by ensuring that all those who commit fraud fear sanction, consistent with the standard analysis. Private actions against individuals thus help deter fraud by ensuring that managers who commit wrong risk sanction even with public enforcers lack either the resources or political will to sanction them. They also economize on public enforcement resources, thereby freeing up public resources for suits that private parties are unwilling to bring. Private actions also ensure that wrongdoers are subject to sanction even when public enforcers face pressures from interest-groups or


\textsuperscript{6} This Article only examines the issue of liability for materially misleading financial statements issued by publicly-held firms. The private actions that result from these statements generally are brought under the Fraud on the Market theory. See \textit{infra} Section I. The present Article does not examine fraud committed by closely-held firms.

\textsuperscript{7} In other words, this Article focuses on public versus private enforcement of the types of securities frauds that could be brought as private actions under the Fraud on the Market theory.
Public versus private enforcement of securities fraud

Congress to under-enforce. Private actions against individual wrongdoers also are justifiable on the grounds that they ensure that wrongdoers compensate victims.

Public actions against individuals nevertheless are needed to supplement private liability. Public enforcement is needed for two reasons. First, it ensures that wrongdoers risk sanction even when a private action is unlikely, for example because the wrongdoer does not have a lot of assets. Second, public enforcement is necessary to supplement private actions in order to allow the law to deter fraud while constraining the potential abuses of private actions. Private actions must be constrained to those cases with clear evidence of fraud in order to reduce the threat of excessive or frivolous litigation, since private actors will not exercise discretion and refrain from suit if an action is legally maintainable. This suggests that private actors should face high pleading hurdles that target private litigation at those managers who did knowingly commit fraud. Since the resulting scope of private liability is likely to be narrower than the scope of actual frauds, public enforcement should be used to pick up the slack, subject to a broader liability rule. This pattern is consistent with that established by the PSLRA.8

Although dual authority is optimal in the case of individual liability, corporate liability must be governed by different standards. Corporate liability for fraud must be narrower than individual liability for fraud; in addition, public enforcers must retain ultimate control over whether corporations are subject to liability for securities fraud. This different allocation of enforcement authority flows from the fact that corporate liability serves a quite different purpose than individual liability.

Private actions against corporations cannot be justified on either compensation grounds or deterrence. Private actions against corporations cannot be justified as a mechanism for ensuring that wrongdoers compensate victims because the burden of this litigation does not fall on wrongdoers. Instead, it falls on the firm’s shareholders, many of whom were victims of the fraud. Accordingly, compensation does not operate to justify the imposition of corporate liability. This removes this argument for private actions against corporations.

Private actions against corporations also do not help deter fraud. Corporate liability is needed to help deter fraud, but it does so quite differently than does individual liability. Corporate liability is needed because public enforcers cannot adequately deter fraud unless they can induce corporations to help detect fraud and identify wrongdoers and corporations will not aid reporting wrongdoing and cooperating unless subject to a liability regime that encourages them to do so. Absent sanctions that encourage reporting, corporations will not report fraud and cooperate with investigations because they face a market penalty for fraud which discourages firms from reporting suspected fraud that otherwise might go undetected. Corporate liability can induce firms to report fraud and cooperate with investigations, but only if it is structured to ensure that firms that report and cooperate face lower expected total sanctions than those that do not. Accordingly, to deter fraud, corporations must be subject to a duty-based liability regime that

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8 The present Article does not address the issue of whether the precise standard employed by the PSLRA is optimal, however.
imposes a substantial sanction on corporations that fail to report and cooperate that is not imposed on those that do. This has two implications. First, it implies that corporations must be subject to a narrower liability rule for fraud than are wrongful managers. Second, it implies that public enforcers must be granted ultimate authority over whether firms are subject to liability. Public enforcers should determine whether firms bear the duty-based sanction because they are better able to determine whether a firm has satisfied its enforcement duties and are less likely than private actors to incorrectly conclude that a firm has not done in order to reap the financial gain associated with a suit. Beyond this, public enforcers must have authority to determine whether firms that do police are subject to any other sanctions because public enforcers cannot use the threat of liability for failure to report and cooperate to induce the desired behavior unless they can eliminate the threat of private liability for firms that do.

Firms cannot be relied upon to report detected wrongdoing if they are subject to private liability for fraud. Firms that report already subject themselves to a substantial market penalty. When firms also are subject to private liability for fraud public enforcers may not be able to provide an adequate incentive to report. While it is true that they can threaten firms with an enormous sanction if fraud is detected and the firm did not report. Yet, the state may not be able to make the sanction large enough to induce reporting if the firm faces substantial private liability if it does report, and has limited financial assets. The concern of asset insufficiency is particularly great in securities fraud cases because firms whose managers commit fraud often are firms in financial distress. This implies that in order to deter fraud public enforcers must have authority to both impose sanctions on firms that do not report and cooperate and to reduce or eliminate monetary sanctions imposed on firms that do report and cooperate. Accordingly, this implies that public enforcers (e.g., the SEC) should be granted authority to terminate private actions for securities fraud against corporations if the SEC concludes that the firm satisfied its enforcement duties and that the private action would not help deter fraud. Private plaintiffs nevertheless should be able to proceed against the wrongful managers, however, using information that public authorities obtain from the firm as part of their investigation.

This Article proceeds as follows. Section I presents the existing law and practice of individual and corporate liability for securities frauds involving publicly-held firms, and discusses the current pattern and practices of public and private enforcement. Section II discusses the general considerations that should determine the allocation of enforcement authority between public and private actors. Section II also applies this analysis to individual actions and shows that dual authority is optimal if private actions can be properly channeled at actual fraud. Section III shows that this same analysis does not apply to corporate liability, because corporate liability serves different purposes than does individual liability and, as a result, must be structured differently. Section IV shows that private actions against corporations can, and should be permitted in some circumstances, but that corporate liability cannot serve its proper deterrence function unless public enforcers have ultimate authority over whether a private action against a firm can be maintained.
I. SANCTIONING SECURITIES FRAUD

This section presents the law governing liability for fraudulent statements made to the market and discusses the current pattern of enforcement. Under current law, a manager who makes a fraudulent statement to the market relating to the value of his firm’s stock is potentially liable for securities fraud. The corporation also is potentially liable. This liability can take the form of private actions by shareholders seeking compensation for fraud or public actions. Public actions include both administrative and civil actions filed by the Securities and Exchange Commission (SEC) and criminal actions filed by the Department of Justice (DOJ). Finally, the market also may impose a penalty on the managers who commit fraud and the corporations whose financial statements were impacted by the fraud.

A. LIABILITY FOR SECURITIES FRAUD

Officers and directors commit securities fraud when they knowingly (or recklessly) make materially misleading statements on behalf of their firms. Securities fraud subjects the wrongdoer to possible sanction by government agents. The most important government actions are those brought by the Securities and Exchange Commission (SEC). The SEC can bring both civil and administrative actions against the individual, and can impose sanctions that include financial penalties, injunctions, and cease and desist orders. In extreme circumstances, the SEC can bar the wrongdoer from certain forms of future employment. In addition, the Department of Justice can bring a criminal action against the wrongdoer for securities fraud; securities fraud actions also often support a criminal charge of mail or wire fraud as well.9

In addition to public sanctions, securities fraud also can give rise to private actions. The United States Supreme Court has long recognized the existence of an implied private right of action for securities fraud by shareholders who either purchased or sold securities during the fraud.10 Private actions for materially misleading public statements generally proceed as class actions under the doctrine of “Fraud on the Market,” which creates a presumption that shareholders of publicly held firms who purchased stock during the fraud were injured by the fraud if it

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9 Securities fraud also can give rise to a criminal action for obstruction of justice if individuals respond to the government’s investigation by making materially misleading statements to government investigators or destroy documents relevant to the investigation.

10 The Supreme Court explicitly recognized a private right of action under Section 14 of the Securities and Exchange Act of 1934 for violations of the anti-fraud provisions governing proxy statements in J.I. Case v Borak, 337 U.S. 426 (1964). By contrast, the Court has largely implicitly assumed the existence of such a right of action under Section 10b and Rule 10b-5. The Court acknowledged the existence of a private right of action under Section 10(b) in passing in a footnote. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n. 9 (1971). The Court also in effect assumed the existence of such a right in cases, such as Basic v. Levinson, 485 U.S. 224, 241-47 (1988) and Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), which address the scope of the private right of action. More recent Congressional activity regulating the procedures governing private rights of action for securities fraud in effect establish their validity. E.g., Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified throughout 15 U.S.C. §§ 77-78).
involved a firm traded on a market that rapidly internalizes public information into the stock price, such as the New York Stock Exchange. ¹¹

When a firm’s managers commit securities fraud, the corporation also is potentially subject to sanction, along with its managers. These sanctions can be both monetary and non-monetary. Moreover, corporations are subject to both public and private actions for securities fraud.

In theory, corporations face strict liability for its managers’ knowing (or reckless) materially misleading statements concerning the value of its shares. Specifically, the doctrine of respondeat superior subjects corporations to liability whenever a corporate employee commits securities fraud in the course of his employment.¹² This liability is strict and does not depend on actions by either senior officers or the board. The corporation is liable even if the board of directors did not condone or in any way encourage the fraud. Indeed, the firm is liable even if the employee who committed securities fraud violated corporate policy or express instructions in committing the fraud.¹³

¹¹ Specifically, Fraud on the Market doctrine creates a presumption of “transaction causation” – not loss causation – in situations where the fraud was material and involved the stock of a firm traded on an arguably efficient market. See Basic v. Levinson, 485 U.S. 224, 241-47 (1988).

¹² E.g., Jennifer Arlen, Corporate Criminal Liability, 191, 193-194, in LEADERSHIP AND GOVERNANCE FROM THE INSIDE OUT (Jeffrey Sonnenfeld & Robert Gandossey, ed., 2004)(summarizing federal corporate criminal law and observing that civil law is similar); see New York Central and Hudson River Railroad Co v. U.S., 212 U.S. 481, 29 S. Ct. 304, 53 L.Ed. 613 (1909) (establishing corporate criminal liability through the doctrine of respondeat superior). In general, publicly held firms generally face a risk of civil penalties for securities fraud. Criminal penalties are rarely imposed on publicly-held firms for securities fraud. See, e.g., Cindy Alexander, Jennifer Arlen, and Mark Cohen, Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms, 42 J. LAW & ECON. 393 (1999) (the vast majority of federal corporate criminal convictions of publicly held firm between 1990 and 1996 are for fraud against the government, antitrust and environmental; very few are for securities fraud or related offenses); Cindy Alexander, On the Nature of the Reputational Penalty for Corporate Crime, 42 J. LAW & ECON. 489, 523 (1999) (finding that federal criminal fraud cases sanctioned between 1984 and 1990 generally involve frauds against government agencies, and not against private parties, such as shareholders).


The corporation is both civilly and criminal liable if the fraud was committed by a manager in the course of employment. It cannot avoid liability by arguing that the wrong did not benefit the company because it threatened it with sanctions. Nor do they avoid liability for securities fraud on the grounds that the shareholders were the victims of the fraud, and thus did not benefit. Nor can the firm avoid liability by observing that it had a strict policy against fraud. See generally Arlen, supra note 12 (discussing respondeat superior liability generally). In this respect, corporate liability imposed through respondeat superior differs from the provisions of the securities laws that expressly govern liability of “controlling persons.” Securities Act of 1933, § 15, 15 U.S.C. §77o (1988) and Securities and Exchange Act of 1934, § 20(a), 15 U.S.C. § 78t (1988). Both Section 15 of the 1933 Act and Section 20(a) of the 1934 Act protect a controlling person from liability if they acted in “good faith,” in the sense that the controlling person (e.g., employer) did not know about the agent’s wrongful act and would not have had reasonable grounds to know about it had the controlling person taken reasonable precautions. Arlen & Carney, supra, at 695. Notwithstanding these provisions, corporations which acted in good faith nevertheless face liability for frauds by officers and directors through the
In theory, the doctrine of *respondeat superior* governs the firm’s liability to both public and private enforcers, and applies both to civil and criminal cases. In practice, however, public enforcers do not generally subject corporations to strict *respondeat superior* liability for their managers’ frauds. Instead, both the SEC and the DOJ generally employ a “duty-based” liability regime under which a corporation whose managers commit securities fraud can either materially reduce, or eliminate, public sanction for fraud if it promptly reports detected wrongdoing and cooperates with the government’s investigation. The SEC and DOJ often use the information they gain from corporate reporting and cooperation to bring actions against individual wrongdoers.

Private actors nevertheless do impose strict *respondeat superior* liability on corporations. Thus, a firm that reports wrongdoing and cooperates nevertheless will be subject to private civil liability for its managers’ fraud. Its good behavior will not reduce its liability. Indeed, it is likely to increase it. In order to get credit for full cooperation, firms often conduct internal investigations and release these reports to the SEC. They also often release materials that otherwise would be subject to either the attorney-client privilege or work product doctrine. Waiver of the privilege to the SEC generally also waives the privilege for purposes of private actions arising out of the fraud as well. These combined effects of reporting and cooperation greatly assists private plaintiffs, thereby increasing corporations’ expected liability. Consistent with this, evidence suggests that private plaintiffs recover more in cases where the firm self-reported and cooperated than in cases where it did not.

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operation of the common law doctrine of *respondeat superior*. Courts have consistently held that *respondeat superior* operates as an alternative, valid, doctrine upon which to predicate liability. Id. at 695-96; see *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576-77 (9th Cir., 1990), cert. denied, 111 S. Ct. 1621 (1991); *In re Atlantic Financial Mgt., Inc.*, 784 F.2d 29, 32-35 (1st Cir. 1986). Cf. *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, cert. denied 409 U.S. 1125, 93 S. Ct. 938, 35 L.Ed.2d 256 (1973) (a corporation can be criminally liable for an employee’s crime committed within the scope of employment even when done against corporate orders).

Corporate criminal liability also is strict. This strict approach to corporate criminal liability differs from the approach taken in other countries, such as Canada. See Jennifer Arlen, *Commentary on Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy*, 635, in *CORPORATE DECISION-MAKING IN CANADA* (Ronald Daniels & Randall Morck, ed., 1995) (discussing the Canadian approach to corporate liability for securities fraud).

The SEC has adopted a policy, referred to as the “Seaboard policy” which states that the SEC will not take enforcement action against firms that engage in effective self-policing prior to the discovery of misconduct, promptly investigate suspected wrongdoing, report findings to the SEC, fully cooperate with the government’s investigation. The DOJ has a similar policy of not bringing criminal actions against firms that had an effective compliance program, promptly reported wrongdoing to the government, and cooperated fully with the government’s investigation. Originally expressed in the Holder memo, this policy is now expressed in the Thompson memo.

For a recent example of such a case, see *McKesson HBOC v. Superior Court of San Francisco County*, 115 Cal. App. 4th 1229, 9 Cal. Rptr. 3d 812 (Cal. App. 1 Dist. Feb. 20, 2004), (McKesson waived its attorney-client privilege and work product privilege by turning documents over to the SEC, even though the SEC and U.S. Attorneys office signed a confidentiality agreement).

Moreover, the majority of damages paid in private civil actions are paid by the firms, directly or indirectly. Securities fraud actions proceed against both the firm and its managers; the settlement is controlled by the managers (who may not be entirely independent of the managers subject to the suit). Managers have strong incentives to settle the action and not risk going to trial, even if the firm might be better off going to trial, because managers can use Director and Officer (D&O) insurance and indemnification provisions to pay settlements but cannot use these resources to pay a judgment imposed for defrauding the firm’s shareholders. Thus, when managers cannot get a suit dismissed on summary judgment, they arrange to settle the case on behalf of the firm and the individuals. Managers thus have strong incentives to settle their claims. Moreover, the corporation often pays the bulk of the total liability. Corporations often bear a disproportionate share of the actual liability because managers may have incentives to structure settlements to impose all liability in excess of their D&O insurance on the firm, thus avoiding any actual out-of-pocket costs. In addition, liability ostensibly imposed on individuals generally is borne by the firm, either directly, in the form of indemnification for any settlement, or indirectly, in the form of an upfront agreement to purchase D&O liability insurance to cover such settlements. Under current law, firms have little reason to resist managers’ efforts to shift liability onto D&O policies since firms subject to 

B. EXISTING PATTERN OF PUBLIC VERSUS PRIVATE ENFORCEMENT

In order to assess the current role of private and public enforcement, it is useful to examine the role of public and private actors in both identifying frauds and initiating actions, as well as the role of public and private enforcers in imposing sanctions. One question of particular interest is to identify the characteristics of frauds that generate only a public action but not a private action, and vice versa. This Part discusses the available information on these issues. Four important conclusions emerge from this literature. First, public and private enforcers often do not pursue the same cases. Thus, public enforcers often bring actions in situations where private actors would not enforce the securities laws. In turn, private actors often enforce when public actors do not. Second, notwithstanding differences in the cases pursued, there nevertheless is considerable overlap between public and private enforcement, with many frauds producing both public and private sanctions. Third, these public and private sanctions are structured differently. Thus, even when a fraud results in both public and private sanctions, the two forms of sanctions target different defendants with different sanctions. Public actions tend to focus sanctions on individuals while sanctioning firms only in limited circumstances. Public

17 This problem is less strong now than it was pre-Enron as a result of the rise of boards that have a majority of independent directors and the practice of placing these directors on a special committee to oversee litigation. Nevertheless, it does appear that corporations still bear a disproportionate share of the private liability for securities fraud, directly or indirectly.

18 See Arlen & Carney, supra note 13 (discussing how corporations bear the liability for securities fraud).
enforcers also make greater use of non-monetary sanctions. By contrast, private actors generally target liability at corporations, either directly or indirectly, by designing settlements to enable managers to pay their obligations with either their D&O insurance or with corporate indemnification. Finally, while both public and private enforcers bring a substantial number of actions, neither is particularly effective at detecting fraud, at least not directly.19

Public versus Private Actions

Private actions for securities fraud occur more frequently than do public actions. Indeed, only about 15% of settled private law suits have parallel SEC enforcement actions, although the percentage of private suits accompanied by an SEC enforcement action (and the total number of SEC enforcement actions)20 appears to have increased in recent years. This increase is most pronounced since Sarbanes-Oxley. After Sarbanes-Oxley, Congress doubled the SEC’s enforcement budget. It appears that the SEC also changed its enforcement strategy to include more actions against large frauds.21

Although private actors proceed alone against managers and firms for frauds, SEC enforcement actions for financial misrepresentation often generate a parallel private lawsuit. Indeed, almost half of all SEC enforcement actions also are accompanied by a private lawsuit.22 Not all SEC enforcement actions produce a parallel private action, however. It appears that this is because the SEC is willing to proceed in cases that cannot be profitably brought as a private action. Specifically, an analysis of private fraud actions filed from 1997 to 2002 found that the frauds that also generated an SEC enforcement action tended to involve smaller market capitalization companies relative to the firms targeted by private plaintiffs. Moreover, the SEC was more likely to bring a fraud action if the firm was in financial distress. The SEC did not seem to target frauds involving higher provable losses, frauds of longer duration, or larger firms with more assets.23 Evidence suggests, however, that this pattern

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19 Public actors may be effective at detecting fraud in directly if they are able to structure their liability regime to induce firms to report wrongdoing themselves, which does appear to happen with some regularity. See infra.

20 From 1978 to 2004, the SEC initiated 697 enforcement actions for financial misrepresentation, Karpoff, et. al, Legal Penalties, supra note 16, at 5, with the number of actions growing with time (from an average of 7.6 per year from 1978-84, to 16.4 per year during 1985-93, to 38.6 per year from 1994 to 2002). Karpoff, et. al., Cost to Firms of Cooking the Books, supra note 1, at 6.


22 Karpoff, et. al., Legal Penalties, supra note 16, at 29, Table 1 (September 2006) (Table 1 shows that of the 323 out of the 697 (approximately 46%) SEC enforcements from 1978 to 2004 had a parallel private class action lawsuit); Cox, et. al., SEC Enforcement Heuristics, supra note 21, at 777 n. 113 (“we find that 55 percent of the SEC enforcement actions recently studied by the SEC have produced parallel private suits”).

23 Cox, et. al., SEC Enforcement Heuristics, supra note 21, at 777-8.
changed following the wave of financial frauds that culminated in the Sarbanes-Oxley Act of 2002. Initial analysis suggests that following these events the SEC shifted its focus from firms in financial distress to frauds that imposed large losses on investors, especially if the frauds involved smaller firms. Consistent with this, the SEC started targeting larger companies after 2002. In the case of actions against corporations arising out of cases that the SEC is investigating, one factor influencing whether the SEC brings a public action is whether the firm cooperated with the SEC’s investigation.

Moreover, even when a fraud does result in a dual public and private action, evidence suggests that public and private enforcement actions are structured quite differently. They are targeted at different types of defendants and favor different types of sanctions. Private actions inevitably are brought against both individuals and the firm, but tend to target liability at the firm. Private actions that produce a payment almost always involve a payment by the firm. While individuals also made payments in 46% of the cases examined in one study, most of these payments were made with proceeds from insurance policies, or were done in ways that would permit indemnification by the firm.

By contrast, public enforcers generally focus sanctions on individuals. The SEC generally targets individuals, imposing on them both monetary and non-monetary sanctions. Both the SEC and the DOJ are far less likely to proceed against corporations. Moreover, they rarely impose monetary sanctions on firms. This is evidenced by the finding that the SEC and DOJ imposed monetary penalties on individuals in 368 of the 697 enforcement actions (52.8%) initiated by the SEC for financial misrepresentation between 1978 and 2004, but only sought monetary penalties from firms in 69 of these cases.

Who Detects Fraud and Initiates Actions

Although public and private enforcers differ in the types of actions they bring, they do appear to share an important characteristic. It appears that neither public actors nor private shareholders stand at the vanguard of those agents who are most effective at detecting securities fraud.

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24 Cox, et. al., Public and Private Enforcement of the Securities Law, supra note 21, at 906. In assessing these results it is important to bear in mind that this study examined only frauds that resulted in a private action. Thus, these results bear on the question of what factors determine whether the SEC sues given that there also is a private action. The authors did not examine the determinants of SEC enforcement actions that did not also result in a private action.

25 Id. at 899.

26 Karpoff, et. al., Legal Penalties, supra note 16, at 23.

27 Id., at 11.

28 Id., at 11. An analysis of enforcement actions brought against firms for financial misrepresentation running from 1978 to November 2005 found that there were 585 such enforcement actions. Only 231 of these involved a fine or civil settlement imposed against a firm (monetary or non-monetary), and only 47 (8%) resulted in a monetary penalty imposed on the firm. Karpoff, et. al., Cooking the Books, supra note 1, at 1, 14. By contrast, this same study found that this set of firms was subject to 231 class action lawsuits, presumably all of which named the firm as a defendant. Id. at Table 7.
A recent examination of financial frauds committed between 1996 and 2004 found that less than 6% of the financial frauds in their sample were detected by the SEC. By contrast, 16% were detected by the media, another 16% by non-financial market regulators (such as the FERC or state attorney general offices) and 19% were detected by employees of the firm.\textsuperscript{29} The SEC not only does not detect many frauds, it also does not appear to be able to do so particularly quickly. The median duration of frauds initially detected by the SEC was approximately 21 months, which is similar to the median duration of frauds initially detected by the media and employees.\textsuperscript{30} By contrast, the median duration of frauds detected by analysts, auditors and non-financial market regulators is only 8.4 months, 14.7 months and 13.3 months, respectively.\textsuperscript{31} This study also found that shareholders were not particularly active at detecting fraud.

In the cases where there are private and SEC enforcement, the private lawsuit usually precedes any SEC action.\textsuperscript{32} Indeed, it is common for private plaintiffs to file suit the day after any public disclosure of impropriety.\textsuperscript{33} Also, this comports with anecdotal evidence that the SEC takes into account the resolution of private lawsuits in determining its sanctions for parallel actions.\textsuperscript{34}

C. CHANGES OVER TIME IN RELATIVE AUTHORITY

The existing pattern of public and private enforcement in the product of repeated intervention by Congress and an evolution in the SEC’s own approach to its enforcement authority. Neither Congress nor the SEC has ever settled on a clear conception of the proper role of either private action or public enforcement, however.

In the 1980s, it appears that federal authorities were content to permit private actors to bring securities fraud actions, and indeed relied on them to do so.

\textsuperscript{29} Alexander Dyck, et. al., \textit{Who Blows the Whistle on Corporate Fraud?} (January 2007).

Of course, the conclusion that the SEC does not detect fraud does not imply that its actions do not induce detection. As is discussed in Section III, SEC enforcement actions may induce fraud detection if firms are induced to self-report by the threat of sanctions for failure to report should the SEC detect the fraud on its own. Thus, some employee-reporting may be properly attributable to the threat of SEC enforcement.

\textsuperscript{30} \textit{Id.}, at 55.

\textsuperscript{31} \textit{Id.}

\textsuperscript{32} Karpoff, \textit{The Legal Penalties for Financial Misrepresentation}, supra note 16, at 6-7 (timeline of events places the initial filing of a private suit very soon after the trigger event, i.e. “the initial public disclosure of an impropriety”, and before any SEC inquiry, but this is a generalization).

\textsuperscript{33} \textit{Id.} at 7 (“The initial filing of [a private] lawsuit can occur at any time relative to the enforcement period, but typically occurs soon after the trigger date (indeed, most commonly one day after the trigger date.”). But see Howell Jackson & Mark Roe, \textit{Public Enforcement of Securities Law: Preliminary Evidence} (Oct. 6, 2006) (discussing studies showing that “private enforcement tends to ride the coat tails of public enforcement”).

\textsuperscript{34} \textit{Id.} at 11 (“The data reveal that many financial reporting violations trigger a combination of private and regulatory penalties. In addition, anecdotal evidence indicates that the SEC and Department of Justice take into account the results of private lawsuits in establishing their own penalties for financial misconduct.”)
Consistent with this, neither the SEC nor the DOJ were particularly active in bringing enforcement actions against publicly-held firms. This complacent attitude towards private actions changed, however, following the rise in private class actions generated by the Supreme Court’s 1988 ruling in Basic v. Levinson. Seven years after Basic, Congress responded with laws designed to curtail private actions for securities fraud. They also adopted laws that expanded the SEC’s enforcement authority. These latter laws initially did not have much effect because Congress expanded the SEC’s authority without also increases the SEC’s enforcement budget. Indeed, the SEC’s enforcement budget fell in real terms during this period. This situation changed in the early part of this century, following the spectacular frauds perpetrated by managers at Enron and WorldCom. Following these and other well-publicized frauds, Congress adopted laws to increase the penalties for fraud. It also doubled the SEC’s enforcement budget. Finally, the SEC itself started bringing more actions against larger firms. Evidence that private filings plummeted in recent years suggests that it is possible that increased public enforcement may have crowded out some private actions. If so, public actions hardly eliminated the bite of private actions, however, as evidence suggests that settlements during this period have soared.

The continued debate over and repeated changes in public and private enforcement of securities fraud have proceeded over the last decades without a thorough analysis of how the allocation of enforcement authority over securities fraud actions affects the ability of the securities fraud laws to achieve their primary goals: deterrence and compensation. This Article undertakes this analysis. The central contribution of this Article is to distinguish the analysis of optimal enforcement authority over individual actions from the proper analysis applications to corporations. In addition, this Article incorporates the effects of reputation into its analysis of optimal enforcement against corporations.

II. PRIVATE VERSUS PUBLIC ENFORCEMENT AGAINST INDIVIDUALS

The existence of a substantial number of parallel public and private actions raises the issues of whether dual authority is ever appropriate and, if so, whether circumstances exist where public actors should be given ultimate authority over whether securities fraud actions are brought.

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35 E.g., Private Securities Litigation Reform Act of 1995 (tightening the pleading standards for private fraud actions and creating a safe harbor for forward looking statements); Securities Litigation Uniform Standards Act of 1998, 112 Stat. 3227 (effectively eliminating shareholders’ right to file securities fraud actions in state court). Legal developments that expand the SEC’s ability to sanction wrongdoers for securities fraud include the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the Remedies Act), which gave the SEC three types of civil remedies: (i) civil penalties; (ii) cease and desist orders, and (iii) corporate bar orders. The Sarbanes-Oxley Act also added new remedial provisions, including some that expand the sanctions the SEC may impose. Finally, the 1991 U.S. Sentencing Guidelines increased the potential criminal sanctions imposed on corporations for federal crimes; it also expanded the authority of public enforcers to employ non-monetary sanctions.

36 Todd Foster, et. al. Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar, NERA Report (January 2007) (showing a steady fall in federal filings since 2001 but a rise in both median and mean private settlements since 2004).
This Section examines the arguments in favor of private and public enforcement authority as applied to individual liability for securities fraud. It shows that these arguments favor dual authority by both public and private actors over securities fraud actions against individuals. Dual authority is justified both on compensation and deterrence grounds. Dual authority is important because neither public nor private enforcers have adequate incentives on their own to bring all the individual actions that should be brought. In addition, permitting individual actions reduces the cost of enforcement. Nevertheless, individual authority should be more circumscribed than public authority in order to reduce the risk of frivolous litigation.

The relative merits of public and private authority to bring securities fraud actions depends on the goals of securities fraud actions. Do they function purely to deter fraud or are they also properly used to compensate victims? It also depends on the way in which securities laws deter fraud. Does it optimally deter fraud through the imposition of liability on the defendant whenever a fraud is committed or does deterrence require the exercise of discretion?

A. BENEFITS OF PRIVATE ENFORCEMENT AGAINST INDIVIDUAL WRONGDOERS

In the case of actions against individual defendants, private litigation is an important supplement to public enforcement. Private litigation against wrongful managers is justified as a mechanism for ensuring that wrongdoers compensate their victims. Private actions against individuals also help deter wrongdoing.

Individual liability is consistent with the compensatory aim of liability because it provides redress to some of those injured by the fraud. Moreover, this redress is provided by imposing liability on individuals who were responsible for the fraud. If fraud is shown, then these individuals acted either knowingly (or with deliberate recklessness) to harm shareholders. It is thus appropriate to hold them responsible for the harm. They also may be unjustly enriched by the fraud should liability not be imposed. Accordingly, in the case of individual actions, compensation is a legitimate goal of securities fraud litigation.

Private litigation is a more effective mechanism for ensuring that victims of fraud are compensated than is public enforcement. Private litigation better serves the goal of compensation because the right to compensation properly turns on finding both that the defendant committed a wrong and that the wrong harmed these particular plaintiffs. Private actions adjudicate both issues simultaneously. Public enforcement only adjudicates the former. Programs that distribute public settlements to victims then require a separate adjudication of the right to recover. The distribution of the proceeds from public litigation to private plaintiffs to date has presented a sufficient administrative challenge that it does not operate effectively.

37 For example, the fraud may have permitted them to obtain additional compensation from the firm that they would not have received had the truth been revealed sooner.

Private litigation also can promote deterrence. Securities fraud can best be deterred when managers who commit fraud expect that they will be sanctioned. This implies that fraud can best be deterred when wrongdoers expect that fraud will be detected and wrongdoing sanctioned. Wrongdoers will not be deterred from committing fraud unless they face a substantial probability of sanction. Public enforcement cannot effectively deter fraud by relying on a strategy of infrequent enforcement accompanied by extraordinarily high sanctions. Securities laws will not deter fraud unless the expected sanction imposed on wrongdoers (given the probability that fraud is detected and sanctioned) exceeds the benefit to managers of committing fraud. A manager contemplating fraud views the expected sanction as the actual penalty for fraud adjusted for the probability that his fraud would be sanctioned. Thus, a manager contemplating a sanction of $F$ for fraud will view the expected sanction as being given by $pF$, where $p$ is the probability of sanction. The manager will commit the fraud if the benefit of fraud, $B$, exceeds $pF$ and will not commit it otherwise.\footnote{Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (March/April 1968).} Mechanisms that increase the probability of sanction thus help deter fraud by increasing the expected sanction for fraud; private actions are potentially just such a mechanism.

Deterrence depends particularly on efforts to increase the probability of sanction when, as here, the state cannot effectively counter-act a low probability of sanction by raising the penalty imposed.\footnote{An alternative approach to reducing the probability of detection is to enhance the sanction, for example, through the use of non-monetary sanctions, such as prison or injunctions against future employment as an officer or director, Becker, supra note 74; see A. Mitchell Polinsky & Steven Shavell, *Public Enforcement of Law*, [5-6] in *The New Palgrave Dictionary of Economics* (Lawrence Blume & Steven Durlauf, ed.) (2nd ed., forthcoming) (the optimal enforcement strategy is a low probability of detection coupled with maximum sanctions, in the form of fines or, if needed, imprisonment); A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. LEGAL STUD. 1 (1999) (same).} Yet a high sanction/low probability of detection approach to enforcement is not necessarily superior to a more moderate sanction coupled with a higher probability of detection, however, especially when the high sanction involves imprisonment. First, there is evidence that sanctions deter more effectively when they are imposed more frequently. E.g., James Q. Wilson & Richard Herrnstein, *Crime and Human Nature* 397-401 (1985); see Michelle M. Mello and Troyan A. Brennan, *Deterrence of Medical Errors: Theory and Evidence for Malpractice Reform*, 80 TEXAS L REV. 1595, 1624 (2002). Second, high sanctions may not be cheaper than increased enforcement because both prison and injunctions against future employment are expensive. Putting people in prison is expensive in and of itself. Both prison and injunctions against future employment are costly if the wrongdoer is in fact an effective employee if he could be deterred from committing fraud.

In addition, the high punishment approach raises marginal deterrence concerns. The state cannot effectively deter crime unless the sanction for more serious crimes exceeds that for less serious crimes. As a result, the state must ensure that the punishment for fraud is less than that for murder; it probably also should be less than that for armed robbery. This need to adjust relative sanctions reduces the state's ability to solve the low probability of detection problem through the use of long jail sentences. See generally George Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526 (1970) (discussing marginal deterrence); Louis L. Wilde, *Criminal Choice, Nonmonetary Sanctions, and Marginal
low probability of sanction through higher financial penalties because the state cannot impose financial sanctions that exceed managers’ wealth, and even without any adjustment, damages for securities fraud cases can be expected to equal or exceed the wealth of most managers. Given wealth constraints, and other considerations limiting the use of non-monetary sanctions, the state can best deter fraud by increasing the probability of detection. Thus, a risk neutral manager with wealth of 900,000, will commit a fraud that confers a benefit of 300,000 on him if the probability of sanction is only 1 in 10, because, no matter what the official monetary penalty is, he will not pay more than 900,009, and thus faces an expected penalty of only 90,001. By contrast, however, he will be deterred if he faces a 1 in 3 chance of being sanctioned for fraud, because now his expected penalty is 300,003, which exceeds the benefit of fraud.

Ensuring an adequate probability of sanction is particularly important to efforts to deter fraud because it often is not possible to impose a financial sanction on managers that equals any multiple of the benefit conferred on him by fraud. The benefit of fraud often comprises a substantial portion of the manager’s wealth. It may even exceed it. Managers often commit fraud in order to save their jobs by hiding poor performance in order to buy time to improve the situation. These

Excessively high sanctions also may undermine the accuracy of criminal litigation. Sanctioning wrongdoers is, after all, only one of the goals of the criminal justice system. Another goal is to avoid sanctioning those who are not wrongdoers. This latter goal may be better served when the state spends resources on enforcement in order to determine whether a wrong was in fact committed and, if so, who committed it. A high sanction approach, by contrast, may lead to poor outcomes because people falsely charged with a wrong accompanied by an enormous sanction may agree to plead guilty, notwithstanding confidence in their innocence, because they are risk averse and fear the sanction. A state that has not spent adequate resources on enforcement is unlikely to know that the plea is being made by an innocent man. See Bruce H. Kobayashi & John H. Lott, Jr., Low-Probability—High-Penalty Enforcement Strategies and the Efficient Operation of the Plea Bargain System, 12 Int’l Rev. L. & Econ. 69, 70 (1992) (large sanctions may cause innocent people to plea guilty).

Finally, normative considerations other than efficiency also may limit the state’s ability to use the low probability/high sanction approach to optimal deterrence (e.g., prison sentences for minor frauds would seem unjust even if justified, in theory, because there is a very small probability of detection).

41 See supra note 40.

42 See infra note 60 (discussing the evidence for this claim). Managers who do not fear termination face strong market pressures to avoid fraud, even absent liability, because their ability to manage the firm often depends on their ability to obtain financing from the capital markets. Managers who commit defected fraud cannot obtain this new financing without paying a premium, and thus are likely to be fired by shareholders. Thus, fraud is unlikely when managers do not fear termination.

One exception to this situation is managers of firms facing future (but currently undisclosed) bad news when the managers themselves own large amounts of options that are due to vest shortly. These managers may face strong financial pressures to hide bad news in order to maintain the stock price long enough for their options to vest. See supra text accompanying note 61. Nevertheless, even this incentive depends on managers taking a relatively short-run view. A manager who expects to remain with the firm for another 15 years would be unlikely to risk his future employment for such a short-run gain. Fraud is attractive only when the short-run gain exceeds the expected cost of fraud, which is the future long-run rewards lost should the fraud be detected and the manager sanctioned.
frauds confer an expected benefit on managers equal to the expected net present value of his annual income over his expected future tenure with the firm, adjusted by the marginal positive effect of fraud on the probability that he retains his job. Given executives’ multi-million dollar annual compensation, this amount is substantial. It may well exceed the managers’ existing assets. Deterrence thus depends increasing the probability of sanction in order to ensure that expected sanctions are high enough, given resource constraints on the sanctions that can be imposed.

Given the importance of regular enforcement, private actions promote deterrence because the SEC does not have the resources to bring all the securities fraud actions that it would need to bring in order to deter fraud effectively. Private actions expand the total enforcement resources available for deterring securities fraud, thereby allowing the SEC to deter more frauds than it otherwise could. Private actions are a more politically palatable way to enhance enforcement than is increasing the SEC’s budget by the amount needed to adequately deter fraud because private actions imposes the cost of enforcement on those who benefit from it, rather than requiring securities fraud enforcement to compete for government resources with all the other demands on public resources.

Private actions also are needed to ensure that actions are brought when the SEC lacks the political will to pursue effective enforcement against individuals. The SEC Commissioners and the Chairman generally are drawn from business or Wall Street; most will return to large corporations or law firms when they leave government. This raises the concern that they may have interests that are not entirely consistent with those of public shareholders. They also must be subject to

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43 James D. Cox, Randall S. Thomas, with the assistance of Dana Kiku, SEC Enforcement Heuristics: an Empirical Inquiry, 53 Duke L. J. 737, 779 (explaining position taken: “the SEC cannot and does not prosecute all violation and the private suit picks up the slack”); Joseph A. Grundfest, Dismissing Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority, 107 Harvard Law Review 961, 969 (1994) (“… private litigants take the laboring oar and pursue cases that the government does not bring. The Commission ‘does not have the resources to investigate every instance in which a public company’s disclosure is questionable.’

44 See Stephenson, supra note 5, at 110 (private enforcement suits can “correct for agency slack – that is, the tendency of government regulators to underenforce certain statutory requirements because of political pressure, lobbying by regulated entities, or the laziness or self-interest of the regulators themselves.”); see also Matthew D. Zinn, Policing Environmental Regulatory Enforcement: Cooperation, Capture, and Citizen Suits, 21 STAN. ENVTL. L. J. 81, 133-37 (2002).

Stephenson also identifies a detection function for private enforcement. Id. at 108. While it is true that in many situations private litigation can provide private actors with incentives to detect fraud that they otherwise would not have, this does not appear to be a significant benefit to private securities fraud litigation. First, even without litigation, private actors can already benefit from detecting fraud since a shareholder who detects fraud can profit by selling shares before the fraud is revealed. A short-seller can profit even more from detecting fraud and then ensuring its disclosure. Notwithstanding this opportunity for profit, the existing evidence suggests that few frauds are detected by shareholders and short-sellers. Detection thus properly is viewed as an advantage of public enforcement authority, as the best way to detect fraud is to induce corporate officials to report it, and public enforcers can the sole ability to structure liability to induce corporations to detect and report wrongdoing. See infra Sections III and IV.

interest group capture in other ways.  Finally, when the SEC acts in ways that displease Congress, it is subject to pressure from them. Congress has not always sought to enhance enforcement, as evidenced by the decline in the real value of the SEC’s enforcement budgets prior to Sarbanes-Oxley. Private actions can redress this problem by ensuring that wrongdoers are sanctioned even when public enforcement authorities are not proceeding as aggressively as they should. To the extent that private actions receive publicity, they also may have the ancillary benefit of creating pressure for public enforcers to launch investigations and enforcement actions that they otherwise would not bring.

B. BENEFITS OF PUBLIC ENFORCEMENT

Notwithstanding the potential benefits of private actions, securities fraud enforcement cannot rely solely on private actions. Public enforcement also is needed. Public enforcement is needed to redress limitations in private parties’ incentives to sue. Private parties sue for their own benefit, not for the public benefit. As a result, private actions will result in too few suits being brought in some circumstances and too many in others. Public enforcement can be used to redress both problems.

Sole reliance on private enforcement would result in under-enforcement against many wrongdoers because private plaintiffs cannot be relied upon to bring all actions that serve the public’s interest. Private parties do not sue unless they expect to obtain a net benefit, and thus will not proceed against wrongdoers who are unable to a judgment large enough to justify the costs of litigation, even if the litigation would help deter fraud. Public enforcement can ameliorate the problem of under-enforcement of fraud both indirectly and directly.

Public enforcers can promote deterrence directly by pursuing actions against wrongdoers who are unlikely to face a private suit. Most obviously, public enforcers can help deter fraud by proceeding against individual wrongdoers with insufficient assets to generate private litigation. Indeed, historically, the SEC has targeted such...
defendants, as previously discussed. Public actions against low wealth individuals help deter fraud by subjecting all wrongdoers to an expected sanction, including those whose wealth is not great enough to attract private litigation. Public enforcement also helps deter wrongdoing by asset constrained individuals because public enforcers can impose non-monetary sanctions on wrongdoers not available to private parties. For example, the SEC can prevent managers from acting as an officer or director in the future. In serious cases, the SEC can refer a case for criminal prosecution. Public enforcement also may indirectly enhance the non-monetary sanction imposed on wrongdoers. There is evidence that directors of firms sanctioned by the SEC for fraud experience a significant decline in other board seats held; directors subject to purely private actions do not experience this decline. Given this, the SEC, by bringing an enforcement action, can enhance deterrence even if it imposes little or not formal penalty.

Public enforcement also can enhance deterrence indirectly by encouraging effective private litigation. It can do this by helping to identify instances of fraud and reducing private parties’ costs of obtaining the information needed to obtain damages from the wrongdoers responsible for it. Public enforcers can do this by using their resources to detect and investigate frauds; this information can be shared, directly or indirectly, with shareholders pursuing valid private litigation against individual wrongdoers. This goal supports the use of public resources to identify and investigate frauds that are likely to generate a private action. Public resources may not be needed to pursue these actions, however, unless the imposition of a formal public sanction enhances deterrence by imposing a reputational sanction on wrongdoers that does not result from purely private actions, as appears may be the case.

firms are willing to invest in enforcement only if they at least break even—their fine revenue must be at least as large as their enforcement costs. Under public enforcement, however, the optimal solution may result in fine revenue which is less than enforcement.); Cox, SEC Enforcement Heuristics, supra note 1, at 744 (“In many cases, the loss suffered by the plaintiff or even a group of plaintiffs may not rise to a sufficient level to attract the interest of the entrepreneurial plaintiffs’ attorney.”); James Bohn & Stephen Choi, Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. PA. L. REV. 903, 949 (1996) (“the SEC should intensify its enforcement for smaller sized IPOs, IPOs that experience only a moderate aftermarket loss, and IPOs in SIC code groups where plaintiffs’ attorneys traditionally do not venture”).

Cox, et. al., SEC Enforcement Heuristics, supra note 1, at 777-8.

Corporate liability is one of the mechanisms that public enforcers can use to detect fraud. This is discussed in Sections III and IV below.

See John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer As Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 220 (1981) (“[private plaintiffs [piggyback on the efforts of public agencies…in order to reap the gains from the investigative work undertaken by these agencies”); Author F. Greenbaum, Government Participation in Private Litigation, 21 ARIZ. ST. L.J. 853, 981 (1989) (“The SEC at times shares the fruits of its investigation with the public at large, which may use the information in private enforcement efforts.”).

Helland, supra note 50.
C. Restricting Private Enforcement Relative to Public Enforcement

Although both public and private enforcement can be used to deter fraud, public and private enforcers should not enjoy the same scope of authority to proceed against individual wrongdoers. Public enforcers should enjoy broader authority to proceed against individual wrongdoers than should private actors, as long as public enforcers do not appear to pursue excessive litigation against managers.

Although private actions are needed as a substitute for public enforcement, they should not be treated as a perfect substitute (enjoying the same standards for imposing sanctions) because private parties cannot be relied upon to proceed only against actual wrongdoers. Securities frauds are not easily distinguishable from actions that are not wrongful. Indeed, the only difference between an innocent financial restatement and one that signals a prior fraud is whether the managers knew that the initial financial statement was materially misleading. Managers’ scienter is not easy to establish. This implies that the law faces two choices. It can either ensure that wrongdoers do not escape detection by permitting actions based on circumstantial evidence of knowledge. Alternatively, it can protect managers from being improperly sanctioned by requiring clear evidence of actual knowledge, but at the risk of losing the ability to deter frauds that are unlikely to produce this evidence.

Private actions should not be permitted to proceed without clear evidence of scienter because private actors cannot be relied upon to use broad enforcement authority in the public interest. Private actors will sue even when fraud did not occur if the legal standard is structured to enable them to extract a positive settlement if there is uncertainty about whether managers had the requisite scienter to commit fraud.

Dual public and private authority can obtain the benefits of private actions, while minimizing the costs, by placing greater restrictions on private suits than on public ones. One way to do this is to impose on private parties a stricter burden to show that a material misstatement was made with the requisite scienter for fraud than is imposed on public enforcers. This supports Congress’s decision to impose a heavier pleading burden on private plaintiffs that requires them to plead facts that demonstrate that managers deliberately lied. If public enforcers can be relied upon not to proceed against innocent parties, then there is no need to subject them to the same heightened burden. Restrictions on private parties must be accompanied by an increase in public enforcement resources, however, or else these restrictions could have the perverse effect of producing both more fraud and more litigation.56

56 A decision to impose hurdles on private actions can lead to both more fraud and more litigation if Congress and the SEC do not ensure that public enforcers act aggressively to bring fraud actions precluded by the higher hurdles imposed on private actions. Absent intervention by public enforcers, these hurdles can induce more fraud and more litigation because managers subject to a lower risk of private action will be more likely to commit fraud. This in turn generates greater litigation if shareholders presented with evidence of potential fraud (e.g., a financial restatement) conclude that it is more likely than not the product of fraud because they know the private litigation under-deters fraud. See Antonio Bernardo, Eric Talley and Ivo Welch, *A Theory of Legal Presumptions*, 16 J. LAW, ECON. & ORGAN. 1 (2000).
The conclusion that public and private enforcers should both be able to proceed against individual wrongdoers does not carry over to corporate defendants, however, as is shown in Sections III and IV.

III. PURPOSES OF CORPORATE LIABILITY FOR SECURITIES FRAUD

Currently, both public enforcement agencies and private plaintiffs have authority to bring securities fraud actions against corporations whose managers commit securities fraud. Moreover, under the law, both may bring an action whenever an individual committed a fraud, although public enforcers have adopted policies of not proceeding against firms which acted aggressively to deter fraud by monitoring, reporting wrongdoing and cooperating with the government. Private plaintiffs are free to proceed against such corporations, however, even if the corporation has endeavored to deter fraud by monitoring, reporting the wrong and cooperating.

Although dual enforcement authority is optimal in the case of individual liability, it is not optimal in the case of corporate liability for securities fraud. Instead public enforcers should retain ultimate authority over whether securities fraud actions are brought against corporations.

Corporate liability requires a different relationship between public and private enforcement because, as this Section shows, corporate liability serves different purposes than does individual liability. The primary goal of corporate liability is to deter fraud, not to compensate victims. Corporations can deter fraud in two different ways. First, corporations can intervene to prevent wrongdoing by taking actions that reduce the benefit of fraud or make it more costly to commit. In addition, corporations can deter fraud by adopting measures that increase the deterrent effect of individual liability by increasing the probability that fraud is detected and wrongdoers sanctioned. These mechanisms, called “policing mechanisms,” include monitoring, reporting and prevention.

The primary purpose of corporate liability is to induce firms to adopt policing mechanisms that increase the probability that fraud is detected and individual wrongdoers are sanctioned. Corporate liability is needed to induce policing notwithstanding the reputational penalty imposed on firms with detected fraud because this reputational penalty does not encourage firms to report wrongdoing or cooperate with investigations. Indeed, it may discourage it.57

Corporate liability can be structured to induce policing by overcoming the disincentive to report and cooperate presented by the market penalty for fraud. Corporate liability can induce policing measures if liability is structured so that firms that bring fraud to light face lower total expected sanctions than those that do not. This can be accomplished through subjecting firms to a duty to monitor, report and cooperate; firms that fail to adhere to this duty would be subject to a large sanction that is not imposed on those firms that do comply. This sanction induces reporting and cooperation if it is sufficiently large to ensure that the firm’s expected liability is

57 By contrast, this reputational penalty does encourage firms to prevent fraud. Moreover, it is more effective when firms engage in aggressive policing.
lower if it does report and cooperate than if it does not, even though reporting instantly subjects it to a market sanction for fraud. This regime not only encourages reporting but also promotes prevention, since the firm’s market incentives to prevent fraud are stronger when the probability of detection is greater.

In order to ensure that corporations benefit when they report wrongdoing and cooperate, the state must be able to ensure that the expected sanction imposed on firms that do report and cooperate (which occurs with probability one) is less than the expected sanction imposed on those that do not, given the likelihood that the state may not detect the wrong if the firm does not report and cooperate. This implies that, in contract with other forms of wrongdoing, corporations subject to liability for securities fraud often should be completely insulated from all liability if they satisfy their policing duties. They should not be subject to residual liability designed to induce them to prevent wrongdoing. Residual liability often is not necessary to induce prevention because corporations detected with fraud are subject to an enormous market penalty that encourages prevention. Even when the market penalty is not sufficient, residual liability often is not advisable because it undermines public enforcers’ ability to induce policing by increasing the risk that the firm will not have sufficient assets to pay the optimal duty-based sanction needed to induce reporting and cooperation.

A. COMPENSATION VERSUS DETERRENCE

Public control over corporate securities fraud actions best serves the goal of corporate liability because these actions serve solely to deter fraud; they do not serve legitimate compensation goals. The absence of a legitimate compensatory purpose is important because compensation of victims is one of the standard justifications for private actions.

Liability serves compensatory aims when it operates to shift the cost of a wrong from the victim to the person who committed it (or the person who wrongfully benefited from it). As previously shown, individual liability for the managers who committed the fraud serves this purpose. Corporate liability for financial misstatements fails this test because corporate liability does not fall on wrongdoers; nor does it even fall on the shareholders who benefited from the wrong. Instead, much of it falls on shareholders who were victims of the fraud.

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58 Arlen & Carney, supra note 13 (arguing that corporate liability for fraud on the market does not serve a compensatory goal and can only be justified if it deters wrongdoing); see Tamar Frankel, Implied Rights of Action, 67 Va. L. Rev. 553, 556-57 (1981) (deterrence, not compensation, is the primary purpose of private actions for securities fraud); John C. Coffee, Jr., Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working, 42 Md. L. Rev. 215, 218 (1983) (same); Donald Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639 (1996) (same); cf. Stephenson, supra note 5, at 98-106 (federal private actions generally emphasize deterrence goals over compensation).

59 See James D. Cox, Randall S. Thomas with Dana Kiku, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L. J. 737 (2003) (concluding based on an analysis of the “Fair Fund” provision that authorizes the SEC to designate civil penalties it recovers for the benefit of defrauded private investors that SEC enforcement is likely to offer only limited potential relief for private investors). See supra Section II.A.
At the moment that fraud is publicly detected, the corporation’s share price falls to reflect both the market penalty for fraud and the expected amount of corporate liability. Accordingly, the cost of corporate liability for securities fraud falls primarily on the shareholders held shares at the time the fraud was detected. With the exception of those shareholders who also are managers, few of these shareholders could have condoned or even benefited from the fraud. Indeed, many were harmed by it.

Securities fraud by publicly held firms generally involves lies designed to make the firm look healthier than it is. To understand who benefits from such lies, it is necessary to consider when, and why, the managers who control the firm’s financial statements would be willing to knowingly deceive the financial markets. In general, managers have little to gain from lying to the markets. It is hard to hide poor financial news forever. Thus, all frauds carry with them some significant probability that the fraud will be revealed. Revelation of the fraud will damage the firm. The stock price will fall when the market learns the truth, imposing an instant penalty on all shareholders (including managers). In addition, the firm will be penalized by the financial markets should it need future financing. This is a substantial price to pay to hide bad news. Thus, managers secure in their jobs generally will not commit fraud since the long-run cost is likely to exceed the short-run gain. By contrast, managers who fear termination may have an incentive to lie. Specifically, managers may commit securities fraud when they fear termination if the market learns the truth about the firm’s situation – either because the firm is failing or because it is under-performing relative to other similar firms in the industry. Managers in or near a terminal period do not share the firm’s long-run benefit from truthful reporting. Consequently, they may benefit from lying if they believe that fraud will buy them time to turn the firm around and potentially save their jobs.60

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60 Arlen & Carney, supra note 13 (providing a theoretical argument that managers who commit pure securities fraud, unconnected to insider trading, only can benefit from doing so when they fear that they are in a last period, and evidence that this is the case); see also Jonathan Karpoff, et. al., The Cost of Firms of Cooking the Books, supra note 1, at 18 (finding that 49% of their sample of firms with fraud enforcement actions against them failed or delisted during their enforcement period). Cf. Cindy R. Alexander and Mark A. Cohen, New Evidence on the Origins of Corporate Crime, 17 MANAGERIAL DECISION ECONOMICS 421 (1996) (crime by managers is less likely the greater managements’ ownership stake, consistent with the agency cost hypothesis about the causes of corporate crime). Recent frauds at Enron and WorldCom appear to be examples of managers attempting to hide bad news for fear that the truth would harm the share price which could well result in their termination – especially in these days of growing shareholder activism.

Managers’ incentives to commit securities fraud in the hope of hiding bad news may be heightened by the Supreme Court’s ruling in Dura Pharmaceuticals v. Broudo, 125 S. Ct. 1627 (2004), which held that plaintiffs cannot recover unless they can demonstrate that the fraud caused an ex post decline in the stock price. Demonstrating price inflation at the time of purchase is not enough for maintain an action for securities fraud. As a result, managers may be able to avoid private liability for securities frauds that involve hiding bad news for long enough to allow the simultaneous release of both good and bad information to the market. See James Spindler, Why You Want Your CEO to Lie to You After the Supreme Court’s Dura Pharmaceuticals Decision, GEORGETOWN L. J. (2007). Given that shareholders both are risk neutral and need accurate information about firm performance to monitor managers, shareholders themselves are unlikely to benefit from the lies encouraged by Dura; these additional frauds are likely to result from agency costs between managers and shareholders. But see Spindler, supra. The effect of Dura also may be muted by the fact that the primary sanction imposed
the modern era of shortened managerial job tenure, managers of firms that are not failing also may be tempted to lie if they are near the end of their expected tenure and can obtain a substantial private benefit from doing so. Thus, managers who hold large unvested stock options grants may lie in order to delay any decline in the stock price until after the managers are able to exercise their options and sell their shares.\footnote{61} In either set of circumstances, managers, not shareholders, are both the perpetrators of fraud and its intended beneficiaries. Thus, the compensatory goal is served by private actions against managers.

Compensation might justify corporate liability if the corporate shareholders who pay the liability derived a net benefit from the fraud, even after it was detected, since then liability would operate to deprive them of this unjust enrichment. Yet, analysis reveals that generally corporations, and their shareholders, often do not obtain a net benefit from securities fraud ex ante, and almost always do not once the fraud is detected. First, securities fraud does not confer any ex ante benefit on the firm itself if it does not seek financing during the fraud. Firms that are not seeking financing get little benefit from an increase in the share price and have much to lose should the fraud be detected. Corporations with a long time horizon also have little to gain from fraud even if they expect to obtain financing during the fraud. The one-time benefit derived from financing during the lie is unlikely to exceed the long-term cost to the firm of lying. It is difficult to hide fraud forever and once the firm is forced to restate its financial statements it will suffer a substantial reputational penalty if the market concludes that the previous statements were fraudulent. This reputational penalty will both lower the firm’s share price and adversely affect the cost to the firm of raising capital for multiple periods. For most firms, the long-run cost of this reputational penalty generally is likely to exceed any short-run benefit the firm might gain from the misstatement.\footnote{62}

\footnote{61} Eric Talley & Gudrun Johnsen, Corporate Governance, Executive Compensation and Securities Litigation (finding that higher executive compensation is associated with a higher likelihood of securities fraud litigation).

\footnote{62} Arlen & Carney, supra note 13, at 701-702 (shareholders generally do not benefit from fraud because publicly-held corporations rely on public markets for future financing, and repeat players in these markets are likely to find that the long-run cost of fraud exceeds the benefit).

Moreover, even when firms are in a last period situation the ex ante benefit to shareholders of fraud inevitably is less than the benefit to managers. This implies that managers may be motivated to commit frauds that do not confer an ex ante benefit on shareholders. First, managers are more likely to benefit from fraud than are shareholders because managers are risk averse with respect to the risk of firm failure whereas shareholders are risk neutral. Thus, many frauds that are attractive for managers will not confer a net gain on risk neutral shareholders. Second, shareholders have more to lose from fraud because shareholders often do not lose all the value of their shares when the firm fails. While managers often lose their jobs, shareholders may emerge as equity holders in the firm if it enters bankruptcy reorganization. Fraud thus can harm shareholders even when the firm is in financial trouble because the fraud (and actions managers take during the fraud) may reduce the value
Moreover, even if shareholders might benefit ex ante from fraud, they generally do not retain any unjust enrichment from the fraud once it is detected. Upon revelation of the fraud, the market price of the stock instantly adjusts to eliminate any gain from the fraud. The firm also is subject to a substantial reputational penalty. This market reaction more than eliminates any benefit shareholders might have obtained from the fraud. The only shareholders who do obtain a net benefit are those who sold shares during the fraud. But these shareholders are not affected by corporate liability for securities fraud. Accordingly, the shareholders holding shares when the fraud is revealed do not benefit on net from the fraud. Thus, there is little justification for forcing them to compensate the victim’s of fraud.

Indeed, the shareholders harmed by corporate liability not only do not benefit from the fraud, they are harmed by it. Subjecting these same shareholders to corporate liability for securities fraud only exacerbates the harm imposed on them by the fraud. Many of these shareholders were, in fact, victims of the fraud.

Consequently, unlike corporate managers, corporate shareholders do not retain a net benefit from fraud once it is detected even when the firm is in a last period.

Shareholders nevertheless may retain a net benefit unless there is liability if the market cannot determine whether there was fraud absent a legal resolution of the issue. For example, concerns arise that the market may not punish frauds that do not lead to a fall in the share price, for example because the firm was able to release unexpected good news contemporaneously with restating the financial statements previously distorted by the fraud and the market did not detect the fraud. See Spindler, supra note 60. Of course, to the extent that this confers an unjust enrichment on shareholders, there is a benefit conferred that corporate liability only if shareholders are able to detect the fraud for purposes of filing suit even though the market does not detect it for purposes of imposing a reputational sanction. Alternatively, the reputational penalty might not operate if the market does not punish managers who lie even as long as they can later release counter-acting good news. But it is unclear why the market would rationally respond this way given that managers who are willing to lie (but who have the good fortune of getting good news) also are more likely to lie in advance of a period where there is no good news.

The fact that liability falls on victims implies that liability does not substitute for the reputational sanction in the way that it does in other circumstances. In the case of wrongs against third parties (say someone purchasing from the firm), a liability (or warranty payment) can substitute for a reputational sanction because parties who are protected against the cost of wrongdoing by the promise of compensation will feel no need to refuse to deal with wrongdoers in the future. In this way liability and warranties can be welfare enhancing by deterring wrongdoing with less social cost ex post (because the liability is a transfer whereas the loss of reputation is a social cost). See W. Bentley MacLeod, Reputations, Relationships and Contract Enforcement, J. ECON. LIT. (forthcoming, 2007) (discussing how warranties and reputation can be substitute devices for assuring quality with the former imposing lower social costs than the latter). By contrast, here liability does not have this effect because liability does not reduce the cost of wrongdoing for most victims given that victims bear the expected cost of liability ex post in the form of a decrease in share price when the fraud is publicly detected.

Liability is imposed on these shareholders, and not the shareholders who own the firm when the settlement is finalized, because revelation of the fraud reveals two pieces of information to the market. First, the market learns that previous information released to the market was materially
Shareholders who hold shares at the moment that fraud is revealed include both direct and indirect victims of the fraud. Many of the people holding shares in the firm at the moment that the fraud is revealed are direct victims of the fraud because they either purchased shares at inflated prices during the period of the fraud or were dissuaded from selling by the fraud. Corporate liability does not reduce the harm for these shareholders; it often enhances it. The second group obviously is harmed by corporate liability because this group of victims bears the cost of liability but is not entitled to seek compensation. The first group also may be harmed because they bear the cost of liability imposed for their benefit through a fall in the share price when the fraud is revealed. If the class size is large enough, this cost may exceed their expected recovery because the cost to the firm of liability exceeds the expected benefit to shareholders by an amount equal to both the firm’s litigation costs and the amount paid to plaintiffs’ lawyers. Accordingly, often the total expected cost of fraud to victims would be less if corporate liability were not imposed. The remaining shareholders also are victims of fraud that is detected because the market reaction to fraud more than eliminates any share price increase caused by the fraud. Thus, all shareholders on whom corporate liability is imposed were injured on net by the fraud already.

Accordingly, corporate liability for securities fraud cannot be justified as a mechanism for compensation victims because it fails both requirements for a good compensation system. Compensation requires that liability be imposed on those who committed the wrong, or at least on those who benefited from it. Corporate misleading. Second, it learns that shareholders likely have the grounds for a securities fraud action. The market price of the stock will fall, immediately, in response to both pieces of news. As a result, much of the cost of firm-level liability is borne by those people who are shareholders at the moment the market learns that there was a fraud.

Shareholders who were dissuaded by the fraud from selling shares they otherwise would have sold are harmed by fraud but do not have a private cause of action as a result of the Supreme Court’s ruling that only those people who were injured by the actual purchase or sale of shares during the fraud can sue. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

See Karpoff, et. al., Cost to Firms of Cooking the Books, supra note 1 (providing empirical evidence on the substantial reputational penalty for fraud).

For similar reasons, corporate liability for securities fraud cannot be justified as a mechanism for attaching blame to wrongdoers.

In other areas, there may be a “blaming” function for corporate liability to the extent that some of the incidence of securities fraud liability does fall on employees who may have known about, or participated, in the wrong in ways unlikely to result in them being subject to direct sanction. See Samuel W. Buell, The Blaming Function of Entity Criminal Liability, 81 IND. L. J. 473 (2006). This “blaming” function may be appropriate in a number of circumstances. It does not appear to be a good justification for imposing liability on publicly held firms for fraudulent statements affecting secondary markets, however. Unlike other forms of corporate liability, much of the incidence of corporate liability for securities fraud falls on shareholders – often the same shareholders who were victims of the wrong. Generally, none of it falls on the shareholders who benefited directly from the fraud by selling their shares during the period when the price was inflated by the fraud (often without knowing the price was inflated by fraud). These shareholders, by definition, are no longer shareholders when the fraud is revealed. They do not bear the sanction – even if they knew there was fraud. Thus, the shareholders to whom liability attaches are not those who benefited from the fraud. While managers may bear some cost, to the extent that they own shares, there are better ways to
liability for securities fraud instead imposes liability on innocent bystanders who did not derive a net benefit from the fraud. Moreover, corporate liability for securities fraud does not even confer a net benefit on the victims of the fraud. It harms those victims of the fraud who are not entitled to sue and may not even confer a net benefit on those who are entitled to sue, once litigation costs are taken into account.

B. NEED FOR CORPORATE INTERVENTION

Although corporate liability cannot be justified as a mechanism for compensating victims, it can be justified as a mechanism for deterring securities fraud. The deterrence role of corporate liability differs substantially from the deterrence role of individual liability, however. Corporate liability does not operate as a direct sanction on wrongdoers. Rather, the deterrence function of corporate liability is purely instrumental. Liability is impose on entities not because they are the wrongdoers but because public enforcers are better able to deter and detect wrongdoing when corporations help them do so, and corporations will not do all they can to enforce the anti-fraud laws unless public enforcers structure corporate liability to induce them to do so. Liability imposed to deter fraud may benefit shareholders – even though they pay for it – if the expected benefit to shareholders of the resulting decrease in fraud exceeds the expected cost of liability.

Understanding how liability can best be structured to regulate corporate behavior requires analysis of why public enforcers need to enlist the aid of corporations, given the availability of individual and market sanctions for fraud.

Why Individual Liability Alone is Not Sufficient

States need corporate liability because they cannot adequately use individual liability to deter securities fraud unless corporations act to help prevent, detect, and punish fraud. As previously explained, in order to deter fraud completely, the state must impose an expected sanction on potential wrongdoers that at least equals their expected gain from fraud.70 In order to do this, wrongdoers must believe that they are reasonably likely to be sanctioned if they commit fraud. Private actions help by causing wrongdoers to expect that detected fraud is likely to be sanctioned (if the wrongdoers have financial resources). Yet this is not enough. This threat of liability for detected fraud is unlikely to adequately deter fraud unless wrongdoers expect that fraud will be detected. To ensure adequate fraud detection, it is necessary to induce corporations to intervene to detect and report fraud. Liability is needed to induce

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The optimal individual sanction to absolutely deter a wrong when the probability of detection, p, is less than one is given by B/p, where B is the benefit of the crime. Becker, supra (showing that the optimal sanction is H/p, where H is the harm caused by the fraud). The present analysis sets the sanction at B/p instead of H/p on the theory that there is no optimal amount of fraud, and thus we do not want managers committing fraud even if B > H. If there is an optimal amount of fraud, then the analysis here can be adjusted by substituting H for B.
them to do this. Corporate liability also can induce firms to lower the expected benefit of fraud.\textsuperscript{71}

Private and public actions cannot optimally deter fraud absent increased detection of fraud because, as previously discussed, managers will not be deterred from committed fraud unless they face an expected sanction that exceeds the expected benefit of fraud. Private and public individual liability cannot eliminate the expected benefit on their own unless something is done to enhance the probability of detection, because the expected benefit of fraud is so great that it is likely to exceed the expected penalty that can reasonably be imposed on liquidity-constrained managers, absent a high probability of detection.

Indeed, asset insufficiency is a greater problem with securities fraud than with other frauds because managers who commit securities fraud do not immediately reap the benefit of the fraud in terms of real financial gain. Thus, this pool of resources is not available to those seeking to enforce the law. As previously discussed, managers often commit fraud in order to save their jobs by hiding poor performance in the hope that they can turn the firm around.\textsuperscript{72} These frauds confer an immediate expected benefit on managers equal to the expected net present value of his annual income over his expected future tenure with the firm (adjusted by the marginal positive effect of fraud on the probability that he retains his job). Yet the actual pecuniary gain from securities fraud is not realized immediately. It is realized only over time – for as long as the fraud is successful. Accordingly, when fraud is detected, the actual financial resources available to the manager to pay the judgment against him may be less than the expected long-run benefit to him of the fraud, if there was a significant chance of non-detection.

Although this penalty can be supplemented by other sanctions (such as termination of the manager from his job), the combined effect of these sanctions

\textsuperscript{71} The original economic analyses of how the limits of individual liability justify the imposition of liability on corporations are Lewis Kornhauser, \textit{An Economic Analysis of the Choice Between Enterprise Liability and Personal Liability for Accidents}, 70 CAL. L. REV. 1345 (1982) and Alan O. Sykes, \textit{The Economics of Vicarious Liability}, 93 YALE L. J. 1231 (1984); see also Reinier H. Kraakman, \textit{Corporate Liability Strategies and the Costs of Legal Controls}, 93 YALE L. J. 857 (1984) (joint corporate and individual liability is optimal when there exists a risk that either the firm or the individual may be insolvent).

\textsuperscript{72} See supra note 60 (discussing the evidence for this claim). Managers who do not fear termination face strong market pressures to avoid fraud, even absent liability, because their ability to manage the firm often depends on their ability to obtain financing from the capital markets. Managers who commit defected fraud cannot obtain this new financing without paying a premium, and thus are likely to be fired by shareholders. Thus, fraud is unlikely when managers do not fear termination.

One exception to this situation is managers of firms facing future (but currently undisclosed) bad news when the managers themselves own large amounts of options that are due to vest shortly. These managers may face strong financial pressures to hide bad news in order to maintain the stock price long enough for their options to vest. See supra text accompanying note 61. Nevertheless, even this incentive depends on managers taking a relatively short-run view. A manager who expects to remain with the firm for another 15 years would be unlikely to risk his future employment for such a short-run gain. Fraud is attractive only when the short-run gain exceeds the expected cost of fraud, which is the future long-run rewards lost should the fraud be detected and the manager sanctioned.
often will be less than the benefit of fraud if the probability of detection is low. 73 Often, the state cannot hope to adequately deter fraud through firing and monetary sanctions unless it can either increase the probability of detection or alter corporate policies to reduce the benefit of fraud. 74 Among the best ways to increase the probability of sanction is to enlist the aid of the corporations in both acting to prevent fraud and in increasing the effectiveness of public enforcement.

How Corporations Can Help Deter Fraud

Corporations can help deter securities fraud if they are willing to act to increase the probability that fraud is detected and sanction and also are willing to reduce the manager’s incentives to commit fraud by reducing the benefit they derive from it. 75

Corporations can reduce the net benefit of fraud by designing internal systems to either reduce the benefit of fraud or make it more costly to commit (hereinafter “prevention measures”). 76 These direct interventions deter fraud by reducing the net benefit of fraud even if it is not detected. For example, corporations can deter managers from committing fraud in order to boost short-run earnings by ensuring that compensation, promotion and retention is based on the

73 The deterrent effect of the threat of termination in particular depends on managers’ beliefs that fraud is likely to be detected, because under-performing managers who commit fraud often expect to be fired if they do not commit the fraud. Thus, managers will be deterred from fraud by the threat of termination only if the probability of detection is great enough that the combined fear of the monetary sanction plus termination for fraud exceeds the benefit of fraud, even though the manager is likely to lose his job if he does not commit fraud. Arlen & Carney, supra note 13, at 702-703 (the threat of termination will not deter frauds motivated by managers’ fear of termination).

74 The state can benefit from reducing the benefit of fraud and increasing the probability of detection even though the state can supplement monetary sanctions with non-monetary sanctions, such as prison. See supra note 40 (discussing why it may be better to increase the probability of sanction than to increase the sanction itself through the use of nonmonetary sanctions).

75 This part is based on the analysis of the purposes of corporate liability presented in Jennifer Arlen & Reinier Kraakman, Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes, 72 N.Y.U. L. Rev. 687 (1997); see Jennifer Arlen, The Potentially Perverse Effects of Corporate Criminal Liability, J. LEGAL STUD. 833 (1994) (identifying the goal of inducing corporate detection of fraud and cooperation as an important goal of corporate liability).

76 These interventions that reduce the benefit of fraud (or increase its cost) without altering the probability of detection are referred to as “prevention measures.” They are distinct from “policing measures,” such as monitoring, reporting or cooperating with the government, all of which increase the probability that a wrongdoing is sanctioned. Arlen & Kraakman, supra note 75, at 687, 699, 701-707.
long-run health of the firm, not short-run measures of financial health. Corporations also can make fraud more costly by both increasing the amount of internal oversight over important financial transactions, and encouraging direct communication of suspicious matters to appropriate committees of the board.

Corporations also can deter fraud by adopting policing measures that increase the probability that fraud is detected and the wrongdoers are sanctioned (hereinafter referred to as “policing measures”). Policing measures include (i) monitoring that makes it more likely that fraud will be detected; (ii) corporate reporting of suspected frauds to the SEC; and (iii) corporate cooperation with government investigations. Each of these measures has the effect of increasing the probability that fraud will be detected and the wrongdoer sanctioned. This increased risk of sanction deters fraud by increasing the expected sanction for fraud. A manager contemplating a fraud in the hope of saving his job or obtaining additional options compensation is less likely to do it when he is almost certain to be detected and sanctioned than when he believes he is likely to get away with it. Thus, policing can deter fraud even when there is a limit on the magnitude of the sanction that can be imposed. Policing measures also economize on enforcement costs to the degree to which corporations can detect and investigate fraud at lower cost, and more accurately, than can the state. Corporations thus can deter fraud by intervening ex ante to adopt prevention and monitoring measures, and by intervening ex post (after the fraud has occurred) to investigate and report suspected wrongdoing and cooperate with the government’s efforts to sanction those who committed fraud.

Corporations can assist the state by implementing policing measures because public entities generally are not as well positioned as is the corporation to detect fraud and identify those responsible. Corporations (and their employees) know more about their own operations and thus are better positioned to detect fraud than are public enforcers. Moreover, corporations already spend resources to detect

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77 For example, there is empirical evidence that the incidence of certain types of corporate crimes is greater when employees’ compensation or performance evaluations depends on the corporation’s annual rate of return or short-run profits, as opposed to long-run profits. E.g., C. Hill, et al., An Empirical Examination of the Causes of Corporate Wrongdoing in the United States, 45 Human Behav. 1055 (1993); John Lott and T. Opler, Testing Whether Predatory Commitments Are Credible, 69 J. Bus. 339-382 (1996); see Mark A. Cohen & Sally S. Simpson, The Origins of Corporate Criminality: Rational Individual and Organizational Actors, in DEBATING CORPORATE CRIME: AN INTERDISCIPLINARY EXAMINATION OF THE CAUSES AND CONTROL OF CORPORATE MISCONDUCT (William S. Loquist, Mark A. Cohen, and Gary A. Rabe, eds., 1997); see also Talley & Johnsen, supra note 61 (finding evidence consistent with the existence of a link between the probability of fraud and options compensation).

78 Securities frauds usually involve the direct or indirect cooperation of many people within the firm. It is rare that a firm can lie about its financial situation in a situation where only one manager knows the truth. Often many people – especially in the accounting department – know that there is a problem.

79 See supra note 76 (defining “policing measures”).

80 Arlen & Kraakman, supra note 75, at 706-717; see Arlen, supra note 75.

81 Corporations can better detect fraud than outside parties because fraud cannot always be detected from a review of publicly-disclosed documents. Fraud may substantially distort these documents. Alternatively, fraud may be hard to detect because financial statements are complicated and internalize many judgment calls. A corporation’s agents are likely to know better than an outsider
fraud as part of its on-going operations. Finally, corporations are better able to conduct the detailed investigations of suspected fraud needed both to distinguish innocent misstatements from actual fraud and to determine which individuals are responsible for any fraud that has occurred. Thus, the state often can deter fraud more effectively if it can enlist corporations' aid in detecting and investigating fraud. To achieve this aim, it must ensure that firms have an incentive both to prevent fraud and to help public actors detect, investigate and sanction fraud.82

C. IS CORPORATE LIABILITY NEEDED GIVEN REPUTATIONAL PENALTIES?

Corporations thus can help deter fraud through the adoption of both prevention measures and policing measures (monitoring, investigation, reporting and cooperation) that increase the probability that wrongdoers are sanctioned. The state could induce corporations to deter fraud by imposing liability on them. The question is, is this liability necessary given that firms also are subject to a market penalty for fraud? This Part shows that the primary purpose of corporate liability is to induce firms to detect, report, and investigate fraud. This purpose cannot be achieved unless firms are subject to financial penalties in addition to any reputational penalty the market imposes. Indeed, absent formal financial sanctions, the market penalty imposed on corporations will deter them from intervening to detect and report wrongdoing.83

Reputational Penalty

Securities fraud differs from many other wrongs in that corporations are sanctioned when fraud is detected even if no formal sanctions are imposed. When such a judgment (e.g., about projected defaults or about the proper accounting treatment for an off-balance sheet transaction) has a reasonable basis in fact and when it does not. The corporation also will have better information than outsiders about which individuals bear ultimate responsibility for any material misstatement. Cf. Dyck, et. al., supra note 29 (finding that only 6% of the corporate frauds involving large companies were detected initially by the SEC; whereas 19% were detected by employees of the firm).

82 For a discussion of whether the state can remedy some of its enforcement problems through large non-monetary sanctions, such as criminal penalties, see supra note 74.

83 The present analysis only examines the use of corporate liability to deter fraud. Corporate liability is only one of several regimes that can deter fraud by inducing third-parties to aid the state's enforcement efforts. Others mechanisms include “gatekeeper liability” imposed on accountants and lawyers to induce them to prevent and report corporate fraud, Reinier Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J. LAW, ECON. & ORGAN. 53 (1986), supervisory liability imposed on managers and directors for breach of a duty to properly monitor for wrongdoing and report it, cf. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996), and bounties offered to induce employees, directors, and third parties to monitor for fraud and report detected frauds to the government. E.g., Ronald Daniels and R. Howse, Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy, 525-549, in CORPORATE DECISIONMAKING IN CANADA, (Daniels, R., and Morck, R. eds., 1995); Assaf Hamdani & Reinier Kraakman, Rewarding Outside Directors, 105 MICH. L. REV. ___ (forthcoming 2007) (advocating rewarding outside directors for policing efforts as a way to deter corporate wrongdoing); see also Jennifer Arlen, Commentary on Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy, 635 in CORPORATE DECISIONMAKING IN CANADA (Daniels, R., and Morck, R. eds., 1995) (discussing the need to tailor bounty regimes to encourage corporate policing).
Revelation that the firm issued fraudulent financial statements produces an automatic and substantial decline in the firm’s share price, even if no formal sanction is imposed on the firm. To some degree the price falls to adjust to the new, accurate and unfavorable information about the firm. Yet beyond this, the price falls because the firm suffers a reputational penalty based on the market’s reduced willingness to trust management’s disclosures. This reputational penalty generally exceeds the magnitude of the fraud itself. Indeed, one recent study of the magnitude of this penalty found that a firm loses $2.71 in lost reputation for every dollar that it misleadingly inflates its market value, in addition to the dollar it loses when the market adjusts to the correct information and the $0.36 it loses from expected legal penalties.84

Accordingly, even without corporate liability, firms (and their shareholders) are penalized when managers commit fraud.85 Moreover, this penalty falls on the same shareholders who would be hit with the primary incidence of corporate liability -- those who own the firm’s shares at the moment the fraud is revealed.86 Indeed, previous analyses of fraud have suggested that this significant reputational sanction obviates the need for substantial corporate liability for fraud.87

Yet closer analysis shows that the reputational penalty does not obviate the need for corporate liability for securities fraud.88 First, the reputational penalty may not be large enough to induce firms to invest optimally in fraud prevention if fraud often is not detected or if firms know they can mute the reputational damage ex post by hiring new managers. Second, and more important, even when the reputational terminal penalty is large, it is insufficient to deter fraud.

84  Karpoff, et. al., Cost to Firms of Cooking the Books, supra note 1, at 1. Indeed, this study found that the reputational penalty for financial misstatements generally dwarfs the formal penalties imposed by both private and public actors. Specifically, the point estimate of the reputational penalty for financial misstatement is over 7.5 times the sum of all penalties imposed through the legal and regulatory system. Id., see also, Stephen Choi & Marcel Kahan, The Market Penalty for Mutual Fund Scandals (September 24, 2006) (finding that funds with reported scandals experience an economically and statistically significant outflow of assets); cf. Alexander, supra note 12, at 504-05 (finding that federal crimes against related parties produce substantially greater adverse stock reactions than those against third-parties, but observing that this sanction includes the impact on firm value of committing fraud against the federal government). For a formal economic discussion of the reputational penalty see Benjamin Klein & Keith Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. POL. ECON. 615 (1981); Carl Shapiro, Premiums for High Quality Products as Returns to Reputations, 98 Q. J. ECON. 659 (1983).

85  See supra Section III.A (shareholders generally do not benefit from fraud because publicly-held corporations rely on public markets for future financing, and, as repeat players in these markets, are likely to find that the long-run cost of fraud exceeds the benefit).

86  These shareholders are hit with the incidence of corporate liability even when it is imposed later because, at the moment fraud is revealed, the share price will fall to reflect both the news about the fraud and the expected liability.

87  E.g., Jonathan M. Karpoff & John R. Lott, Jr., The Reputational Penalty Firms Bear From Committing Criminal Fraud, 36 J. LAW & ECON. 757, 760-726 (1993) (suggesting that the market penalty often is enough to deter fraud).

88  This article modifies the conclusion of Arlen & Carney, supra note 13. That article focused only on the question of whether corporations should not face private liability for securities fraud. That article did not consider either public sanctions for fraud or the use of liability to induce policing measures. This article shows that while private actions against corporations may not be optimal, public actions may be where they can be used to induce monitoring, reporting and cooperation.
penalty is large it does not eliminate the need for corporate liability because the reputational penalty is not structured in a way likely to induce corporations to engage in optimal policing. Specifically, the reputational penalty does not adequately encourage reporting and cooperation. This part begins with the second problem.

**Why Market Penalties Will Not Induce Optimal Policing**

Although a market penalty is capable of inducing firms to invest in optimal prevention, if it is large enough, it generally is not capable of inducing firms to act optimally to police wrongdoing, no matter how large it is. As a result, the state cannot induce corporations to engage in optimal policing without using the threat of corporate liability for failure to do so. Corporate liability, if properly structured, can ensure that firms benefit from implementing effective policing measures both *ex ante*, before fraud is detected, and *ex post*, after evidence of fraud emerges.

The market penalty for fraud potentially provides a strong incentive for firms to intervene to prevent fraud, but it does not encourage firms to take actions that increase the probability that fraud is detected and sanctioned. Most important, it does not encourage firms to report wrongdoing because reporting instantly subjects the firm to a reputational penalty that it may avoid if the fraud remains undetected. To see this, consider a corporation that expects to face a fixed reputational penalty should fraud be detected. At first, it would appear that this penalty should encourage the corporation to implement policing measures (including reporting) to deter wrongdoing and thereby reduce the expected reputational sanction. But this “deterrence effect” is not the only effect of policing. In addition to deterring fraud, policing measures also increase the likelihood that the frauds that do occur are detected. Consequently, policing measures enhance the expected reputational penalty by facilitating the detection of frauds that otherwise might have gone undetected, an effect that is most evident when the firm decides to report wrongdoing. When this “market penalty enhancement” effect of policing exceeds the deterrent effect, firms subject to a market penalty will not police. Indeed, in this situation, the market penalty for fraud may actively discourage policing, including reporting. Moreover, the market penalty operates as a particularly strong penalty for policing in those situations where it is most valuable: where public enforcers are unlikely to detect and sanction fraud without assistance from the firm.89

To see how a fixed reputational penalty can deter policing it is useful to consider first the *ex ante* incentives of a firm to adopt a policy of monitoring for

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89 The effect of the market penalty on corporate policing depends on the structure of the penalty. Actual penalties should turn on the market’s expectation as to the future risk of fraud, which in turn depends on both firm characteristics and market conditions favoring fraud, the reputation of current managers for fraud deterrence, a sense of the firm’s culture, and other factors. Holding those factors constant, we can now consider the effect of this penalty on a firm’s incentive to report suspected wrongdoing, assuming that there is a substantial chance that the wrongdoing may escape detection (at least for many years) if the firm does not report it. Specifically, consider for simplicity the situation of a firm that expects to suffer a fixed reputational sanction if fraud is detected, that is the same whether the SEC detects the fraud or it reports it. In this situation, the market penalty would operate as a kind of strict liability for fraud which, it has been shown, can deter firms from adopting measures that increase probability of fraud being detected.
wrongdoing and reporting it to the authorities. 90 Consider a firm which faces a probability of 7% that one of its managers will commit a fraud if it does not monitor and threaten to report. Nevertheless, should fraud occur, the firm knows that it faces only a 1/20 risk that it will be detected and sanctioned, given its failure to monitor and report. By contrast, a firm that does monitor and threaten to report doubles the probability of detection from 1/20 to 1/10. This has two effects. First, it reduces the expected likelihood of fraud, by making it more likely that wrongdoers will be detected (thus making wrongdoer more costly). This is the “deterrence effect.” Assume that in our example, policing reduces the likelihood of fraud from 7% to 4%. This deterrent effect benefits the firm. But this is not the only effect of policing. While policing does deter fraud, it also increases the probability of sanction for the frauds that do occur. As a result, the 4% risk of fraud no longer is associated with a 1/20 risk of sanction. It is now associated with twice as greater a risk of sanction (1/10). This dramatic increase in the risk of sanction is sufficiently costly for the firm that is outweighs the benefit to the firm of the deterrence produced by policing. Accordingly, the net effect of policing on the firm is to increase the expected reputational sanction on the firm from (7%)(1/20)R (if the firm does not police) to (4%)(1/10)R if it does, where R is the reputational sanction. Since the latter exceeds the former, the firm is better off, ex ante, if it does not spend resources on policing.91

Moreover, even in situations where the reputational sanction does not create a perverse effect ex ante, it is likely to deter reporting ex post (after the fraud is detected) because this penalty creates a “time-inconsistency problem.”92 Even when

90 Monitoring can increase the probability that the fraud is brought to light publicly even if the firm does not report. Monitoring can increase the likelihood that the market learns about fraud it makes it more likely that public enforcers detect it or that someone within the firm learns about it who is willing to reveal it publicly. For an interesting discussion of how fraud is brought to light see Dyck, et al., supra note 29.

91 This same perverse effect can deter the firm from implementing an effective compliance program to monitor for fraud. Arlen, supra note 75.

92 Time-inconsistency refers to the fact that the actions that are in a party’s interests ex ante may not be in his best interests ex post, once he must actually execute this contract. This problem can undermine principal’s ability to regulate agents if both parties to the contract have time inconsistent preferences. Specifically, a principal cannot use a threat of sanctions to induce agents to work hard if the principal and agent benefit ex ante from agreeing to such a sanction, while both benefiting ex post from a waiver of the sanction after the agent has expended effort, when the sanction can no longer affect behavior.

To my knowledge, this is the first application of time inconsistency analysis to the question of whether market sanctions will induce firms to implement policing measures designed to protect its own shareholders. The seminal analysis of the time-inconsistency problem as applied to principal-agent incentive contracts is Drew Fudenberg & Jean Tirole, Moral Hazard and Renegotiation in Agency Contracts, 58 ECONOMETRICA 1279, 1279-87 (1990). In the corporate liability context, Arlen & Kraakman identified the time-inconsistency problem as a reason why strict corporate liability will not induce reporting. Arlen & Kraakman, supra note 75, at 712-717; see also infra text accompanying notes. For a discussion of time inconsistency (or credibility) problems as applied to public enforcement see, e.g., Nahum D. Melumad & Dilip Mookherjee, Delegation as Commitment: The Case of Income Tax Audits, 20 RAND J. ECON. 139 (1989); Jennifer F. Reinganum & Louis L. Wilde, Equilibrium Verification and Reporting Policies in a Model of Tax Compliance, 27 INT’L ECON. REV. 739 (1986).
the firm benefits *ex ante* from policing, it may not benefit from reporting *ex post*, once the fraud is detected. Once the fraud is committed, the sanction enhancement effect is likely to dominate the deterrence effect because deterrence is achieved primarily by the threat to report. Once a firm suspects fraud, its incentives change dramatically because this fraud can no longer be deterred by reporting. It has already occurred. Thus, once fraud has occurred, the primary effect of reporting, thus, is not to deter fraud; the primary effect of reporting is to guarantee that the market learns about a fraud that otherwise might go undetected. Accordingly, at this point, the market penalty for fraud operates to discourage reporting because the firm knows that if it reports fraud its stock price will fall substantially, whereas if it does not it may be able to hide the fraud forever and escape the market penalty. Thus, a firm threatened with a market penalty (and only a market penalty) may refrain from reporting detected fraud in order to reduce its expected sanction. Moreover,

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93 Thus, the fact that a firm benefits from announcing to its agents, and the market, that it plans to monitor aggressively and report any detected wrongdoing (and wrongdoers) to the government in the hope of deterring fraud, does not imply that it necessarily has a strong incentive to follow-through and actually report fraud and cooperate should fraud occur.

94 The time-inconsistency problem arises because the main deterrent effect of reporting operates through the threat to report and not the actual decision to do so, in those circumstances where managers can detect fraud without its existence being widely known within the firm. The deterrent effect of the decision to report -- as opposed to the threat to report -- would be stronger if fraud occurred sufficiently frequently that firms could establish a strong reputation for policing based on their actual reporting behavior, as opposed to their threats. Reputation can operate as an effective commitment mechanism when a decision by the firm to deviate is quickly observable and when the future cost of losing the reputation are high relative to the immediate gain from deviation. The problem with securities fraud, however, is that it occurs infrequently and it often is not observable when it does occur. Thus, the market presented with two firms that have not reported fraud in 5 years cannot distinguish the firm that detected fraud but failed to report it from the firm that simply did not have a fraud. Thus, a firm that obtains information about fraud but chooses not to report it may be able to get away with it without harming its reputation so long as information about the fraud is not widely known within the firm. See also Klein & Leffler, supra note 84 (Even when consumers can perfectly verify the quality of a good after the fact, high reputation firms will have an incentive to “cheat” and supply a low quality good unless these firms are earning a continual stream of rental income from producing the high quality good the discounted value of which exceeds the one-time wealth increase obtained from low quality production).

95 A recent study of financial misrepresentation found that, on average, firms lose 41% of their market value when news of misconduct is reported. It is estimated that almost a quarter of this loss represents the market adjusting to more accurate information. Over 66% appears to be reputational penalty, however. E.g., Karpoff, et al., *supra* note 16, at [1-2].

96 For example, the firm may be able to turn the situation around (and possibly find enough good news to mute the effects of any earnings restatements). Cf. *supra* note 72 (discussing the impact of *Dura Pharmaceuticals* on managers’ incentives to commit fraud when they hope to receive good news in the future).

97 Arlen & Kraakman, *supra* note 75, at 712-717. For example, even a firm that could deter 6 out of 7 expected frauds if it could credibly threaten to report is likely to fail to adhere to that threat if it actually detects a fraud. If the firm reports the fraud it guarantees that it is subject to a reputational sanction of $R$; if it does not report, it is subject to only an expected sanction of $R/p$, where $p$ is the probability that the fraud is detected if the firm does not report. As long as $p$ is less than one, the firm is better off not reporting. Thus, the market penalty here discourages reporting since reporting hurts the firm more than not reporting. *Id.*
observe that the disincentive to report is strongest in the very circumstance where it is most beneficial: when the probability of sanction for fraud is substantially higher if the firm does report detected fraud and cooperate than if it does not.

This time-inconsistency problem undermines firms’ efforts to deter fraud, however, because managers can anticipate firms’ reluctance to report detected fraud. Thus, their threat to report and cooperate will not have the desired deterrent effect. Accordingly, to induce credible reporting ex post, and thereby deter fraud ex ante, the government must intervene to provide incentives beyond those created by the market.

Market sanctions for fraud also may be insufficient to induce reporting and cooperation because shareholder do not control the decision to report, managers do. It often is not in their interests to report even if shareholders might want them to. As previously discussed, fraud usually takes the form of inflating the corporation’s earnings. While good managers would prefer that fraud not occur, once it has occurred they also may be better off keeping it under wraps, absent the threat of sanctions should they get caught doing so. Managers may be loath to report fraud because they also benefit from the inflated earnings, especially if they have

Of course, the market penalty may not operate quite so strongly to deter policing if the magnitude of the reputational penalty depends on the firm’s policing efforts. Yet, in order for the market penalty to encourage reporting it would have to be the case that the penalty imposed by the market for fraud falls exactly proportionately with the impact of fraud on the probability of detection. In other words, if the market penalty would need to fall 20-fold for firms that face a 1/20 probability of detection if they do not report. Cf. Arlen & Kraakman, supra note 75, at 721-22 (showing that strict liability need not create perverse ex ante incentives to refrain from policing if the sanction adjusts appropriately to reflect the impact of enforcement on the probability of detection but nevertheless can create time inconsistency problems). There is no reason to expect that it will do so.

First, absent corporate liability, markets are unlikely to penalize every firm that does not report wrongdoing because they cannot always distinguish firms that did not report before fraud was not detected from those that did not report even though fraud was detected. Corporate liability that is predicated on the firm’s policing efforts helps the market distinguish these firms by giving a public enforcer the incentive to determine whether a firm had information about wrongdoing that it did not report.

Second, even with this validation, the market penalty will not adjust optimally to ensure reporting. The market penalty for fraud will adjust for reporting based on the effect of reporting on shareholders’ expectations about the probability that fraud will occur in the future. The penalty thus should adjust based on the impact of reporting on the expected number of frauds. Thus, if we consider a firm where the threat to report reduces the number of frauds from 7 to 3 and doubles the probability of detection from 1/20 to 1/10, then reporting would cause shareholders to believe that there is a 4/7 lower chance of them being harmed directly by fraud and a (7(1/20) – 3(1/10)) lower chance of them owning shares in a firm that suffers a reputational penalty for fraud. The resulting reduction in the expected cost of owning the firm (4/7 H + 1/20 R) is less than the effect on the firm of the resulting increase in the reputational penalty if it reports detected fraud that otherwise would only face a 1/20 chance of being detected, which is given by 19/20 R. Moreover, the firm’s incentives to report are further muted if firms can take actions ex post to mute the reputational penalty, such as hiring new managers with strong reputations once fraud is detected, an approach employed by firms such as Tyco.

98 Cf. Arlen & Kraakman, supra note 75, at 712-717 (showing that strict corporate liability for corporate wrongdoing to third parties creates a time-inconsistency problem because firms want to deter wrongdoing by threatening to report it, but cannot effectively do so because this threat is not credible since reporting harms a firm subject to strict vicarious liability).
substantial amounts of money in unvested options that should vest soon. They also may be reluctant to report fraud designed to hide the fact that the firm is underperforming its peers because they also are subject to termination should the market learn how badly the firm is performing. While many managers might not commit fraud to save their jobs, many may well be willing to look the other way should fraud occur, rather than reporting a fraud that puts their positions at greater risk.99

Accordingly, market forces alone do not provide adequate incentives for corporations to report and cooperate with the state. Therefore, in order to induce policing the state must provide firms with a direct financial incentive to do so. An effective way to do this, which simultaneously encourages firms to want to prevent fraud, is to hold corporations liable for securities fraud. As discussed below, the structure of this liability must ensure, however, that reporting and cooperation is in the firm’s best interests both ex ante and ex post.

D. CORPORATE LIABILITY FOR INADEQUATE POLICING

In order to induce firms to undertake policing measures, the government must intervene and subject firms to liability for corporate fraud. It also must structure this liability to ensure that firms have direct financial incentives to implement the desired policing measures. This part shows that this requires that corporations not be subject to strict vicarious liability for managers’ frauds. In turn, this implies that public enforcers should have ultimate authority over whether corporate liability is imposed, as is shown in the next section.100

Duty-Based Liability

In order to induce policing measures the state must structure liability to ensure that firms suffer lower expected penalties when they act to increase the probability that fraud is detected and sanctioned than when they do not. The state cannot achieve this through the use of strict corporate liability. Strict corporate liability is not an effective mechanism for inducing corporations to adopt policing measures for the same reason that a fixed market penalty for fraud is not effective: a fixed penalty for fraud can deter firms from adopting policing measures that increase the probability of detection. A firm subject to a fixed penalty for fraud may

99  This same agency cost problem also can affect ex ante incentives to monitor to deter fraud. Arlen & Carney, supra note 13, at 715 (Managers at a firm in financial trouble have a conflict of interest when it comes to deterring fraud because they benefit from frauds committed by others that hide the firm’s condition).

100  The discussion in this section is based on the analysis of optimal corporate liability presented in Arlen & Kraakman, supra note 75; see Arlen, supra note 75. For a discussion of alternative forms of strict liability that in theory could be used to induce optimal policing by adjusting the sanction to reflect corporate policing measures see Arlen & Kraakman, supra, at 719-726. As a practical matter, duty-based liability appears to impose lower information costs and lower coordination costs across different enforcers than these special forms of strict liability. This may be why one does see various forms of duty-based mitigation regimes in practice, but one generally does not see sanction-adjusted strict liability regimes in practice. See id., at 745-752 (discussing how the Sentencing Guidelines operate as an incomplete duty-based mitigation regime); Arlen, supra note 12 (discussing how current federal policy imposes a form of duty-based criminal liability on corporations).
discourage monitoring and other \textit{ex ante} policing measures because these measures not only deter fraud but also increase the probability that detected fraud is sanctioned. If this sanction enhancement effect exceeds the deterrence effect, then a firm faced with strict corporate liability will not undertake \textit{ex ante} policing measures to detect fraud.\footnote{See \textit{supra} Section III.B; Arlen, \textit{supra} note 75, at 833; Arlen & Kraakman, \textit{supra} note 75, at 707-709. To see this, consider a firm with 7 agents. Assume that if the firm has a policy of not reporting and cooperating and all 7 managers commit a fraud, but that each fraud faces a low probability of detection of only 1/20. By contrast, if the firm does monitor and report, the probability of detection doubles, raising the expected cost of wrongdoing sufficiently high so that only 4 managers commit a fraud. The state clearly wants the firm to undertake these policing efforts as it reduces the expected number of frauds. Yet a corporation subject to strict liability will not do so, however, because the deterrence benefit of the reduced expected number of frauds is dwarfed by the negative impact on the firm’s profits of the liability enhancement effect. Specifically, the firm’s expected costs are (7/20) F if it does not police and (4/10)F = (8/20) F if it does. As the latter exceeds the former, the firm is better off, \textit{ex ante}, adopting a policy of no reporting or cooperation.} Beyond this, strict \textit{respondeat superior} liability deters reporting. Corporations subject to strict vicarious liability have little to gain and much to lose from reporting detected fraud since under this rule reporting automatically subjects the firm to a sanction that it might avoid by remaining silent.\footnote{See \textit{supra} Section III.B.}

The state can induce policing if it subjects firms to duty-based liability for securities fraud. Duty-based liability is not simply superior to strict liability. It also can be used to counter-act the disincentive to police created by the market penalty for fraud. Federal enforcers can induce policing by imposing on firms an implicit or explicit duty to adopt an effective program to monitor for fraud, report suspected fraud promptly, or cooperate effectively with the government’s investigation. Firms whose employees committed crimes would be subject to a special and substantial sanction if, but only if, the firm breached these duties. This sanction would not be imposed on firms that satisfy their policing duties, even though their managers caused them to issue fraudulent financial statements. The sanction imposed for breach of the firm’s policing duties must be sufficiently large that the firm’s expected costs are higher if it fails to monitor and report than if it does, notwithstanding the impact of policing on the probability of sanction. The magnitude of the sanction imposed for failure to report must take into account the fact that firms detected with fraud will be punished by the market, even if no formal liability is imposed.

To see this, consider the how liability can be structured to induce reporting of suspected fraud by a firm. Assume that the firm faces an \textit{ex ante} probability of detection of 1/10 if it does not report detected wrongdoing and a probability of detection of 1 if it does.\footnote{In addition to inducing reporting, the sanction also must be structured to provide \textit{ex ante} incentives to monitor and to announce that the firm will report. Duty-based liability also can do this. Assume that the \textit{ex ante} probability of detection is 1/20 if the firm does no policing but is 1/10 if it monitors. The state can induce monitoring if it imposes a sanction on firms that did not monitor of $\lambda$, $\lambda$ is such that $(1/20)(\lambda+R) = (1/10)R$, where $R$ is the reputational sanction imposed on firms detected with fraud. This implies that $1/20 \lambda = 1/20 R$ or that $\lambda=R$, when monitoring doubles the probability of detection.} In order to induce reporting, the firm must be subject to an additional penalty for failure to report that ensures that the firm’s expected costs are higher if it fails to report than if it does report. This implies that the monetary
penalty for failure to report, \( F \), would have to just exceed \( 9R \), where \( R \) is the market penalty for fraud.\(^{104}\) This duty-based mitigation system should induce corporate policing, even when firms face a reputational penalty when fraud is detected. Even though reporting ensures imposition of the reputational sanction (\( R \)), the firm is better off bearing \( R \) with certainty than facing a \( 1/10 \) chance of facing both the reputational sanction and the fine for failure to report, since the expected cost of this is given by \( (1/10) (R+F) = (1/10) (10R + e) > R \), where \( e \) is the amount that the monetary penalty exceeds the reputational sanction.

Accordingly, corporate liability can ensure that shareholders want their firms to monitor, report and cooperate – notwithstanding the fact that doing so increases the probability that the firm will be subject to the market penalty for fraud – provided that public enforcers impose a sufficiently large sanction for failure to monitor, report and cooperate that is not imposed on firms that do.

**Duty-Based Liability and Agency Costs**

An additional benefit of duty-based liability is that it may reduce the agency costs that otherwise plague a firm’s decision to report suspected fraud and cooperate with the government’s investigation. Corporate liability falls on shareholders who do not directly control whether the firm reports detected wrongdoing or cooperates. Instead these decisions are made by managers. Shareholders exercise only indirect influence, both through proxy voting and their ability to sell shares.

Absent duty-based liability managers may be disinclined to report suspected fraud, even committed by other managers. Reporting subjects the firm to an immediate market penalty. This can hurt managers both directly, by affecting the value of their stock options, and indirectly, through any indirect reputational effects. Duty-based liability can be used to remove this direct disincentive to report fraud by ensuring that the expected value of the firm is higher if it does report and cooperate than if it does not. Beyond this, duty-based liability also promotes policing by enabling shareholders to better monitor managers. This can help ensure that managers report and cooperate even if doing so imposes a personal cost on managers (beyond the effect of liability on share value).\(^{105}\) Duty-based liability helps shareholders to determine whether managers neglected their reporting and cooperation duties because the corporation is not subject to the duty-based sanction unless public enforcers conclude that managers failed either to report suspected wrongdoing or to cooperate fully with the government’s investigation. Thus, the imposition of this sanction signals to shareholders that management neglected its duties. This may induce them to take action. The government also can strengthen the signal by identifying individual managers responsible for the neglect when it proceeds against the firm. Managers who subject their firms to a duty-based sanction for corporate breach also be sanctioned indirectly, to the extent that other

\(^{104}\) If the state imposes a sanction in addition to the market penalty on firms that monitor and report, the sanction for failure to report would need to be \( 10(R+S) \), where \( S \) is the state imposed sanction for firms that monitor and report.

\(^{105}\) The present analysis focuses on reporting by a manager who is not the actual wrongdoer.
firms are less likely to invite these managers to join their boards. As a result, managers whose firms are subject to duty-based liability are more likely to report and cooperate than are managers whose firms are governed by traditional respondeat superior. The duty-based regime thus can mute the agency cost problem that otherwise plagues managers’ decisions to report.

E. IS RESIDUAL LIABILITY NEEDED TO INDUCE FIRMS TO PREVENT FRAUD?

A duty-based regime that mitigates liability for firms that effectively monitor, report and cooperate encourages policing measures. The question is, is additional liability needed to induce firms to adopt prevention fraud? In the case of crimes to third parties, it has been argued that corporations will not have adequate incentives to prevent fraud unless they are liable for their employees’ wrongs, even when the firm does monitor, report and cooperate. This implies that the optimal liability regime is a mitigation regime where the firm is subject to residual liability designed to induce prevention, but faces an additional sanction if it fails to monitor, report and cooperate.

The imposition by public enforcers of a sanction for failure to report may harm managers directly if other firms are more reluctant to hire managers who have already been identified as having breached a reporting duty. For example, several studies have found that directors of firms detected for fraud experience a significant decline in other board seats held, and that this decline is greater when outside directors are more responsible for monitoring fraud. E.g., Eliezer Fich & Anil Shivdasani, Financial Fraud, Director Reputation and Shareholder Wealth, J. FIN. ECON. (forthcoming, 2007); Eric Helland, Reputational Penalties and the Merits of Class Action Securities Litigation, J. LAW & ECON. (forthcoming, 2007). Presumably, if the market penalizes failure to monitor it also would penalize directors who detected fraud but failed to report it and cooperate, especially when this failure subjects the firm to a publicly-imposed sanction that it otherwise would not bear.

By contrast, under traditional respondeat superior liability for securities fraud, managers who detect fraud have nothing to gain and everything to lose from reporting suspected fraud. If they report it, the firm is subject to both an immediate market penalty and to the monetary sanction associated with respondeat superior liability. If they do not report it, the firm may escape penalty altogether. Moreover, if it is penalized, the firm’s penalty is unaffected by the failure to report – the firm faces the reputational sanction plus the monetary penalty associated with respondeat superior liability. Beyond this, it is likely that shareholders will not punish the managers personally for failure to report. First, shareholders may never know of the neglect since under standard respondeat superior public enforcers have little reason to expend resources determining whether a manager detected wrongdoing and failed to report it. Second, shareholders may rationally conclude that the failure to report was not a breach of duty since, as previously explained, under traditional respondeat superior shareholders are better off when wrongdoing is not reported.

See Arlen & Kraakman, supra note 75.
This Part shows that securities fraud is different.\(^{109}\) Firms that satisfy their policing duties often should not be subject to any liability at all for detected fraud for two reasons. First, firms often have adequate incentives to prevent fraud even without this liability because firms that adhere to their policing duties face a substantial expected market penalty should fraud occur. Second, residual liability often should not be imposed even when the expected market sanction is not enough because imposition of residual liability on firms that satisfy their policing duties undermines public enforcers’ ability use the duty-based sanction imposed for failure to police to induce firms to report and cooperate.

**Prevention Measures**

Prevention measures differ from policing measures in that they do not affect the probability that the wrongdoer is sanctioned. They simply make fraud more costly or less beneficial to commit. One important set of prevention measures are compensation, promotion and retention practices. Fraud appears to be more attractive if retention and compensation depend on short-term measures of performance. Managers have less incentive to commit fraud if compensation is tied to long-run measures of firm performance and if managers expect to retain their jobs notwithstanding short-term weak firm performance. Managers are less likely to incur the risks associated with fraud if they expect to be given a chance to turn the firm around even if they do not lie. Similarly, they have less incentive to lie to boost short-term performance if their compensation is based on long-run share value.\(^{110}\)

Firms often face a trade-off in designing prevention measures between providing immediate incentives to boost performance and deterring fraud. One goal of the securities fraud laws should be to encourage firms to strike the right balance, by ensuring that they adequately take the cost of fraud into account. Firms can be expected to strike the right balance if they internalize the cost of fraud even when they expected to satisfy their duties to monitor, report and cooperate.

Optimal deterrence of securities fraud may not require the imposition of liability on firms that satisfy their policing duties. First, the market penalty may

\(^{109}\) This section thus reaches a different conclusion from Arlen & Kraakman, supra note 75, which concluded that corporations generally should face residual liability for corporate wrongdoing to fit the special circumstances of securities fraud. Arlen & Kraakman, supra, focused on corporate crimes to third parties. Corporate liability is needed to induce corporations both to prevent these wrongs and to police them because wrongdoing to third parties does not generate a substantial reputational sanction. Thus, corporate liability must serve multiple aims, including inducing preventive measures and regulating activity levels. Accordingly, we concluded that it likely would be optimal to allow the state to impose a duty-based liability for failure to monitor, report and cooperate, while retaining residual liability (public or private) even for firms that did monitor, report and cooperate. Arlen & Kraakman, supra note 75, at 741-42.

Securities fraud is different because the people who would be reached by the residual sanction – the corporation’s shareholders – automatically are subject to a market penalty for fraud. Moreover, the magnitude of this penalty is enhanced by policing measures. Accordingly, there is less need to impose residual liability. Residual liability also is more costly, because it makes it more likely that the state cannot use duty-based liability to induce policing because residual liability increases the likelihood that the firm will not have sufficient assets to pay the additional duty-based sanction needed to induce optimal policing.

\(^{110}\) See supra Section
provide these firms with adequate incentives to prevent fraud. In addition, even when it does not, it still may be better not to impose residual liability on firms that police because this liability may undermine the state’s ability to use corporate liability to induce policing.

Interaction of Reputation and Policing

Firms may have adequate incentives to incur costs to prevent fraud even if they can avoid all threat of formal sanction by policing (monitor, report and cooperate) because firms detected with financial fraud are subject to a substantial reputational penalty.111 Existing analysis suggests that there is a significant reputational sanction that on average results in the market imposing a sanction of approximately four times the amount of the fraud.112 This reputational penalty provides firms with an incentive to prevent fraud.

By definition, prevention measures deter fraud without affecting the probability of detection. Accordingly, firms subject to a reputational penalty for detected fraud have an incentive to adopt measures to prevent fraud, even without any threat of liability. This incentive to prevent fraud is particularly strong for firms that adhere to their policing duties, because firms that monitor, report and cooperate are more likely to have their managers’ frauds detected than those that do not. Thus, to the extent that the duty-based sanction induces effective policing, it also indirectly induces prevention through the interaction between policing and the reputational penalty for fraud.

Negative Impact of Residual Liability on Policing

Of course, even firms that police effectively may not face a sufficiently large expected reputational sanction to induce them to invest optimally in preventing fraud. In some cases, the solution to this may be to subject firms with detected fraud to residual liability, and in addition subject them to a duty-based sanction if they fail to monitor, report and cooperate. But residual liability should be the exception, not the rule, even when market incentives to prevent fraud are not strong enough. Public enforcers generally should eschew the use of residual liability imposed on

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111 This analysis assumes that corporate policing does not produce a one-for-one reduction in the market penalty for fraud. This assumption seems reasonable. The market penalty for fraud is based, to a considerable degree, on the market’s assessment of the probability of future financial misstatements (and its assessment of trader’s assessment of this future probability) conditional on a fraud being detected. The market is likely to impose this penalty even on firms that policed effectively because, conditional on policing, the market may reasonably conclude that a firm whose managers committed fraud is more likely to suffer fraud in the future than a similar firm (with similar policing) whose managers did not, since fraud may signal something about the nature of the firm that indicates that it is more vulnerable to fraud. While policing may reduce the penalty relative to a firm that did not police, it is unlikely to reduce the penalty proportionate to the effect of policing on the probability of detection. Thus, a firm that reports a fraud that otherwise would face only a 1/20 chance of detection is unlikely to see its market penalty reduced 20-fold unless the market concludes that such a firm is 20-times less likely than it otherwise would have to have a fraud in the future. The market may reasonably fail to reach this conclusion, for example, if the firm is in a cyclical industry which frequently places managers in a potential last period situation where they may be tempted to commit fraud in order to save their jobs.

112 See supra note 77 and accompanying text.
firms that satisfied their policing duties, because the imposition of residual liability often undermines the state’s ability to use corporate liability to induce policing, which is the more important goal.  

Imposing residual liability on firms that satisfy their policing duties may actually reduce firms’ incentives to prevent by undermining the state’s ability to use the duty-based sanction to induce policing. Residual liability undermines policing by increasing the likelihood that the firm will not have sufficient assets to pay both the duty-based penalty imposed for failure to police and the residual sanction.

To see this, consider the structure of a mitigation regime that imposes a residual sanction on all firms whose managers commit fraud, $F$, in addition to imposing a duty-based sanction of $D$ on those firms that fail to satisfy their policing duties. These sanctions are imposed in addition to the market penalty for fraud. Given this, the firm faces the following total penalties (including the market penalty). A firm that satisfies its policing duties faces a total penalty of $F + R$, where $R$ is the reputational penalty). A firm that does not satisfy its policing duties faces a total penalty of $F + R + D$.

Consider now the firm’s incentives to report detected wrongdoing. The firm’s expected liability if it does report is given by $F + R$. Its liability if it does not report is given by $(p) \ (F + R + D)$, where $p$ is the probability of sanction if the firm does not assist the government by reporting or cooperating. The duty-based sanction of $D$ can induce reporting only if $D$ is such that the firm is better off reporting than not reporting. This in turn implies that the firm will report only if it has sufficient assets to pay a total sanction in the event that it does not police of $D + F + R = (F + R)(1/p)$. Observe that, the higher the cost to the firm of reporting – in particular, the higher the residual sanction $F$ – the greater $D$ must be in order to ensure that the firm would be better off reporting. Moreover, each dollar increase in the residual sanction $F$, must be matched by a much greater increase in $D$, since a firm that does not report knows it may avoid sanction altogether. Imposition of residual liability on firms that do report, thus, places substantial upwards pressure on the total sanction imposed on firms that do not report ($F + D + R$). Residual liability may require the state to impose a sanction for failure to report that exceeds the ability to pay of most firms with detected fraud.

Pushing the total sanction above the firm’s ability to pay undermines the state’s ability to use corporate liability to induce policing. A firm will determine whether to report based on the actual sanction that it can pay. If the residual sanction is high enough that the optimal total liability for failure to report exceeds the firm’s wealth, then, by definition of the optimal sanction, it follows that the firm

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113 The better solution to the problem of inadequate prevention is to increase the probability of detection, which in turn increases the expected reputational sanction. The greater the expected market penalty for fraud, the greater firms’ incentives to employ measures to prevent it. Thus, in the case of securities fraud, sanctions and practices designed to induce policing also operate to encourage firms to prevent fraud through the operation of the market penalty for fraud.

114 For example, a firm that faces a 1 in 4 chance of fraud being detected if it does not report, would need to face a duty-based sanction of 3 times the combined residual liability and reputational sanction, in addition to bearing the residual liability and the reputational sanction.
is better off if it does not report than if it does. In this case, the residual sanction undermines the most important goal of corporate liability: policing. Accordingly, the state often cannot impose a residual sanction on firms that satisfy their policing duties without undermining its efforts to induce policing.

Asset insufficiency is likely to operate as a general impediment to the state’s ability to induce policing if firms are subject to residual liability for two reasons. First, firms whose managers commit securities fraud often are in either financial trouble or are relatively small. Second, even when these firms are not in trouble ex ante, they often are severely weakened when it is revealed that their managers committed fraud. Residual liability for fraud would weaken them even more, since it would greatly facilitate the ability of private plaintiffs to recover from the firm.

When, as is likely, there exists a conflict between policing and prevention goals, the state should focus on policing for two reasons. First, policing supports the goal of prevention (by increasing the expected market penalty for fraud), whereas sanctions that induce prevention do not in turn encourage policing. Second, policing often is more effective than prevention because fraud is often hard to prevent ex ante. Deterrence thus often will be better accomplished by ensuring effective enforcement ex post. Fraud often is hard to prevent ex ante because inevitably managers placed in charge of prevention also will face incentives to either commit fraud or look the other way – as when fraud is committed when managers know that the firm is not performing well and fear that either new management will be brought in or the firm will be taken over if the market learns how badly the firm is doing.

115 In some circumstances, the state may be able to use a duty-based sanction to induce firms to report even when the firm does not have sufficient assets to pay the optimal sanction. Public enforcers may be able to use this mitigation regime to induce reporting if the imposition of duty-based liability on the firm for failure to report indirectly affects managers’ and directors’ welfare through either a personal reputational penalty or the threat of a derivative action. Managers whose firms are subject to an additional penalty for failure to report may report, even if the firm faces a ruinous reputational penalty if they do so, if they fear that stakeholders can sue them for breach of fiduciary duty if they detect fraud and fail to report it, thereby subjecting the firm to an additional state-imposed sanction. Breach by managers of a duty to report may induce shareholders (or creditors) to file a fiduciary duty action against them if breach results in the imposition by the state of a criminal sanction for failure to report which is not dischargable in bankruptcy, since this non-dischargable claim can harm the both shareholders and creditors who might have otherwise been able to obtain more value from the firm following a bankruptcy reorganization. See generally Credit Lyonnais Bank Nederland v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991) (directors’ fiduciary duties may run to creditors when the firm is in the shadow of insolvency at the time the action was taken); Geyer v. Ingersoll Publications Co., 1992 Del. Ch. Lexis 132 (Del Ch. June 18, 1992).

The imposition by public enforcers of a sanction for failure to report also may induce reporting and cooperation even when firms are insolvent through the reputational impact of this sanction on the firms’ managers. See supra note 106.

116 See supra text accompanying note .

117 A firm that reports and fully cooperates increases both the probability that fraud is detected and its expected liability, as plaintiff’s are better able to show that a misstatement was the product of fraud, as opposed to accidental error, if the firm cooperates in producing evidence of managers’ wrongdoing. See Karpoff, et. al., Legal Penalties, supra note 21, at 23 (finding that private lawsuit settlements are larger for firms that self-disclose their financial violations).
Accordingly, the optimal structure of corporate liability for securities fraud is to impose a duty-based sanction on firms which fail to monitor, report and cooperate. In some circumstances, this should be the only sanction imposed, as is the case where the firm will be in financial trouble once the fraud is revealed or when the ex ante probability of detection appears to be high if the firm polices effectively. In other circumstances, it may be optimal for the state to impose a residual sanction on the firm, when this sanction does not interfere with the state’s ability to use the duty-based sanction to induce policing and when the market penalty is not sufficient to induce adequate prevention.

F. SUMMARY

Corporate liability can be used to deter fraud by inducing corporations to adopt policing measures. It also can help deter fraud by inducing prevention measures, either directly through residual liability or indirectly through the impact of policing on the market penalty for fraud. In order to do so, however, corporate liability must be structured differently than individual liability. Specifically, corporate liability must be structured to ensure that corporations benefit from actions that increase the probability of detection, such as reporting. Often, the most effective way to do this is to subject firms to a quite narrow form of liability for securities fraud. Firms whose managers commit fraud should be sanctioned if the firm did not monitor effectively, report promptly and cooperate with the government’s enforcement efforts. Yet they often should escape liability altogether if they satisfy these policing duties. Residual liability may be appropriate in some cases, but only if deterrence is materially enhanced by the impact of residual liability on prevention, and if the firm is sufficiently large and healthy that it would have sufficient assets to pay the full penalty if it did not report. In most circumstances, however, the only reliable way to induce policing is to employ a pure duty-based sanction, under which monitoring, reporting and cooperation completely insulates the firm from all liability for securities fraud.

The question to be addressed now is what are the implications of this analysis for the allocation of enforcement authority between public and private actors?

IV. PUBLIC VERSUS PRIVATE AUTHORITY OVER CORPORATE LIABILITY

The conclusion that corporations that report wrongdoing and cooperate often should avoid all liability for securities fraud has implications for the issue of public versus private authority over securities fraud. As shown in this Section, it implies that public actors should be permitted to bring actions against firms (under a duty-based regime), but private actions should not be permitted against any firm that satisfied its policing duties. Private actions should be permitted against firms that do not report and cooperate, however, as this enhances the expected sanction for firms that do not report and cooperate. Nevertheless, the SEC should retain authority to preclude a private action against a firm if it concludes that the firm adequately reported and/or cooperated. Private plaintiffs should be able to proceed against
firms if the SEC does not object, however. In addition, private plaintiffs should be able to proceed against individual wrongdoers.

As previously discussed, optimal deterrence of securities fraud requires that corporations be subject to a substantial sanction if they fail to comply with their policing duties. In a few circumstances, policing can be induced through the use of a substantial sanction for failure to police that is layered on top of residual default civil liability (designed to induce prevention). In most circumstances, the policing sanction should be the only sanction imposed on corporations for fraud. 118

Public enforcers cannot ensure that the policing sanction is administered to encourage deterrence unless they are granted sole authority to determine whether firms are subject to a sanction for inadequate policing. Public enforcers are in the best position to determine whether a corporation has satisfied its policing duties because they have better information about whether reporting was prompt (given available information) and cooperation effective. Also, public enforcers are less likely than private actors to make improper use of their discretion to sanction a firm for inadequate policing to collect revenues. 119 SEC enforcers are repeat players who

118 The present analysis thus moves beyond Arlen & Carney, supra note 13, which concluded that strict corporate liability was not an effective mechanism for preventing fraud. Arlen & Carney did not analyze duty-based liability for securities fraud because it focused on corporate liability to private parties. As discussed, private liability is not an effective way of operationalizing a duty-based regime because private parties cannot be relied upon to give up their right to proceed against the firm in order to induce reporting and cooperation. After all, corporations are the deep pockets and, moreover, it is difficult for any one group of private plaintiffs to bind all possible private plaintiffs who might want to sue the firm. Selective waiver is inferior to granting public enforcers ultimate control over liability imposed on firms that cooperate for two reasons. First, firms protected by only a selective waiver do not have adequate incentives to report because reporting still enhances their expected private liability even if private plaintiffs cannot access privileged materials. Second, selective waiver does not promote deterrence as effectively as the system proposed here. To deter fraud, private plaintiffs pursuing individual wrongdoers should be able to use the information the company provides the government against these private plaintiffs – at least where the use of this information would not harm the firm. Selective waiver would preclude private plaintiffs from using this information against managers, as well as against firms. Public authority over corporate liability would protect firms while promoting the use of individual liability against wrongdoers.

119 The argument for sole public authority to sanction firms for breach of their policing duties is especially strong it, as is likely, the duty-based sanction for failure to monitor, report and cooperate can most effectively be implemented informally through policies governing when public enforcers proceed against firms whose managers commit fraud, as it currently is being implemented, as opposed to formally, through the explicit establishment and delineation of a legal duty to monitor, police and cooperate by the courts. Formal administration of the sanction would be difficult because courts cannot easily establish precedent that clearly delineates for a firm what actions constitute adequate monitoring, reporting and cooperation. A formal legal duty inevitably would either grant too much deference to managers or would risk imposing too much liability. Indeed, state courts presented with the task of administering fiduciary duty actions against directors for breach of their duty to monitor have avoided the problem of determining what constitutes an “effective compliance program” by granting to the board of directors sole authority to determine what compliance program is appropriate for the firm, subject to Business Judgment Rule protection. In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996). See William A. Klein & John C. Coffee, Jr., Business Organization and Finance: Legal and Economic Principles, 159 (2004) (this standard would seem to protect directors who rationally adopt a minimalist compliance program after weighing costs against benefits). Moreover, the firm and SEC often would be unable to produce clearly verifiable evidence of adherence to the duty. The court often would have to simply accept the agency’s position, giving
generally want to deter fraud, all else equal.\textsuperscript{120} Their ability to deter fraud depends on their ability to induce firms to report and cooperate. This provides them with an incentive to adhere to a policy of sanctioning only firms that breach their policing duties because public enforcers can benefit from the duty to report and cooperate only if they develop a strong reputation for protecting firms that report and cooperate from liability. Thus, public enforcers should control whether firms should be subject to a penalty for failure to police.

Public enforcers cannot reliably use their authority to induce firms to report and cooperate, however, unless they have full authority to insulate firms that report and cooperate from all liability for securities fraud. This includes private \textit{respondeat superior} liability. Public enforcers must be able to preclude private actions because private residual liability can undermine public enforcers’ ability to use the policing sanction to induce reporting and cooperation. Public enforcers cannot induce adequate policing unless it can guarantee that the expected sanction if a firm does not police exceeds the expected sanction if it does. Public enforcers cannot threaten a firm with sufficient liability to induce reporting, however, if it faces ruinous liability even if it does report, especially since reporting guarantees the imposition of such a sanction. This implies that public enforcers must have authority to preclude private parties from suing a firm if public enforcers conclude the suit is not in the public interest.\textsuperscript{121}

Nevertheless, private actions should be permitted against firms if the SEC does not object. Specifically, private actors should be permitted to sue firms that did not report or cooperate, unless the SEC concludes that the firm did not report or cooperate because there is no evidence that fraud occurred. Private actions against firms that breach their policing duties helps deter fraud because the state can induce reporting and cooperation only if the expected sanction imposed on firms that do not report exceeds that imposed on those that do. Private actions can encourage reporting by increasing expected sanction on firms that do not police effectively. Private actions are particularly important if the state is unlikely to either detect the fraud or bring an action on its own because of insufficient resources, interest group capture or political pressure.\textsuperscript{122} It also helps economize on public enforcement

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\textsuperscript{120} In periods of regular disclosure of fraud the agency is likely to come under political pressure, especially if it is shown that the frauds occurred notwithstanding evidence that the agency had adequate funding to bring enforcement actions.

\textsuperscript{121} Control over private corporate actions is superior to other efforts to encourage policing, such as granting firms the right to share privileged materials with the SEC pursuant to a selective waiver. For example, proposed Federal Rule of Evidence 502(c) provides that disclosure to a federal public officer or enforcement agency of a communication privileged by the attorney-client privilege or work-product doctrine does not operates as a waiver of the privilege or protection in favor of nongovernmental persons or entities in any federal or state proceeding. \textit{Selective Waiver of Privilege Provision Likely to be Pulled from Proposed Rules of Evidence}, 75 U.S. LAW WEEK No. 30, 2471, (Feb. 17, 2007).

\textsuperscript{122} See supra text accompanying notes 44-48.
resources by shifting costs from public enforcers to private parties who benefit from the litigation. In addition to bringing actions against firms that do not report or cooperate

Accordingly, unlike individual liability, corporate liability for securities fraud should not be governed by a regime of dual authority over liability. Corporate liability for securities fraud should be under the ultimate control of public authorities. Generally, they should proceed only against those firms that fail to satisfy their policing duties. Private parties also can proceed against these firms. Nevertheless, private enforcers should be able to sue firms only if the SEC does not object. Public enforcers should be permitted to preclude private actions against firms if the public enforcers conclude either that the firm satisfied its policing duties or that no fraud was committed.

CONCLUSION

The health of the securities markets depends on the public’s faith that it can invest in shares without incurring a substantial risk of being injured by securities fraud. An inability to control fraud can harm all firms by causing shareholders to impose a fraud discount on the shares they purchase. All participants in the securities markets, thus, potentially benefit from the use of effective mechanisms to deter fraud. Liability imposed on managers and firms for fraudulent misstatements has the potential to operate as just such a mechanism to deter fraud. Effective deterrence of fraud requires that both public and private actors be permitted to pursue actions when firms issue fraudulent financial statements.

The central issue is to determine the appropriate allocation of enforcement authority between public and private actors. This issue has preoccupied Congress, which has intervened regularly during the course of the last two decades to alter the scope of both public and private enforcement authority in securities fraud cases. Yet each of Congress’ efforts to adjust public and private enforcement authority share a common limitation. Congress’ actions concerning securities fraud involve uniform rules that apply to all actions against primary wrongdoers involving fraudulent financial statements, without distinction between whether the action is against the managers responsible for the fraud or their corporate employer. This would be justifiable if securities fraud actions against managers and corporations served common purposes and had similar effects. They do not.

Individual and corporate liability for securities fraud differ in two important respects that affect the proper allocation of enforcement authority between public and private actors. First, they differ in their goals. Individual liability can operate to ensure that wrongdoers compensate victims; it also directly deters wrongdoers by imposing a sanction on them. By contrast, corporate liability is not justifiable on compensation grounds. Moreover, although corporate liability can be used to deter wrongdoing it does so indirectly, and not directly. Corporate liability deters wrongdoing to the extent that it induces the firm to intervene to discourage fraud, largely by implementing policing measures. Beyond this, individual and corporate liability warrant different treatment because they operate in different contexts. Individual liability often appears to be the primary sanction imposed on a
wrongdoer. By contrast, corporate liability is not the only penalty imposed on firms that commit fraud. In addition, firms detected with fraud are subject to a market penalty which may exceed the formal sanctions. This market penalty must be taken into account when determining the formal sanctions imposed on firms for fraud.

Because individual and corporate actions differ in their purposes and effects, the optimal scope of individual liability for securities fraud differs from the scope of corporate liability for securities fraud. As a result, private actors’ authority to proceed against individual defendants should differ from (and be greater than) their authority to proceed against corporate defendants. Congress’ efforts to regulate private actions have yet to recognize this important distinction.

In its most important legislation affecting private actions, the PSLRA, Congress permitted the continued use of private actions but restricted their scope. The present Article reveals that this approach is correct as applied to actions against individual managers. Private actors should be allowed to sue wrongful managers because private actions against managers require wrongdoers to compensate victims, thereby serving a legitimate goal of securities fraud liability. Private actions against managers also promote deterrence by ensuring that liability is imposed even when public enforcers lack the resources or political will to proceed against powerful and well-connected managers of publicly-held firms. While private actions against managers do present a risk of frivolous litigation, this risk is best addressed by imposing on private parties a stronger evidentiary burden to show that the managers who made the material misstatement did so knowing that it was materially misleading. This approach is consistent with that employed by the PSLRA.123

Nevertheless, this approach is not correct in the case of actions against corporations. Rather than restricting private actions through pleading standards, Congress should grant public enforcers the right to force dismissal of any action against a corporation that the public enforcer concludes satisfied its policing duties. The primary purpose of corporate liability is to induce corporations to monitor, report and cooperate with the government. Compensation of victims is not a legitimate aim; and the market penalty can be relied upon to induce some prevention measures. Corporate liability can achieve this policing goal only if public enforcers can ensure that firms generally are subject to liability for fraud only if the firm failed to satisfy its duties to monitor, report detected fraud and cooperate. Public enforcers thus must generally subject firms only to duty-based liability. Consistent with this, public enforcers must be able to prevent private parties from imposing liability on any firm that has satisfied its policing duties.

The present analysis implies that Congress should intervene again to curtail private actions, but only as applied to actions against corporations. Congress must ensure that private actions against genuine wrongdoers proceed. Moreover, the present analysis suggests that Congress should not interfere with private parties’ ability to use the fruits of government investigations to sanction individual wrongdoers. The solution to concerns raised by private parties’ use of the fruits of corporate cooperation against firms is to restrict corporate liability to private parties;

123 The present Article does not address the issue of whether the precise standard employed by the PSLRA is optimal, however.
it is not to also act to insulate wrongful managers from the liability associated with the use of this information.