What is a Business Crime?

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Why do we criminalize some offenses while other offenses are left to civil remedies? The answer *should* be simple. We should criminalize an offense only when less drastic sanctions do not deter it. The principle that criminalization should be the last resort may not need further explanation. It seems obvious that it is more efficient to rely on private remedies when they work. Why use public resources to prosecute and punish offenses that private litigants can handle? Moreover, in a civil action the point is to make whole the victim of the offense.[1] In a criminal action, compensation is at best an afterthought and at worst a distraction.[2] Finally, it is more consistent with a government of limited powers to rely on the criminal law only when all else fails.[3] That is what freedom and free enterprise are all about. Nevertheless, there seems to be currently at work some sort of presumption that where there is a wrong there oughta to be a *criminal* law to punish the wrongdoer.

There are many forms of business crimes. The focus here is on the relatively new subset of business crimes that has emerged in connection with corporate governance and securities regulation. In general, the subject matter is an extension of fiduciary duty.[4] That is, the ultimate issue is whether the directors, officers, or agents of a corporation are guilty of a breach of trust *vis a vis* investors or the corporation itself.[5] To be sure, there is an ambiguity here. It is not clear that a corporation has any interests independent its investors' interests. But leaving that puzzle aside for the moment, it is worth noting that the investors in question are almost always the stockholders.[6] There are relatively few cases—civil or criminal—in which the interests of

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[1] Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1809 (1992) (noting that one of the "[t]wo paradigmatic remedies" available through civil law is "the court order mandating a return to the *status quo ante*, so as to make the injured party whole . . . . [t]he second is the order to pay money as compensation for damage caused").

[2] *See id.* at 1799, 1806–09 (explaining that the original purpose of criminal law sanctions was to punish and deter public wrongs, regardless of whether an individual person suffered an injury, while civil law developed to compensate private individuals for actual damage to their interests).

[3] *See* Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 31 (1997); Mann, *supra* note 1, at 1811, 1850–53 (highlighting the differences between civil and criminal law as well as exploring Congress's tendency to apply civil law over criminal law). Criminal law "should be reserved for the most damaging wrongs and the most culpable defendants." Mann, *supra* note 1, at 1863.

[4] *See* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (explaining that insider trading liability is based on a breach of fiduciary duty).

[5] Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1734 (1994). "The procedural form of a shareholder suit depends on whether managers are said to have harmed the corporation or instead its shareholders in the first instance." *Id.*

[6] *See id.* at 1733. "Shareholder suits are the primary mechanism for enforcing the fiduciary duties of corporate managers." *Id.*

creditors or other constituencies are the focus.[7] So the question is: what do stockholders want the law to do? The answer depends on the nature of the offense.

I. The Varieties of Civil Remedies

Civil remedies come in many shapes and sizes. And there are few offenses that cannot be effectively addressed by one of three forms of civil remedies: simple damages,[8] punitive and multiple damages,[9] and class and derivative actions.[10]

A. Simple Compensatory Damages (and No Damages).

Simple compensatory damages (SCDs) are enough to deter most offenses. If the offense arises from inadvertence or even recklessness and does not involve gain to the culprit, a civil action for SCDs should suffice.[11] If the culprit cannot gain from the offense, SCDs are sufficient to deter bad behavior.[12]

There is a danger that SCDs may be too much in some cases.[13] As a matter of state corporation law, the business judgment rule and the ability for a corporation to absolve management of liability in negligence mean that managers cannot be held liable for mere mistakes of judgment.[14]

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[7] *See* Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 413 n.1 (1986) (providing a description of the position of bondholders and other creditors in the corporate realm in comparison to that of stockholders). Unlike the rights of stockholders, the rights of bondholders and other creditors are not protected against corporate abuses and thus there are few interests able to be brought before the court. *Id.*

[8] *See infra* Part I.A.

[9] *See infra* Part I.B.

[10] *See infra* Part I.C. To be sure, class actions and derivative actions are procedures not remedies. The point is that they provide a remedy where one might not otherwise be available. The thesis here is that one should be able to say the same thing about the criminal law.

[11] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 315–52 (1991) (providing a thorough discussion of remedies available in corporate law cases); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. Chi. L. Rev. 611 (1985).

[12] Lynch, *supra* note 3, at 32, 40. "Because such crimes are typically committed for financial gain, by people who often have significant economic resources, the use of fines has seemed to many an adequate deterrent." *Id.* at 32. To be sure, there are many forms of gain. Monetary gain is the most obvious. But it may be another form of gain simply to keep a business afloat. Although intangible benefits may motivate some bad behavior, requiring a threshold showing of tangible benefit would filter out dubious cases.

[13] *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 11, at 334–35. Easterbrook and Fischel present a hypothetical in which a manager proclaims that his firm will soon be worth billions, which in turn causes the firm's stock to increase dramatically. Shortly thereafter, the manager admits that his proclamation was a "false alarm" and the price drops back down to the "original level." *Id.* at 334. The people who bought stocks during the interval in which it was believed that the firm was worth billions would at this point be faced with great loss. The manager and firm would not be financially benefited from the situation. In this scenario, "[a] rule that required the firm to compensate the buyers for their full loss would impose damages far in excess of the net harm." *Id.* at 335.

Stockholders have no remedy in such cases. But a rational stockholder does not want a remedy in such cases. By holding a diversified portfolio of stocks, a stockholder can eliminate the risk of good faith mistakes of judgment.[15] Because stockholders can insure themselves effectively through diversification, they should be opposed to wasteful litigation by other stockholders seeking recovery in such circumstances. Diversification works for stockholders because the goal of a business is to make money[16] and because business does in fact make money in the aggregate.[17] As long as the decision or behavior in question is part of a good faith effort to further that goal, a stockholder has no complaint.[18] On the other hand, if the bad act is one that subtracts money from the pot – on purpose – then stockholders have a legitimate complaint.[19]

The business judgment rule applies only to business decisions made in good faith. If a decision is made other than in good faith and it gives rise to losses, a manager may be held liable for the harm done to the corporation.[20] If a decision is tainted by conflict of interest, the manager may be required to disgorge any ill-gotten gains or may be required to restore the corporation to the

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[14] *See, e.g.*, *id.* at 93 (acknowledging that the business judgment rule absolves managers from liability even when they act negligently).

[15] *See id.* at 28–30 (defining diversification as having an "investment in the economy as a whole" and explaining that such diversification allows investors to concern themselves with the value maximization of firms in the entirety instead of the value maximization of individual firms, which therefore eliminates the risks associated with individual firms).

[16] *See id.* at 120 ("When there is competition, investors agree that the corporation should have the objective of maximizing wealth because greater wealth gives them the ability to consume or rejuggle their portfolios to yield greater returns . . . ."). Although investors may not always prefer the wealth maximization in every corporate decision, the overall objective is to increase wealth.

[17] *See id.* at 121 (relating diversification to the idea of how businesses in the aggregate make money by providing an example of an investor whose stock in an individual firm is near worthless while the aggregate of his investments in multiple firms is financially profitable).

[18] *See* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 437–38 (1998); *see also* EASTERBROOK & FISCHEL, *supra* note 11, at 93–100 (detailing the interests of the stockholders and how they tend to react to corporate decisions and behavior affecting those interests).

[19] *See* Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It,* 4 BERKELEY BUS. L .J. 1 (2007) [hereinafter Booth, *End of Securities Fraud*]. Creditors and other stakeholders are in a different boat. They do not gain when a company increases in value. *See* McDaniel, *supra* note 7, at 418–19, 435. But they can lose when a company loses value. *Id*. This is no great insight. It is well known among scholars of corporation law. *See id*. The point is that the interest of stockholders and other constituencies conflict. Accordingly, the conventional wisdom is that creditors and other constituencies must protect themselves by contract. *Id.* at 413 n.1; *see also* Richard A. Booth, *The Duty to Creditors Reconsidered—Filling a Much Needed Gap in Corporation Law*, 1 J. BUS. & TECH. L. 415, 416 (2007). And there are few cases in which creditors have succeeded in connection with a claim that they have been harmed by business decisions intended to benefit the stockholders. *A fortiori,* it is quite difficult to say such a decision should ever be seen as a crime. *Id.* at 46 n.7.

[20] S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 130, 134 (1979) "[I]n the absence of the business judgment defense, [which does not apply in situations indicating a lack of good faith], directors are liable to the corporation for losses sustained by the corporation because of knowingly illegal conduct." *Id.* at 130.

status it would have enjoyed if the transaction had never happened.[21] Although the latter remedy is somewhat different from SCDs, it is nonetheless a simple remedy that seeks only to restore the parties to the *status quo ante.*

Similarly, federal securities law relies on simple remedies for the most part.[22] Indeed, it is noteworthy that federal securities law expressly prohibits awarding damages in excess of actual loss.[23] On the other hand, the business judgment rule does not apply in connection with claims arising under federal securities law.[24] Under the Securities Act of 1933,[25] an issuer is absolutely liable if there is a misstatement or omission of a material fact in connection with an *offering* of securities.[26] In essence, investors can demand a refund if they have been misled in connection with an offering of securities.[27] The Securities Exchange Act of 1934 governs *trading* in securities.[28] Here a plaintiff must allege and prove that the defendant acted with *scienter* [29]—some level of intent to defraud.[30] This requirement is similar in a way to the business judgment

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[21] *See* EASTERBROOK & FISCHEL, *supra* note 11, at 333–35; *see also* Vernazza v. SEC, 327 F.3d 851, 861 (9th Cir. 2003) (ordering defendants to be disgorged because the public needed to be protected from their deceptive tactics in selling municipal bonds and other securities), *amended by* 335 F.3d 1096 (9th Cir. 2003).

[22] *See* Arnold S. Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 GEO. L.J. 1093 (1977) (offering a thorough discussion of available remedies under federal security laws); *see also* Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970) ("The gist of the Rule 10b-5 action for damages is economic injury to the plaintiff resulting proximately from the acts of the defendant[ ] . . . .").

[23] 15 U.S.C. § 78 bb(a) (2000). Section 28(a) provides:

> [T]he rights and remedies provided by [the 1934 Act] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the 1934 Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . . [N]othing in [the 1934 Act] shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of [the 1934 Act] or the rules and regulations thereunder.

[24] Burks v. Lasker, 441 U.S. 471, 486 (1979) (holding that federal policy disallows the application of the business judgment rule to suits involving federal securities laws violations); Laurie C. Nelson, *Judgment Day for the Business Judgment Rule*, Galef v. Alexander, 47 BROOK. L. REV. 1169, 1170, 1172–91 (1981) (noting that the Second Circuit ruling in *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), laid the groundwork for the argument that the policy underlying section 14(a) of the Securities Exchange Act of 1934 is "so significant that any business judgment rule dismissal . . . would likewise violate the statute and should not be permitted").

[25] Federal Securities Act of 1933, 15 U.S.C. §§ 77a–77bbbb (2000 & Supp. IV 2006).

[26] Securities Act of 1933 §11, 15 U.S.C. § 77k; *see also* Harold F. Lusk, *The Federal Securities Act of 1933*, 7 AM. L. SCH. REV. 1162, 1164 (1934).

[27] *See* 15 U.S.C. § 77k(e) (2000).

[28] Securities Exchange Act of 1934 §10(b), 15 U.S.C. § 78j(b) (2000 & Supp. IV 2004).

[29] *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270.

rule. A mere mistake does not give rise to liability.[31] But the *scienter* requirement is different from the business judgment rule in that it does not matter if a misstatement or omission was prompted by a valid business purpose.[32]

B. Punitive Damages & Multiple Damages

The situation is complicated if the culprit stands to gain from the offense. For example, in the case of insider trading, the culprit may not be deterred by the prospect of SCDs.[33] If the culprit is caught, he must disgorge the profit. If not, he keeps the profit. It seems fair to assume that sometimes the culprit will get away with it. So there is no reason not to give it a go.[34] Similarly, a broker may be tempted to engage in excessive trading in customer accounts in order to generate commissions—a practice known as *churning*.[35] As with insider trading, it is not clear that SCDs

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[30] *See* EASTERBROOK & FISCHEL, *supra* note 11, at 343–44 (explaining how the intent to defraud requirement relates to rules on damages). Although *scienter* is defined as intent to defraud, it has come to mean some level of intent without much attention to the fraud part. If the fraud part mattered, the courts would presumably require that the wrongdoer expect some sort of gain from the conduct (though it might suffice that the victim merely suffer a loss). In practice, the courts do not require any showing that the wrongdoer anticipated a gain. To be sure, it might be seen as a gain (for example) for a CEO to hope that an overly optimistic statement might afford enough time to turn the company around. (If such tactics work the public would never know.) But the courts have not discussed the issue much. For some attention to the issue, see In re Time Warner Securities Litigation, 9 F.3d 259 (2d Cir. 1993).

[31] *See* Fla. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 654 (8th Cir. 2001) (noting that a successful complaint in a securities fraud case must state specific facts that show a "strong inference" that defendant acted with scienter); Camp v. Dema, 948 F.2d 455, 461 (8th Cir. 1991) (specifying that clear recklessness is required to hold defendant liable in securities fraud case where duty to disclose is concerned); SEC v. Moran, 922 F. Supp. 867, 897 (S.D.N.Y. 1996) (stating that where defendant made a mistake regarding allocation of certain cable stocks, he did not intentionally or recklessly defraud clients).

[32] United States v. Chiarella, 588 F.2d 1358, 1368 n.15 (2d Cir. 1978) (noting that "the presence or absence of a business purpose has no bearing on [defendant's] liability for defrauding the sellers"), *rev'd on other grounds*, 445 U.S. 222 (1980). Although *scienter* is defined as intent to defraud, it has come to mean some level of intent without much attention to the fraud part. If the fraud part mattered, the courts would presumably require that the wrongdoer expect some sort of gain from the conduct (though it might suffice that the victim merely suffer a loss). In practice, the courts do not require any showing that the wrongdoer anticipated a gain. To be sure, it might be seen as a gain (for example) for a CEO to hope that an overly optimistic statement might afford enough time to turn the company around. (If such tactics work the public would never know.) But the courts have not discussed the issue much. For some attention to the issue, see In re Time Warner Securities Litigation, 9 F.3d 259 (2d Cir. 1993).

[33] *See* Comment, *A Role for the 10-b Private Action*, 130 U. PA. L. REV. 460, 484–85 (1981) (arguing that absent an additional punishment such as negative publicity or payment of plaintiffs' attorney's fees, mere disgorgement of "ill-gotten profits" will not deter a defendant from insider trading).

[34] *Id.* Of course, this reasoning ignores other consequences, such as the cost of litigation or the possibility that one will get fired. In some cases, agents who fear they are in the "last period of employment," for financial reasons or otherwise, may be more likely to commit fraud. Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 724-27.

[35] *See* Note, *Churning By Securities Dealers*, 80 HARV. L. REV. 869, 869 (1967) (explaining that churning occurs when a dealer acts in his own interest rather than the customer's interests and "induces transactions in the customer's account which are excessive in size and frequency in light of the character of the account"). As Woody Allen once said: "A stockbroker is someone who takes all your money and invests it until it's all gone." *Unloved?*, ECONOMIST, Oct. 25, 1997, at 83.

will work to deter churning. The broker will reckon that he can simply pay back his ill gotten gains if he gets caught.

Although simple damages will not deter insider trading or churning, punitive damages or something similar should work. The problem with simple damages is that insider trading and churning are both offenses from which the culprit stands to gain and that may not be detected or pursued by the victim.[36] So the solution is to award some multiple of damages based on the likelihood that victims will sue, thus eliminating the potential for profit.[37] For example, if only one-third of insider trading cases are detected, then the culprit should be required to pay damages equal to three times the gain. Accordingly, the Insider Trading & Securities Fraud Enforcement Act of 1988[38] (ITSFEA) (like its predecessor the Insider Trading Sanctions Act of 1984[39] (ITSA)), provides for a triple-the-gain fine for insider trading in addition to disgorgement of profit. [40]

The argument for multiple damages raises a question about cases arising under the Securities Act of 1933. A public offering affords an opportunity for gain. Why is there no need for multiple damages under the 1933 Act? There are several answers. There is almost no chance that an offense will not be detected because market prices are readily available following a public offering of stock. And the victims will almost always sue because the 1933 Act affords an issuer no defenses. Finally, it seems unlikely that an offender under the 1933 Act would engage in repeat offenses.[41]

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[36] *See* Marleen A. O'Connor, *Toward a More Efficient Deterrence of Insider Trading: The Repeal of Section 16(b)*, 58 FORDHAM L. REV. 309, 313 (1989) (discussing efficient deterrence of insider trading).

[37] *See* Edward D. Cavanagh, *Detrebling Antitrust Damages: An Idea Whose Time Has Come?*, 61 TUL. L. REV. 777, 787 (1987) (stating that "multiplying actual damages is necessary because some violations of the antitrust laws go undetected").

[38] Pub. L. No. 100-704, 102 Stat. 4677, 4678 (codified as amended in scattered subsections of 15 U.S.C. § 78).

[39] Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered subsections of 15 U.S.C. § 78); *see* Jerry Edward Farmer, Note, *The Role of Treble Damages in Legislative and Judicial Attempts to Deter Insider Trading*, 41 WASH. & LEE L. REV. 1069, 1071 (1984) (stating that the Insider Trading Sanctions Act "would authorize the SEC to seek treble damages from inside traders in addition to the SEC's current injunctive powers").

[40] Moreover, punitive damages are quite common in churning cases (albeit as a matter of pendent state law claims for breach of fiduciary duty or fraud). *See, e.g*, Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1227 (8th Cir. 1990); Miley v. Oppenheimer & Co., 637 F.2d 318, 332 (5th Cir. 1981) (finding that a jury award in the "three-times-compensatory-damages ballpark" was reasonable and not an abuse of discretion); Michael Siconolfi, *NASD Is Developing Guidelines for Punitive Awards to Investors*, WALL ST. J., June 7, 1991, at C1. One problem is that the culprit may be effectively judgment-proof with regard to any penalty. Richard A. Booth, *Damages in Churning Cases*, 20 SEC. REG. L.J. 3, 19–20 (1991). That is, the culprit may have little net worth in addition to the ill-gotten gains. And indeed ill-gotten gains may have been dissipated. *Id.* Another problem is that under ITSFEA, the government keeps the money. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 21A(d)(1), 102 Stat. 4677.

[41] Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988). *See generally* Robert Bacon, *Initial Public Offerings and Professional Sports Teams: The Regulations Work, But Are Owners and Investors Listening?*, 10 SETON HALL J. SPORT L. 139, 155 (2000) (noting on corporations' tendencies to use "extreme caution" to prepare required

disclosure materials because of "the Act's imposition of liability upon the corporation for omissions or material misrepresentations"). On the other hand, underwriters are also liable under the 1933 Act subject to limited defenses, and they are repeat players.

C. Class Actions & Derivative Actions

While punitive damages fix the problem of harms that are difficult to detect or pursue, some claims are too small to justify legal action by any single plaintiff. The solution is a class action or derivative action. Indeed, virtually all securities fraud actions are maintained as class actions.[42] Class actions address the problem of individual claims that are too small to justify legal action by any single plaintiff. [43]

One danger with class actions is that plaintiffs may seek (and courts may award) punitive damages on the simplistic rationale that they would be appropriate in an individual action. But punitive damages make no sense in a class action if the primary rationale for punitive damages is that plaintiffs are reluctant to sue because of small claims.[44] Moreover, the allure of class actions is such that it induces plaintiffs -- and plaintiff attorneys -- to seek out claims.

In some cases, a derivative action works better than a class action.[45] For example, in an insider trading case, the culprit may have made a significant profit, but when that profit is disgorged and spread over hundreds or thousands of trades, the recovery to any one individual will be miniscule.[46] Indeed, the cost of administering the claims may exceed the recovery.[47] On the other hand, if the issuer recovers, the claim is easy to administer and the stockholders are made whole by the increase in value of the issuer.[48]

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[42] *See* LAURA E. SIMMONS & ELLEN M. RYAN, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2006 REVIEW AND ANALYSIS 1 (2006).

[43] *See* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497 (1997).

[44] The same is true with regard to the award of punitive damages in arbitration. *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 795-96 (N.Y. 1976) (explaining why public policy prohibits punitive damages for private wrongs).

[45] *See* Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747, 1774 (2004) (discussing the benefits of derivative suits with public company defendants); *see also* Richard A. Booth, *End of Securities Fraud*, *supra* note 19, at 27 ("The practical question for a court is whether a securities fraud action is direct or derivative. The answer depends on whether the harm is primarily to the corporation or to individual stockholders and whether recovery should go to the corporation or individual stockholders.") *Id.*

[46] *See* Cox, *supra* note 43, at 497.

[47] *See id.*

[48] Booth, *End of Securities Fraud*, *supra* note 19, at 9-10, 27. Never mind that the identity of the stockholders may have changed. If they are diversified it all comes out in the wash. *Id.* at 9.

II. The Proper Role of Criminal Law

What does this leave for criminal law to do in the area of corporate governance and securities regulation? Perhaps not much. But it is possible to imagine cases that are not addressed well by lesser remedies. If the culprit causes harm that is disproportionate to the gain (or potential for gain), a criminal sanction may be the only remaining remedy.[49]

One possible example that comes to mind is the fraud at Enron.[50] Suppose the plan there was simply to report false income to induce investors to buy the stock and raise its price so that insiders could cash out their stock options. Specifically, suppose the idea was to suck in (say) $10 billion in new investment dollars (that could have gone to other ventures) to create a gain of $50 million on stock options. Such a case might be a legitimate occasion for criminal prosecution. The scheme implies a disregard for the interests of others that is akin to malicious destruction of property. Call it criminal indifference.[51]

Contrast simple insider trading. Insider trading does not usually involve the creation of any additional harm to investors.[52] It simply redistributes gains and losses that would otherwise occur.[53] Indeed, it is arguable that insider trading may mitigate redistribution problems by

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[49] This approach to the definition of crime may be seen as an extension of the notion that liability ought to lie with the party who can most cheaply avoid the harm. Although the concept is sound, it may describe some acts and practices that are not likely to be seen as crimes. For example, studies indicate that the corporate income tax costs more than twice as much to administer as it raises in revenue. *See generally* J. Brent Wilkins, *The Sarbanes-Oxley Act of 2002: The Ripple Effects of Restoring Shareholder Confidence*, 29 S. ILL. U. L.J. 339, 352-55 (2005) (characterizing the added costs of certifying financial statements including tax consultant fees, experts, and internal investigations as opportunity costs of these compliance activities). Moreover, as I have argued elsewhere, securities fraud class actions cause a net reduction of stockholder returns. *See* Booth, *End of Securities Fraud*, *supra* note 19. The implication would seem to be that both could be viewed as criminal.

[50] *See* John R. Emshwiller & Rebecca Smith, *Corporate Veil: Behind Enron's Fall*, WALL ST. J., Dec. 5, 2001, at A1.

[51] The name is the same as the charge against the central characters of Seinfeld in the final episode, but the idea is somewhat different. Note that a $10 billion increase in market capitalization does not imply $10 billion in new money. So it might be difficult to prove criminal intent in cases in which it is not clear how to measure collateral damage. There is a similar problem generally with the federal sentencing guidelines. In some financial fraud cases, the courts have applied simplistic measure of harm in sentencing. *See, e.g.*, Harris v. Am. Inv. Co., 523 F.2d 220, 224–25 (8th Cir. 1975); Mitchell v. Tex. Gulf Sulphur Co., 446 F.2d 90, 104-05 (10th Cir. 1971).

[52] *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1502 (1996). One worry is that the opportunity to trade on inside information may induce corporate actors to withhold information that is ripe for disclosure. Curiously, relatively few insider trading cases involve insiders that would be in a position to disclose the information to the market. *See* SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) (involving insider trading by a former employee); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984) (finding employee of financial printing company guilty of fraud). Indeed, every case that has reached the Supreme Court has involved an unconventional insider. *See, e.g.*, Carpenter v. United States, 484 U.S. 19 (1987) (involving a financial newspaper reporter); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980). This suggests that the real worry may be more about keeping secrets than about disclosure. It also suggests that this crime may be less common in settings where its definition is clear. In any event, it is disturbing that prosecutors seem to focus on the exotic rather than the routine.

helping the market move to the correct price sooner. It is difficult to see how that should be crime.[54]

Criminal sanctions seem appropriate for offenses that involve the creation of additional harm—collateral damage—and not simply the redistribution or misappropriation of wealth.[55] As the

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[53] *See* Alexander, *supra* note 52, at 1502.

[54] Similarly, securities fraud seldom results in gain to the perpetrators except in cases in which there is also insider trading. *See* Booth, *End of Securities Fraud*, *supra* note 19, at 9. It is somewhat curious that criminal enforcement focused almost exclusively on insider trading for so long. The explanation may be that such cases appeared to be the only cases that involved monetary gain. But that does not explain why prosecutors have not also pursued churning cases or violations of the 1933 Act.

[55] *See* JOHN STUART MILL, ON LIBERTY 13 (1863) (stating "the only purpose for which power can rightfully be exercised over any member of a civilized community, against his will, is to prevent harm to others."); *see also* JEROME HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 213 (2d ed. 1960) (1947) ("Harm, in sum, is the fulcrum between criminal conduct and the punitive sanction . . . ."); Paul H. Robinson, *A Theory of Justification: Societal Harm As a Prerequisite for Criminal Liability*, 23 UCLA L. REV. 266, 266–68 (1975) (suggesting that criminal law punishes conduct that creates harm, but not conduct that produces either benefit or no harm). It is ironic, but a criminal sanction seems more appropriate if the culprit has little to gain from the offense relative to the costs imposed on others. If the victim's loss is the culprit's gain, a civil remedy is likely to be adequate. The idea that the prospect of a monetary penalty should usually suffice to induce appropriate caution depends to some extent on whether the defendant has something to lose. The implication is that if the defendant has nothing to lose, there is no incentive for self-control, and criminal sanctions might be necessary. (As Bob Dylan said, when you got nothing, you got nothing to lose.) This suggests that criminal law is likely to apply more often to offenses involving poor people. This is not to say that the poor are prosecuted selectively, but rather that the offenses we criminalize are much more likely to involve poor people than rich people. *See, e.g.*, JEFFREY REIMAN, . . . AND THE POOR GET PRISON: ECONOMIC BIAS IN AMERICAN CRIMINAL JUSTICE 91–92 (1996) (noting that the incarcerated population is predominantly poor); Travis C. Pratt & Francis T. Cullen, *Assessing Macro-Level Predictors and Theories of Crime: A Meta-Analysis*, 32 CRIME & JUST. 373, 411–13 (2005) (statistical evidence supports the proposition that poverty has a significant effect on crime); Alice Ristroph, *Desert, Democracy, and Sentencing Reform*, 96 J. CRIM. L. & CRIMINOLOGY 1293, 1344 (2006) (crime and poverty are closely correlated). That seems wrong—or at least impolitic. It also may be a subtle force for creeping criminalization. If the poor must suffer jail for their offenses, so too should the rich. *See* J. Scott Drutcher, Comment, *From the Boardroom to the Cellblock: The Justifications for Harsher Punishment of White-Collar and Corporate Crime*, 37 ARIZ. ST. L.J. 1295, 1303, 1312 (2005) (arguing for harsher punishment of white collar crimes through deterrence). *Compare* Jayne O'Donnell & Richard Willing, *Prison Time Gets Harder for White-Collar Crooks*, USA TODAY, May 11, 2003, at 1A (reporting that after Enron and WorldCom scandals, the Justice Department began toughening up on white collar crime), *with* Howard Gleckman, *Where White-Collar Criminals Belong: Jail*, BUS. WK. ONLINE, Jan. 3, 2002, http://www.businessweek.com/bwdaily/dnflash/jan2002/nf2002012_5188.htm (reporting that, unjustly, white collar criminals are rarely charged, receive short jail sentences, and are a low priority for the criminal justice system). Although this explanation seems at first to make sense, it misses a key point of economics: the less you have, the more you value what you have. So one could equally well argue that criminal sanctions are more important in a situation in which the defendant is likely to be relatively wealthy. Indeed, one common argument is that in the absence of criminal or quasi-criminal penalties such as punitive damages, simple compensatory damages will be viewed simply as part of the cost of doing business. *See* Simon v. San Paolo U.S. Holding Co., 113 P.3d 63, 78–79 (Cal. 2005); Grimshaw v. Ford Motor Co., 174 Cal. Rptr. 348, 387–89 (1981); *see also* Jonathan Kagan, Comment, *Toward a Uniform Application of Punishment: Using the Federal Sentencing Guidelines as a Model for Punitive Damage Reform*, 40 UCLA L. REV. 753, 785 (1993) (explaining that inconsistent punitive damages awards prevent defendants from factoring such damages into the cost of doing business); O'Donnell & Willing, *supra*. The odd thing about that argument is that it is precisely the point of the civil justice system that a business (or an individual for that matter) will think about externalities as part of the true cost of doing business. Deborah J. La Fetra, *Freedom, Responsibility, and Risk: Fundamental Principles Supporting Tort Reform*, 36 IND. L. REV. 645, 648, 654–57 (2003). If the point is that paying damages occasionally covers only a small fraction of the costs generated

Model Penal Code states, the primary goal of criminal law is "to forbid and prevent conduct that *unjustifiably and inexcusably* inflicts or threatens substantial harm to individual or public interests."[56] Criminal sanctions are not well-suited to situations in which there is real doubt about whether the offense was motivated by a legitimate business purpose or who is entitled to the gain (or non-loss).[57] The problem is that a prosecutor can always make out a case by *not* looking for a lawful motivation. So practically speaking the burden must be on the defendant to prove a lawful purpose or at least to raise a reasonable doubt about the matter. In contrast, if criminal indifference were the standard, a prosecutor would need to show that the offense led to a financial harm that would not otherwise have occurred – a net decrease in aggregate investor wealth. Incidentally, this view of how criminal law should apply leaves an important role for SEC enforcement actions where the offense is one that involves unjustifiable redistribution of investor wealth that is otherwise unlikely to be remedied by private civil action.

In short, criminal law should be reserved for offenses that cannot be remedied or deterred by a monetary penalty, either because the monetary penalty is difficult or impossible to quantify (as with murder and other crimes involving bodily violations) or because it appears unlikely to work (as with crimes against property).[58] On the other hand, simple theft and embezzlement are crimes about money.[59] Why do they seem to be appropriate subjects for criminal prosecution while insider trading and faulty accounting seem less so? One answer is that these offenses likely cannot be deterred by multiple damages.[60] They are take-the-money-and-run offenses rather than ongoing practices. Another difference is the participation of the victim. If the victim voluntarily assumes the risk of the offense (as does a trader or an investor), it is difficult to see the offense as criminal.[61] Yet another difference is the definition of the offense. If the offense is such that it

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by the defendant's activities, that is another matter. But the point for present purposes is that the wealth of the defendant seems to have little to do with whether an offense should be seen as civil or criminal.

[56] MODEL PENAL CODE § 1.02(a) (Official Draft 1985) (emphasis added).

[57] *See* Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW AND CONTEMP. PROBS. 23, 31–33 (1997) (arguing that punitive civil sanctions are the most appropriate sanctions for business crimes).

[58] With most crimes against person and property, the offense is one that could be the subject of a tort action. But the fact that the offense would give rise to an action for damages seems not to deter the perpetrator. *See* Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1195 (1985); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1236 (1985).

[59] *See* State v. White, 702 A.2d 1263, 1270 (Md. 1997); Stanley S. Arkin & Mary Louise Guttmann, *Types of Financial Institution Fraud*, *in* 5–20 BUS. CRIME P 20.02 (Jay Shapiro ed., 2007). For a representative list of embezzlement cases, see *id.* at n.29; *see also* John G. Douglass, *Rethinking Theft Crimes in Virginia*, 38 U. RICH. L. REV. 13, 16 (2003).

[60] *See* Jeffrey F. Jaffe, *The Effect of Regulation Changes on Insider Trading*, BELL J. OF ECON. AND MGMT. SCI., Spring 1974, at 93, 105, 108, 112.

[61] *See generally* Vera Bergelson, *Victims and Perpetrators: An Argument for Comparative Liability in Criminal Law*, 8 BUFF. CRIM. L. REV. 385 (2005) (discussing how certain affirmative defenses including victims' actions go toward the determination of "perpetrators' liability"). *But see* John M. Junker, *Criminalization and Criminogenesis*, 19 UCLA L. REV. 697 (1972) (noting that a "consensual" or "victimless" crime should not mean that criminal law should be ignored). Although the fit may not be perfect, it is also seems roughly correct to say that if one cannot buy

may be legal under some circumstances, it is difficult to say that it is a criminal act under other circumstances, particularly when the prosecutor who must prove the circumstances beyond a reasonable doubt.[62]

One (not very good) argument for the use of criminal sanctions is that they are necessary to satisfy public outrage.[63] When a major corporation fails and thousands of people lose their jobs or savings, or both, the public may *feel* that someone must be responsible and that someone must be held responsible particularly if management enjoys a big payday into the bargain. Aside from the obvious *ex post facto* objection, we cannot necessarily depend on public opinion where the offenses are as complex as they are in the business area.[64] Moreover, prosecutors have significant power to shape public perceptions.[65] For example, the public may not have been all that outraged if the failure of Enron had been explained as a chain reaction involving derivatives and the falling demand for energy after 9/11. After all, no one went to jail because of the collapse of Long Term Capital Management, though that may have been because there were no public stockholders involved and few understood exactly what went wrong anyway. And it appears unlikely that anyone will go to jail because of the 2007 subprime meltdown. On the other hand, crowds can be wise.[66] And it may be that in the age of derivatives there is no other way to

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insurance against an offense, it is not likely to be criminal. In essence embezzlement is misappropriation by an agent without the formal consent of the principal. Some recent corporate frauds including those at Adelphia and Hollinger International seem to fit this description and thus seem to be more appropriate subject matter for criminal prosecution than the events at WorldCom and (more recently) Collins & Aikman where there was no direct personal gain and lines of authority seem to have been respected. It may be that much of the overuse of criminal sanctions could be avoided by stricter adherence to such distinctions. *See generally* Larry E. Ribstein, *The Perils of Criminalizing Agency Costs,* 2 J. Bus. Tech. L. xxx (2007).

[62] There is a real danger that overuse of criminal penalties will reduce the stigma that has traditionally gone with conviction of a criminal offense. Arguably, that has already occurred in some communities where a relatively high percentage of the population is incarcerated and jail is just another lifestyle. Joachim J. Savelsberg, *Controlling Violence: Criminal Justice, Society, and Lesson from the US*, 30 CRIME, LAW & SOC. CHANGE, 185, 191 (1999). As for white collar criminals, Martha Stewart and Mike Milken are both good examples of ex cons whose status in the community seems to be little affected.

[63] *See* Meir Dan Cohen, *Causation*, *in* 1 ENCYCLOPEDIA OF CRIME AND JUSTICE 162, 165–66 (Sanford H. Kadish ed., 1983) (discussing the relationship between crime and punishment and society's urge for vengeance); Dutcher, *supra* note 55, at 1311–12.

[64] *See* Lynch, *supra* note 56, at 33.

[65] *See, e.g.*, Shaw v. Garrison, 467 F.2d 113, 114–15 (5th Cir. 1972), (noting that the prosecutor's ambition "as the man who solved the Kennedy assassination" led to bad faith prosecution and harassment of defendant); Lewis v. Superior Court, 62 Cal. Rptr. 2d 331, 332 (1997) (involving a prosecutor who was both implicated in and a victim of the alleged crime); State v. Bell, 370 P.2d 508, 511–12 (Idaho 1962) (original prosecutor was a personal friend of the defendant); City of Maple Heights v. Redi Car Wash, 554 N.E.2d 929, 930 (Ohio Ct. App. 1988) (disqualifying a prosecutor who had previously filed a libel suit against defendant and threatened him with additional criminal actions while defendant was testifying); *see also* Wilt v. Buracker, 443 S.E.2d 196, 211–12 (W. Va. 1993) (Neely, J., concurring) (noting that prosecutors tend to devote greater resources to pursuing cases that will bring more publicity or resources to the office or advance the prosecutor's career); Joan McPhee, *Corporate Criminal Liability and Punishment in the 21st Century: Departures from Constitutional and Criminal Norms and Anomalies in Practice*, 10 ANDREWS WHITE-COLLAR CRIME REP. 2, June 29, 2006, at 1, 1-2.

[66] *See generally* JAMES SUROWEICKI, THE WISDOM OF CROWDS (2002).

contain the potential excesses of business than to maintain a vague threat of criminal prosecution based on know-it-when-you-see-it judgment calls.[67]

Another problem with a consensus definition of business crimes is that the interests of investors and managers have diverged in recent years. Diversified investors want their portfolio companies to maximize stock price.[68] Undiversified managers would prefer to minimize risk, but they are willing to take more risk for more pay.[69] If undiversified managers fail to take risks that may maximize the stock price, someone else will assume control—through takeover or otherwise—and do the job. As I have argued elsewhere, the traditional notion of the CEO as a hired gun who works to maximize stockholder value—because the stockholders own the company—is not the only way—or even the best way—to view the corporation today.[70] Why would a CEO work to maximize the wealth of others without bargaining for a significant share of the gain? Maybe it is better to see the CEO as an equity partner.[71] If we fail to do so and instead continue to raise the risk that goes with being publicly held, better managers may opt for private companies, public investors may be denied better returns, and indeed we may see even more corporate scandals in the future.[72] At the very least, the added risk of criminal prosecution will likely lead to even higher executive compensation.[73]

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[67] Indeed, I have argued elsewhere that fiduciary duty may work in a similar way. Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud*, 2 J. BUS. & TECH. L. 185, 187 n.19 (2007). It is also possible that characterizing Enron as a criminal conspiracy may have been a strategy to divert public attention from the dangers of derivatives in order to avoid overreaction and overregulation of new ways of doing business.

[68] *See* Richard A. Booth, *Who Owns a Corporation and Who Cares?*, 77 CHI.-KENT L. REV. 147, 155 (2001) [hereinafter Booth, *Who Owns*].

[69] *See* Meir Statman, *The Diversification Puzzle*, FIN. ANALYSTS J., July–Aug. 2004, at 44, 45.

[70] *See* Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager*, 2005 U. ILL. L. REV. 269, 271–72 [hereinafter Booth, *Executive Compensation*].

[71] *See id*. at 278; Booth, *Who Owns*, *supra* note 62, at 155–56; Charles M. Elson, *The Answer to Excessive Executive Compensation is Risk, Not the Market*, 2 J. BUS. & TECH. L. 403, 405 (2007). To be sure, risk-averse managers should be naturally reluctant to stretch the envelope. So when they do cross the line—wherever it is—we can be somewhat more confident that the motive was inappropriate.

[72] Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61. According to Federal Reserve Board (FRB) data, as of year-end 2006 there was outstanding $20.603 trillion in (publicly traded) equity of United States companies, of which $5.483 trillion was held by households and nonprofit institutions. *See* FED. RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, FLOWS OUTSTANDINGS FOURTH QUARTER 2006 90 (2007), *available at* http://www.federalreserve.org/releases/z1/20070308/21.pdf (Figures in Table L.213 do not include investment company shares.). Historically, nonprofits have accounted for about 9 percent of the equity holdings of the household sector. *Id.* at 109 (showing the annual date for 1988–2000 on Table L.100.a). Assuming that individual holdings equal 91 percent of the household sector (or about $4.990 trillion), non-individuals—institutions—own about $15.135 trillion or about 76 percent of all equities outstanding. *Id.* Because institutions are fiduciaries, they are generally required to diversify under general principles of trust law or more specific statutes such as the Investment Company Act of 1940 and the Employee Retirement Income Security Act of 1974 (ERISA). *See, e.g.*, Investment Company Act of 1940 § 5, 15 U.S.C. § 80a-5 (2000) (stating that an investment company may not be classified as diversified if it has more than 5 percent of its assets invested in any one issuer); Employee Retirement Income Security Act § 404(a)1, 29 U.S.C. § 1104(a)(1)(c) (2000). Thus, it seems fair to presume that institutions are diversified. FRB data also indicates that about 9.5 percent of families hold fifteen or

The idea that criminalization should be the last resort is more than axiomatic. Criminal law is a blunt instrument that carries all or nothing penalties.[74] With a civil action, the plaintiff must

more stocks. *See* Brian K. Bucks et al., *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, FED. RES. BULL., Mar. 22, 2006, at A1, A15, *available at* http://www.federalreserve.gov/pubs/bulletin/2006/financesurvey.pdf. That is a shockingly low number. *See* William N. Goetzmann & Alok Kumar, Why Do Individual Investors Hold Under-Diversified Portfolios? 4–6 (National Bureau of Economic Research Working Paper No. 8686, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=627321. Nevertheless, if such investors are counted as diversified, total holdings of diversified investors are about $15.609 trillion. Moreover, individuals ultimately hold the interests in the institutions that hold diversified portfolios. Studies indicate that an investor can achieve adequate diversification with as few as twenty different stocks. *See* Franco Modigliani & Gerald A. Pogue, *An Introduction to Risk and Return*, 30 FIN. ANALYSIS J. 68 (1974); *see also* James M. Park & Jeremy C. Staum, *Diversification: How Much is Enough?*, 1 J. ALTERNATIVE INV. 39 (1998). It is unnecessary for present purposes to know how much diversification is enough. It is sufficient to note that it is costless for an investor to diversify and that the risk of securities fraud (like other types of company-specific risk) can be eliminated through diversification. *See The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1244 (1979); A.C. Pritchard, O'Melveny & Meyers v. FDIC*: Imputation of Fraud and Optimal Monitoring*, 4 SUP. CT. ECON. REV. 179, 182 n.12 (1995). Most individual investors diversify by investing in mutual funds and similar pooled investment vehicles. *See* Peter Fortune, *Mutual Funds, Part I: Reshaping the American Financial System*, NEW ENG. ECON. REV., July–Aug.1997, at 44, 44–45. Thus, even a very small investor may invest in a fully diversified portfolio of 200 to 300 different stocks. To be sure, funds charge a variety of fees in addition to the direct expenses of holding and trading portfolio securities. But there are comparable fees and expenses involved in maintaining an individual account. Bhattacharya and Galpin find that in the United States since 2000, about 24% of trading is attributable to stock picking whereas about 60 percent was so motivated during the 1960s. *See* Utpal Bhattacharya & Neal E. Galpin, *The Global Rise of the Value-Weighted Portfolio* (Am. Fin. Assoc. FA 2007 Chi. Meetings Paper), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849627. They also predict that the level of stock picking will continue to decline and stabilize at about 11 percent. *Id.*

[73] *See* Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 505–06 (1998) (discussing the interplay between manager's pay and liability or risk aversion); *see also* Nathan Knutt, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 502 (2005). For a general discussion on the effect of risk on executive compensation, see Rajesh K. Aggarwal & Andrew A. Samwick, *The Other Side of the Trade-off: The Impact of Risk on Executive Compensation*, 107 J. POL. ECON. 65, 67 (1999). The conflicting interests of stockholders and managers may excuse many recent offenses to some extent. Although diversified stockholders do not care if a few portfolio companies go broke, managers care a lot. Indeed, stockholders might even prefer that a few companies fail in order to reduce competition among survivors, but they also understand that they cannot expect managers to throw in the towel at the drop of a hat (to mix metaphors). *See* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429 (1998). Thus, it seems unlikely that stockholders would want managers to be prosecuted for any reasonable effort to keep their companies afloat (even if stockholders would vote – if they could -- to give up the ship earlier and even if success in saving the company might be characterized as personal gain for the manager). On the other hand, it is conceivable (barely) that criminal prosecution is designed to discourage managers from prolonging the agony. I doubt it. *See* Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 2006 Del. Ch. LEXIS 139 (rejecting notion that there exists an independent state law claim for deepening insolvency), *aff'd,* Trenwick Am. Litig. Trust v. Billett, 2007 Del. LEXIS 357.

[74] *See, e.g.*, Jeffrey S. Parker, *The Blunt Instrument, in* DEBATING CORPORATE CRIME 71, 74 (William S. Lofquist, et al. eds., 1997) (noting that punishment—one of the functions of criminal law—is a "blunt instrument" and though it may be appropriate in a given circumstance, it is a measure to be avoided). Further, efforts to make criminal law more scalable—such as the federal sentencing guidelines—seem only to have made matters worse. *See* United States v. Marshall, 908 F.2d 1312, 1326 (7th Cir. 1990) (stating that "[e]very attempt to make the system of sentences 'more rational' carries costs and concealed irrationalities, both loopholes and unanticipated severity"), *aff'd*, 500 U.S. 453 (1990); United States v. Williams, 746 F. Supp. 1076, 1081–82 (D. Utah 1990) (discussing "the

plead and prove damages.[75] Thus, with civil liability you know who lost what and who recovers. A prosecutor need not prove damages.[76] Moreover, a private plaintiff must weigh the costs and benefits of filing a civil action.[77] In other words, civil remedies are both self-executing and self-regulating. Indeed, there is little danger that the defendant will pay more than once in a civil suit, unless the offense is one that calls for punitive damages. In contrast, a prosecutor has little or no reason not to prosecute an offense other than the prospect of losing.[78] We cannot really expect prosecutors to exercise much discretion about when (and when not) to prosecute. We should expect that prosecutors will use the tools they are given. We should assume that a prosecutor will throw the book at the crook.[79]

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exercise of police and court discretion in relation to the aims of our criminal justice system"), *aff'd*, 963 F.2d 1337 (10th Cir. 1992); *see also* Anne Bowen Poulin, *Prosecutorial Discretion and Selective Prosecution: Enforcing Protection After* United States v. Armstrong, 34 AM. CRIM. L. REV. 1071, 1080 n.33 (1997).

[75] FED. R. CIV. P. 8(a). *See generally* 22 AM. JUR. 2D *Damages* § 703 (2007).

[76] *See Damages,* supra note 75. As Gordon Gekko, the fictional character in the movie Wall Street, might have said, "the need to quantify the stakes clears the mind and focuses the will." *See* WALL STREET (20th Century Fox 1987). This suggests that another situation in which criminal law may be appropriate is one in which there is no clear plaintiff. Indeed, there are many crimes that seem to fit this category ranging from public drunkenness and indecent exposure to pollution. One might argue that in a world of diversified investors that do not care about the fortunes of individual companies, there are effectively no plaintiffs (though the volume of litigation suggests otherwise). In other words, it may be that prosecutors have mistaken rational indifference for ignorance. Or it may be that prosecutors misguidedly seek to protect undiversified investors from their own follies. *See also* Jill Fisch, Christine Hurt, Brett McDonnell, David Millon & Jennifer O'Hare, *Roundtable -- The Criminalization of Corporate Law, The Impact on Shareholders and Other Constitents,* 2 J. Bus. Tech. L. xxx (2007) (some questioning relevance of diversification and suggesting that stockholders should suffer when corporation engages in criminal behavior).

[77] *See* BUREAU OF INT'L INFO. PROGRAMS, U.S. DEP'T OF STATE, OUTLINE OF THE U.S. LEGAL SYSTEM 118, 127 (2004), *available at* http://usinfo.state.gov/products/pubs/legalotln/legalotln.pdf.

[78] The bigger worry is a staff with too little to do. *Cf.* Poulin, *supra* note 74, at 1085 (noting that prosecutors bring their own personal biases to their work and are often guided loosely, if at all, in making decisions regarding what crimes to prosecute).

[79] Although one can only pay once in a civil action, one is likely to pay (so to speak) several times over in a criminal action. Indeed, prosecutors have shown that they will test the limits of the powers they are given. Witness the notorious Thompson Memorandum and the tactics used against KPMG. *See* David Anders, *Criminalization of Corporate Law,* 2 J. Bus. Tech. L. xxx (2007). *See also* Bruce H. Kobayashi & Larry E. Ribstein, *The Hypocrisy of the Milberg Indictment: The Need for a Coherent Framework on Paying for Cooperation in Litigation,* 2 J. Bus. Tech. L. 369 (2007); Remarks of Frank Razanno, The Fall and Rise of Federal Corporation Law, University of Maryland School of Law, October 13, 2006, http://www.law.umaryland.edu/conference_detail.asp?conf=32
To be sure, in cases in which criminal prosecution is appropriate, there always will be a potential for lesser included civil remedies and accordingly a proliferation of actions. That seems unavoidable. *See* BUREAU OF INT'L INFO. PROGRAMS, *supra* note 77, at 120. But it suggests that prosecutors should not concern themselves with compensation. *See* Bruce A. Green & Fred C. Zacharias, *Prosecutorial Neutrality*, 2004 WIS. L. REV. 837, 860–62 (noting that some commentators endorse prosecutorial neutrality and specifically asserting that prosecutors should maintain independence from victims and their families, and the decisions they make in prosecution should be "indifferent[] to the preferences and objectives of interested third parties"). *But see* Kenneth L. Wainstein, Comment, *Judicially Initiated Prosecution: A Means of Preventing Continuing Victimization in the Event of Prosecutorial Inaction*, 76 CAL. L. REV. 727, 734 (1988) (suggesting that court initiated prosecution would provide victims with the most appropriate remedy). This is not to excuse the senseless destruction of Arthur Anderson. *See generally* George J. Benston & Al L. Hartgraves, *Enron: What Happened and What We Can Learn from It*, 21 J. ACCT. & PUB. POL'Y 105, (2002) (discussing the history of Arthur Andersen, the long time accounting firm of Enron

Accordingly, it is important to be certain about a crime and its definition. Again, the Model Penal Code is instructive. Another express goal of criminal law is to "give fair warning of the nature of the conduct declared to constitute an offense."[80] If an offense is hard to define or the definition seems to shift with changing circumstances, it is not a good idea to make it a crime. In other words, we should only make an offense a crime if it is a crime all the time. Indeed, a good rule would be that unless we can say that conduct or behavior is always wrong—unless we can construct a definition that draws a bright line for all to see—we should eschew the creation of criminal penalties. The alternative is to depend on prosecutors both to define crimes and to prosecute them.[81]

The bottom line is that money damages should be the remedy when the harm is such that it can be remedied and deterred by money damages. As with law and equity, if there is an adequate remedy at law, the criminal law should keep out. Indeed, this principle seems to be particularly well suited to offenses relating to the conduct of business where the ultimate point is to generate financial return. Where money is the issue, money can fix the problem.

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that was charged criminally and had civil suits filed against it for its role in Enron's collapse). Likewise, studies indicate that the corporate income tax is very costly to administer. *See generally* MICHAEL L. MARLOW, A PRIMER ON THE CORPORATE INCOME TAX: INCIDENCE, EFFICIENCY AND EQUITY ISSUES 1 (2001) (noting that "[e]conomists have estimated that for every dollar collected by the federal government through the corporate income tax, an additional one and a half dollar's worth of economic resources are consumed"), *available at* http://www.taxfoundation.org/files/fa4081493f15d1a41c6b1102917010e9.pdf

[80] *See* MODEL PENAL CODE § 1.02(1)(d) (1985).

[81] Needless to say, there always will be the problem of derivative offenses such as obstruction of justice. It is difficult to argue that obstruction of justice should not be a crime. *But see* Joseph V. De Marco, Note, *A Funny Thing Happened on the Way to the Courthouse: Mens Rea, Document Destruction, and the Federal Obstruction of Justice Statute*, 67 N.Y.U. L. REV. 570, 601–05 (1992) (arguing that the interpretation of the intent requirement of the *Neisweinder* obstruction of justice doctrine goes too far and allows criminal prosecution of negligent acts that should not be classified as obstruction of justice). It also is apparent that obstruction of justice and similar charges have been used in some cases to prosecute offenders who were not even charged with any other offense. Martha Stewart, Arthur Andersen, and Frank Quattrone come to mind. *See* Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 258–60 (2004) (stating "[a]nother set of concerns about the fraud prosecutions relates to which cases prosecutors have chosen to pursue"). Brickey notes that in the Martha Stewart, Arthur Andersen, and Frank Quattrone cases, prosecutors pursued the easier to prove obstruction of justice charges. *Id.* at 258–59. It is difficult to imagine a case in which obstruction alone should be a crime. Then again it is also a crime to escape from jail. To be sure, there are some offenses such as bribing a judge or juror that quite clearly seem to be criminal and that would also constitute obstruction of justice. But it is difficult to believe that such offenses cannot be defined with more precision. *See* Ellen S. Podgor, *Arthur Andersen, LLP and Martha Stewart: Should Materiality Be an Element of Obstruction of Justice?*, 44 WASHBURN L.J. 583, 584, 600–01(2005) (suggesting that judges and prosecutors "factor in an element of 'materiality,' as required for proof of obstruction of justice, when prosecutors can proceed with the underlying conduct they were investigating, but fail to do so upon realizing possible obstructive conduct"). In other words, obstruction (like the offense of quibbling in military schools) seems to be the product of lazy legislators who have nothing to gain (and everything to lose) from not being tough on crime.

III. Why the (Recent) Expansion of Criminal Law?

Over the long haul, the reach of criminal law in connection with business offenses seems to have receded. There are no debtor prisons or workhouses nowadays. And few would argue that it is criminal to sell a stock short or charge usurious interest.[82] Any suggestion that we should recriminalize these offenses—let alone simple breach of contract cases—would be positively medieval. Nevertheless, some of the high profile cases of the early 2000s could be characterized as an attack on limited liability albeit as it applies to publicly traded companies.[83] To be a bit more precise, it has increasingly become common for bankruptcy to give rise to criminal charges.[84] While some cases have focused on creditors as victims,[85] most cases have focused on stockholders as victims.[86] Thus, it would seem that the goal of the prosecutors in these cases has been to vindicate the harm suffered by stockholders -- including employee stockholders -- though there may well have been other creditors harmed in the process. Again, because there is no plaintiff other than the government, and because the prosecution need not plead and prove damages in any concrete way, it is difficult to discern the ultimate goal in these criminal proceedings, though it seems quite clear that the stockholders are seen as an important class of victims.[87]

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[82] And the practice that was formerly known as *payola* is now known as *product placement*. Some commentators would, however, argue that short-selling in certain situations should be redressed by restitution. *See* Moin A. Yahya, *The Law & Economics of "Sue and Dump": Should Plaintiffs' Attorneys Be Prohibited from Trading the Stock of Companies They Sue?*, 39 SUFFOLK U. L. REV. 425, 460–61 (2006) (arguing that a defendant should be entitled to restitution when plaintiff's attorneys short sell stock in a company that they are about to sue because the short sellers profit doubly from the sale of the stock and the proceeds of the lawsuit).

[83] *See* Brickey, note 81, at 222 ("*Corporation, n. An ingenious device for obtaining individual profit without individual responsibility.*"). Enron, WorldCom, Adelphia Communications, Rite Aid, Symbol Technologies, Qwest Communications, Dynegy and HealthSouth all were organized as corporations known for their limited liability. *Id*. at 225–28. The prosecution of these organizations are attacks on limited liability in the context of publicly traded companies.

[84] *See e.g.*, United States v. Milwitt, 475 F.3d 1150, 1155–56 (9th Cir. 2007) (overturning a conviction for bankruptcy fraud because there was not sufficient evidence to prove specific intent); United States v. Wagner, 382 F.3d 598, 613–14 (6th Cir. 2004) (finding that a reasonable trier of fact could have found sufficient evidence to support the conviction for bankruptcy fraud).

[85] For example, the Enron debacle has given rise to numerous actions against banks and other financial institutions that facilitated fraudulent transactions. *See* Brickey, *supra* note 81, at 253, 257–58 (listing the parallel civil and criminal proceedings against Enron; and also listing the criminal defendants in Enron-related prosecutions).

[86] *Cf.* Douglas A. Henry, Comment*, Subordinating Subordination: WorldCom and the Effects of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259, 295–96 (2004) (noting that the WorldCom decision raised the claims of shareholders to be even with the claims of creditors).

[87] *But see* Brickey, *supra* note 81, at 276 (noting that federal prosecution under SOX has made significant progress towards "pinning responsibility on all culpable parties . . . . working up the corporate hierarchy to charge the highest blameworthy executives") Moreover, there have been few if any cases of note involving large privately held companies, further suggesting that prosecutors are focused on the stockholders of publicly traded companies as the supposed victims. Limited liability always has been an uncertain benefit for very small companies. Although it is not

It is not at all clear that stockholders need or want such favors. In the aggregate and over time, business makes profits and investors enjoy positive returns.[88] A well-diversified stockholder wants portfolio companies to seek maximum returns. It does not matter if a few portfolio companies go bankrupt trying. Others will exceed expectations. It all comes out in the wash. If there is reason to believe that a publicly traded corporation has been operated for the primary purpose of defrauding investors and not in a good faith effort to turn a profit, then criminal prosecution may be appropriate. But no one has suggested any such thing about Enron, WorldCom, or any other recent case.

It may be that much of the growth of the criminal law in this setting is a result of problems with civil remedies. Federal securities law provides that a *willful* violation is a crime. The statutes also provide for civil enforcement by the SEC as well as private civil actions under the 1933 Act. To complicate matters further, the courts have implied a broad private remedy under the 1934 Act and Rule 10b-5.[89] The courts recognized long ago that securities fraud litigation can be abusive.[90] Because investors may sue whenever they lose, investor protection can morph into investor insurance. Thus, in 1976 the Supreme Court ruled that to state a claim under Rule 10b-5, the plaintiff must plead and prove *scienter*.[91] And in 1980 the Court ruled that the SEC must meet the same standard.[92] Thereafter, Congress enacted PSLRA,[93] which raised the bar for pleading

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easy to pierce the corporate veil in many jurisdictions, such cases are quite common, presumably because creditors succeed often enough.

[88] *See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (recognizing that "[a] business corporation is organized and carried on primarily for the profit of the stockholders . . . . [t]he discretion of directors is to be exercised in the choice of means to attain that end").

[89] 17 C.F.R. § 240.10b-5 (2007). There is also an express private cause of action under section 18(a) of the Securities Exchange Act of 1934. *See* 15 U.S.C. §78r (2000) (creating the right that a person knowingly misleading "shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading"). But because this remedy requires that the investor prove that he relied on a false statement in a document filed with the SEC—and is thus much narrower than Rule 10b-5—it is seldom invoked. *See* Julie A. Herzog, *Fraud Created the Market: An Unwise and Unwarranted Extension of Section 10(b) and Rule 10b-5*, 63 GEO. WASH. L. REV. 359, 399 (1995) (noting that section 18 has a specific requirement of reliance whereas Rule 10b does not, which has resulted in courts reading a more flexible reliance standard into Rule 10(b)). *But see* Lindner Dividend Fund, Inc. v. Ernst & Young, 880 F. Supp. 49, 56 (D. Mass. 1995) (finding that the purchasers of preferred stock satisfied that requirement for stating cause of action under Securities Exchange Act § 18(a) when their loss was caused by their reliance was subject to challenge, it was not so unsupportable that the cause of action should be dismissed for failure to state a claim).

[90] It also is well recognized that simple civil remedies do not work well in connection with insider trading. So Congress enacted Insider Trading Sanctions Act of 1984 and then Insider Trading and Securities Fraud Enforcement Act of 1988. *See* Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.); Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

[91] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

[92] Aaron v. SEC, 446 U.S. 680 (1980).

scienter (among other things),[94] followed by SLUSA[95] which prevented such actions from migrating to state courts.[96] The bottom line is that the standard of pleading and proof in a criminal proceeding is lower than in a civil proceeding. Clearly, something is awry.

One problem derives from the idea that an investor should have standing to assert a direct claim for damages in connection with a misstatement or omission that affects the *trading* market. To be sure, an investor has a direct claim against the issuer in the context of an offering by the issuer. But that is because the issuer took money from the investor and should give it back if the investor was misled. The situation is completely different if the issuer misleads the market outside the context of an offering. The market price of the stock is bound to move when the truth comes out. The loss must fall somewhere.[97] To afford a remedy to investors who happen to buy or sell at the wrong time is only to rearrange the gains and losses among innocent investors.[98] On the other hand, if insiders use the opportunity to extract gains by trading at a time when they know that the market is misinformed, outside investors suffer to the extent that insiders gain.[99] The upshot is that diversified investors have nothing to gain from a securities fraud action except when there is insider misappropriation involved.[100] Even then, investors can be made whole if the issuer recovers insider gains.[101] In other words, investors would prefer that securities fraud actions be limited to an action by the company (or a derivative action) to recover insider gains. The problem is that the existing system of direct recovery by individual investors -- who happen to buy or sell at the wrong time – is nothing more than a transfer of stockholder wealth among investors less a substantial cut for attorney fees.[102] Investors gain nothing in the end. Rather they lose to the extent of the costs of litigation. But plaintiff attorneys (and maybe even defendant attorneys) have a big stake in the system as it stands.[103]

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[93] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. § 78u–4 (2000)).

[94] *Id*.

[95] Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended at 15 U.S.C.A. § 78bb (2000)).

[96] *Id*.

[97] This problem is not unique to securities fraud litigation. The central issue of many disputes about the application of agency law also boil down to the question of which of two innocent parties – the principal or a third party contractor -- should bear the cost when an agent exceeds her authority.

[98] *See* Booth, *End of Securities Fraud*, *supra* note 19, at 3–4.

[99] *Id*. at 4.

[100] *See id*.

[101] *Id.* at 24.

[102] *Id.* at 3 n.2.

[103] *Id*.

There is a certain twisted logic in the expansion of criminal prosecution when civil remedies are in such disarray. A securities fraud class action is potentially devastating for a target company.[104] Indeed, at least one study has found that 30 percent of target companies end up bankrupt.[105] So it is understandable for a target company to circle the wagons. It is unlikely that a company (or its board of directors) will seek out those who misled the market or even those who may have traded at a gain during the fraud period.[106] It is also understandable that the courts and Congress have sought to limit the reach of private securities litigation.[107] But it is almost comical that they have done so in effect by telling plaintiff lawyers that they may sue only if they *really really* have the facts that will support the claim.[108] The problem is not that plaintiff lawyers are too eager. The problem is that the remedy is too generous and not rationally related to the harm suffered by investors. It is thus not surprising that prosecutors have swept in to fill the near vacuum created by ever narrower private remedies and companies that cannot afford to be candid.

The simple solution is for the courts to recharacterize securities fraud class actions as derivative actions. As I have argued elsewhere, this would be more consistent with the statutory scheme than the current system of securities fraud class actions.[109] For example, section 16(b) of the 1934 Act provides for issuer recovery in connection with short swing trading (which is essentially a variety of insider trading).[110] Moreover, the law of insider trading is founded primarily on the idea that an insider has a duty to the source of the information (usually the issuer) not to use the information for personal gain. So it seems quite clear that the issuer has standing to recover. And indeed there is solid state law precedent to that effect.[111]

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[104] *See* SIMMONS & RYAN, *supra* note 42, at 14.

[105] *See id.*; ANJAN V. THAKOR WITH JEFFREY S. NIELSEN & DAVID A. GULLEY, U.S. CHAMBER INST. FOR LEGAL REFORM,THE ECONOMIC REALITY OF SECURITIES CLASS ACTION LITIGATION app. II, exhibit A (Oct. 26, 2005), Appendix II, Exhibit A (noting plaintiff attorney fees of $1.7 billion in connection with settlements totaling $11.9 billion in a sample of 482 class actions). Assuming that this sample is representative of the percentage of settlement awarded as plaintiff attorney fees (approximately 14 percent in the sample), a good estimate of the total plaintiff attorney fees awarded in Securities Fraud Class Actions (SFCAs) since 1995 is $3.6 billion (14 percent of $26 billion). Assuming that defendant firms have been paid roughly the same amount, it seems a fair estimate that SFCAs have generated about $7 billion in attorney fees over the last ten years. Defendant firms are paid in all cases, whether or not the plaintiff prevails, but presumably defendant firm fees are a good deal less than plaintiff firm fees in cases in which plaintiffs prevail. Note that plaintiff attorney fees are paid out of the settlement and that accordingly the estimated amount available for investors was $26 billion less $3.6 billion or about $22.4 billion. *Id.*

[106]*See* Booth, *End of Securities Fraud*, *supra* note 19, at 7.

[107] *See id.* at 28–29 n.78.

[108] PSLRA requires that a plaintiff allege facts that support a strong inference of scienter. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270. *See generally supra*, notes 89–94.

[109] *See* Booth, *End of Securities Fraud*, *supra* note 19, at 28.

[110] *Id*; *See also* 69A AM. JUR. 2D *Securities Regulation – Federal* §1415 (2007).

[111] It is arguable that the creation of a claim for the benefit of contemporaneous traders under the ITSFEA preempts claims by the issuer. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). But claims under section 20A depend on proof of

another independent violation of federal securities law. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 2007 US LEXIS 8270. A claim under section 20A is not based on any duty to the source of the information. So it is difficult to see how such a claim could displace an issuer claim based on traditional notions of fiduciary duty. ITSFEA is an example of rampant confusion in federal securities law.

Conclusion

Disputes relating to corporate governance and securities regulation are singularly bad subject matter for criminal sanctions. The issues of corporation law come in many forms ranging from self-dealing, to corporate opportunity, to executive compensation, to simple mismanagement. And as for federal securities regulation, the question is almost always one of where the gain and loss should fall. Either way, the issue is ultimately one of distribution. The civil law does not presume any answers other than to allocate the burden of proof to one party or the other depending on the nature of the allegations. In contrast, the criminal law is one dimensional. Although the defendant is supposedly presumed innocent, the issue for the court in a criminal case is a simple factual one: Did the defendant do the crime? Although there may be some cases of outright fraud in which the perpetrator has made no good faith effort to run a profitable business, most cases of business failure are otherwise. A diversified stockholder is perfectly able (and indeed happy) to absorb the occasional loss from the failure of a business if management tries in good faith to maximize stockholder value. As long as management does not have its hand in the cookie jar, gains will more than compensate for losses. The threat of criminal prosecution will likely cause better managers to be more conservative than stockholders want and to seek more pay in the bargain or to go to work for privately held companies. Either way investors lose. So if the issue is stockholder welfare, we should rein in the prosecutors somehow. If the issue is something else, somebody should say what it is.