

September 2003

## An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime

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### Recommended Citation

Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 Fla. L. Rev. 937 (2003).

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# Florida Law Review

Founded 1948

Formerly  
University of Florida Law Review

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VOLUME 55

SEPTEMBER 2003

NUMBER 4

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## AN ENRON LESSON: THE MODEST ROLE OF CRIMINAL LAW IN PREVENTING CORPORATE CRIME

*Geraldine Szott Moohr\**

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As the Enron scandal unfolded, government and industry officials, editorial writers, Enron employees and retirees, and the general public spoke with one voice: those responsible should be punished. In the months that followed Enron's disclosures, a flood of reports about executive malfeasance at other corporations—WorldCom, Adelphia, Tyco, and others—increased the demand for criminal sanctions.<sup>1</sup>

After some initial hesitation, the Bush administration wholeheartedly embraced a criminal response to the crisis.<sup>2</sup> Early in 2002, the Department of Justice charged David Duncan, the chief auditor at Arthur Andersen on the Enron account, with obstruction of justice for directing subordinates to destroy accounting documents.<sup>3</sup> Prosecutors secured his plea agreement and promise to testify,<sup>4</sup> and only months later won conviction of Enron's auditor, Arthur Andersen LLP, for obstruction of justice.<sup>5</sup>

In mid-July, the Bush administration created a "corporate crime task force" to coordinate the growing number of criminal investigations,<sup>6</sup> and newspapers began to headline arrests with photographs of suited

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1. By one count, fifty-four firms were being investigated by prosecutors and regulatory agencies for accounting frauds and other financial misdeeds as of October 2002. See Gary Stoller, *Funny Numbers*, USA TODAY, Oct. 21, 2002, at 3B (listing other firms such as ImClone, Sunbeam, Waste Management, Xerox, Global Crossing, Qwest Communications, and RiteAid).

2. See Robert H. Frank, *The Case for Sanctions*, N.Y. TIMES, Aug. 24, 2002, at A13 (noting that the Bush administration at first resisted criminal initiatives); Stephen Labaton, *Seemingly Close to Nominee, S.E.C. Search is Back to Start*, N.Y. TIMES, Nov. 15, 2002, at A1 (stating that the administration's use of vigorous prosecution was a tool to blunt calls for tougher regulations).

3. *United States v. Duncan*, No. H-02-209 (D. Tex. filed Apr. 9, 2002) (Information).

4. See *id.* (Cooperation Agreement).

5. Andersen, which would not survive the investigation, trial, and verdict, was ultimately fined \$500,000. See Mary Flood & Tom Fowler, *Enron's Auditor Is Given the Max*, HOUSTON CHRON., Oct. 17, 2002, at A1. At the time of this writing, Duncan has not been sentenced.

6. See John R. Wilke, *President Praises Work of Task Force on Business Crime*, WALL ST. J., Sept. 27, 2002, at A4 (reporting that the task force includes law enforcement personnel from the FBI, Treasury, and the SEC).

executives in handcuffs doing the “perp walk.”<sup>7</sup> Congress moved in tandem, holding various congressional hearings at which executives asserted their Fifth Amendment rights.<sup>8</sup> In July 2002, Congress enacted the Sarbanes-Oxley Act, which, among other initiatives, created new offenses and mandated severe penalties for violating criminal laws.<sup>9</sup> In October 2002, prosecutors charged Enron executives Michael Kopper and Andrew Fastow with multiple offenses.<sup>10</sup> As this Article is being written, there are almost daily reports of investigations and arrests.<sup>11</sup>

Empathy with employees, investors, and creditors readily explains the public’s demand for punishment. One can also understand the political expediency of a tough-on-crime response.<sup>12</sup> Yet this rather reflexive turn to criminal law may be premature and is almost certainly incomplete. The catastrophic events at Enron and other companies point to the need for a careful analysis to determine how criminal law can contribute most effectively to the prevention of future Enrons.

With this goal in mind, the first part of this Article reviews the chief criminal laws implicated by conduct at Enron and notes changes wrought by the Sarbanes-Oxley Act. The review indicates that, despite the failure of criminal law to deter corporate misconduct, there was no shortage of

7. David Duncan of Arthur Andersen, Andrew Fastow of Enron, Samuel Waksal of ImClone, Scott Sullivan of WorldCom, Dennis Kozlowski of Tyco International, and John Rigas of Adelphia Communications were among those photographed doing the “perp walk.” See, e.g., Kurt Eichenwald, *After a Boom, There Will be a Scandal. Count on It*, N.Y. TIMES, Dec. 16, 2002, at C3. See also John C. Danforth, *When Enforcement Becomes Harassment*, N.Y. TIMES, May 6, 2003, at A31 (critiquing the use of perp walks on the ground that they have no law enforcement purpose and are a humiliating punishment before conviction).

8. Floyd Norris, *Capital Scorn: Communists to Accountants*, N.Y. TIMES, Jan. 25, 2002, at C1.

9. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

10. See David Barboza, *Enron’s Many Strands: Fallen Star; From Enron Fast Track to Total Derailment*, N.Y. TIMES, Oct. 3, 2002, at C1; Rebecca Smith & John R. Emshwiller, *Prosecutors Probe Skilling’s Role in Enron’s Failed Telecom Venture*, WALL ST. J., Dec. 13, 2002, at A1. In March 2003, federal prosecutors charged Kevin Howard and Michael Krautz with securities fraud, wire fraud, and lying to investigators. See Kurt Eichenwald, *Fraud Charges Filed Against 2 Employees of Enron Unit*, N.Y. TIMES, Mar. 13, 2003, at C1 (reporting indictment of two midlevel Enron employees).

11. See, e.g., Kurt Eichenwald, *Second Enron Energy Trader Pleads Guilty*, N.Y. TIMES, Feb. 5, 2003, at C2; Smith & Emshwiller, *supra* note 10 (reporting that federal prosecutors are investigating fraud in connection with Enron’s high-speed communications business); Rebecca Smith & John Wilke, *Top Enron Trader Admits to Fraud in California Crisis*, WALL ST. J., Oct. 18, 2002, at A3 (reporting that prosecutors had reached Enron’s electricity dealings and that Timothy Belden, former head of Enron’s energy-trading desk, had pleaded guilty to wire fraud for submitting false data to California’s grid operator).

12. See David Stout, *Washington Talk; For Candidates, Crimes Are Now Wearing White*, N.Y. TIMES, Sept. 5, 2002, at A19 (noting that politicians of both parties agreed on what to do: punish the wrongdoers).

criminal laws and substantial sanctions already “on the books.” Part II reveals that the most significant feature of the criminal provisions of the Sarbanes-Oxley Act is severe prison terms. Will enhanced criminal penalties be any more effective in preventing corporate crime than were the previous sanctions?

In an effort to answer that question, Part III presents the two primary theories of law-abiding behavior, the rational choice and the unconscious instinct models, and discusses their inherent limitations. The rational choice model is limited because biased judgment can impair the calculation that measures risk of punishment. The unconscious instinct model is limited because competing social values of subgroups, such as a corporate culture, can subvert an instinct to obey the law. The Enron experience illustrates the limitations of each model. The experience demonstrates that, standing alone, criminal law is not a particularly effective means of creating a law-abiding business community.

But the criminal law does not stand alone. Part IV suggests that criminal laws are only one method of monitoring business conduct; private civil suits and government regulatory enforcement actions also are important deterrent mechanisms. Although the criminal law can and should be part of the effort to prevent future Enrons, it is no panacea. For maximum effectiveness, the criminal law is better viewed as one part of a comprehensive scheme that includes private enforcement and government regulation. Each of these enforcement mechanisms should deliver a single, consistent message to the corporate sector that expresses the community’s conception of law-abiding behavior in the corporate world.

#### I. THE CRIMINAL LAW LANDSCAPE BEFORE AND AFTER THE SARBANES-OXLEY ACT

Published reports and criminal indictments indicate that at least some of the misconduct at Enron and other firms violated existing federal criminal laws.<sup>13</sup> These laws carried substantial prison terms and fines.<sup>14</sup> Thus far, the indictments indicate that prosecutors are relying on familiar criminal laws that are often applied to white collar crimes. For instance, Andrew Fastow, the former Chief Financial Officer of Enron, is charged with committing wire fraud, money laundering, obstruction of justice, and conspiracy to commit wire fraud, securities fraud, and money laundering.<sup>15</sup>

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13. See, e.g., *supra* note 3 and *infra* note 15.

14. See *infra* notes 19-21 and accompanying text.

15. See *United States v. Fastow*, No. H-02-0665 (D. Tex. filed Oct. 31, 2002) (listing charges of 18 U.S.C. § 371 (2003) (conspiracy); *id.* § 1343 (wire fraud); *id.* §§ 1956, 1957 (money laundering); *id.* § 1512(b) (obstruction of justice); 18 U.S.C. § 2 (aiding and abetting)).

These offenses trace a typical trajectory that centers on providing misleading and material information to others with intent to defraud them. This conduct motivates a course of other criminal violations. For instance, when a fraudulent scheme is undertaken by more than one person, it is often preceded by an agreement to defraud, implicating the conspiracy statute.<sup>16</sup> The fraud may be followed by attempts to conceal evidence from investigators, triggering violations of obstruction of justice statutes.<sup>17</sup> Finally, the offense of money laundering follows completion of the fraud, when actors conceal their proceeds by using or transferring profits gained from the fraud.<sup>18</sup>

Each of the criminal laws just mentioned specifies a maximum term of imprisonment.<sup>19</sup> In addition, convicted felons who obtained pecuniary gain or caused pecuniary loss are subject to criminal fines that are authorized by a separate provision.<sup>20</sup> The amount of the criminal fine depends upon the defendant's gain or the victim's loss; the fine is twice the gain or loss, whichever is greater.<sup>21</sup>

It is commonly assumed that white collar offenders are not subject to significant penalties.<sup>22</sup> Troubling disparities in sentences between "crime in the suites" and "crime in the streets" undoubtedly exist.<sup>23</sup> Nevertheless, punishment of white collar offenders is significantly harsher than the prison terms that were the focus of Edwin Sutherland's critique.<sup>24</sup> Accordingly, a few comments about the federal sentencing scheme for

16. 18 U.S.C. § 371 (2003).

17. *Id.* §§ 1503, 1505, 1512.

18. *Id.* §§ 1956, 1957. Mail and wire fraud, obstruction, and money laundering are predicate acts for RICO charges. *See id.* § 1961 *et seq.* Under RICO, forfeiture of real property and financial accounts follow conviction, and in the meantime defendants' assets are placed in escrow. *Id.* § 1963(a).

19. *See supra* notes 15-18.

20. 18 U.S.C. § 3571(d) (2003). In nonpecuniary crimes, the maximum fine is \$250,000 for individuals and \$500,000 for corporations. *Id.* § 3571(b)-(c). Unless a specific provision indicates otherwise, all Title 18 felonies are subject to this fine provision. *Id.* § 3571.

21. *Id.* § 3571(d).

22. *See* Clifton Leaf, *Enough Is Enough; White Collar Criminals: They Lie They Cheat They Steal and They've Been Getting Away with It for Too Long*, FORTUNE, Mar. 18, 2002, at 60. *But see* Russ Mitchell, *White-Collar Criminal? Pack Lightly for Prison*, N.Y. TIMES, Aug. 11, 2002, at BU4 (disputing the notion that major-league white collar offenders do not face heavy prison time).

23. For analyses of this discrepancy, see Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1311-60 (2001); Joseph E. Kennedy, *Making the Crime Fit the Punishment*, 51 EMORY L.J. 753, 756-59 (2002).

24. Sutherland is credited with identifying white collar crime in 1939. *See* Gilbert Geis & Colin Goff, *Introduction to EDWIN H. SUTHERLAND, WHITE COLLAR CRIME: THE UN-CUT VERSION* xii-xiii (1983).

white collar crimes are instructive before turning to a more detailed discussion of the existing fraud and obstruction statutes.

Penalties for federal crimes are a function of both the particular criminal offense and the Sentencing Guidelines.<sup>25</sup> Although criminal laws specify a maximum punishment, in most cases the Guidelines largely determine the actual sentence.<sup>26</sup> Since the advent of the Guidelines, punishment of federal white collar offenses has become more serious and more certain.<sup>27</sup> For example, the Guidelines immediately reduced the possibility of probationary sentences for white collar offenders.<sup>28</sup> They also increased prison time served by white collar offenders by ensuring that Guideline sentences exceeded the average prison time imposed in the pre-Guideline era.<sup>29</sup>

Moreover, under the Guidelines, judges have far less sentencing discretion,<sup>30</sup> which, in the past, may have led to lighter sentences for middle-class offenders. Certain factors that would normally operate to reduce the prison terms of white collar offenders, such as community service and family responsibilities, are considered irrelevant in determining

25. See generally Sentencing Reform Act of 1984 § 211, 18 U.S.C. §§ 3551-3742 and 28 U.S.C. §§ 991-998 (2003). UNITED STATES SENTENCING GUIDELINES MANUAL [hereinafter USSG], ch. 1, pt. A(3) (2002) (explaining that the Guidelines were formulated to provide greater honesty, uniformity, and proportionality in federal sentencing).

26. See *Mistretta v. United States*, 488 U.S. 361, 371-412 (1989) (upholding the constitutionality of the Guidelines).

27. See generally Frank O. Bowman, III, *The Quality of Mercy Must Be Restrained, and Other Lessons in Learning to Love the Federal Sentencing Guidelines*, 1996 WIS. L. REV. 679 (tracing the development of the Guidelines and noting their radical departure from previous federal practice); Stephen Breyer, *The Federal Sentencing Guidelines and the Key Compromises Upon Which They Rest*, 17 HOFSTRA L. REV. 1 (1998) (recounting policy considerations that influenced the formulation of the Guidelines); Kate Stith & Steve Y. Koh, *The Politics of Sentencing Reform: The Legislative History of the Federal Sentencing Guidelines*, 28 WAKE FOREST L. REV. 223 (1993) (examining the legislative history of the Guidelines).

28. See USSG ch. 1, pt. A(4)(d) (2002) (noting that the Commission purposely wrote Guidelines that treat white collar offenses, such as tax evasion, antitrust violations, insider trading, and fraud as serious offenses that justify prison terms rather than probation).

29. To arrive at its initial sentencing scheme, the Commission surveyed existing sentencing practices and used average sentences to compile new Guideline sentences. See Bowman, *supra* note 27, at 733-34 (noting that the Commission attempted to discover the federal common law of sentencing and to codify it rather than determine what the penalty for an offense should be). White collar crimes were treated differently. Instead of basing sentences on past practices, for white collar crimes the Commission prescribed substantial increases over average prior sentences. See *Mistretta v. United States*, 488 U.S. 361, 413-15 (1989) (Scalia, J., dissenting) (providing examples of public corruption, antitrust violations, and tax evasion).

30. The discretion of prosecutors, however, is enhanced by the Sentencing Guidelines. Prosecutors decide what charges will be brought and also play a role in recommending a prison sentence. See Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 56 (1997) (discussing current role of prosecutors).

the Guideline sentence.<sup>31</sup> Although judges may depart from that sentence,<sup>32</sup> they may not use an offender characteristic, such as age or family responsibility, unless it “is present to an unusual degree.”<sup>33</sup> In 2001, the sentencing scheme was modified to increase sentences of white collar offenders who cause great pecuniary harm.<sup>34</sup> Thus, even before passage of the Sarbanes-Oxley Act, those who committed federal white collar crimes faced significant prison sentences and criminal fines. The failure of these penalties to deter business misconduct raises the issue of whether increasing criminal penalties is an effective mechanism for preventing corporate crimes.

To begin the analysis of that issue, the following discussion reviews three of the crimes implicated in recent scandals: mail fraud, securities fraud, and obstruction of justice. It also notes how the Sarbanes-Oxley Act changes the white collar crime landscape. The discussion ends with an evaluation of the criminal provisions of Sarbanes-Oxley.

### A. Mail and Wire Fraud

Fraud, which courts have historically regarded as particularly iniquitous,<sup>35</sup> is at the heart of most white collar offenses. Fraud is synonymous with dishonesty, disloyalty, and a disregard for ethical standards of conduct; it is inherently dishonorable, marked by secrecy, lies, and betrayal.<sup>36</sup> In both the civil and criminal context, the main component of fraud is deceit.<sup>37</sup> Two federal criminal laws generally prohibit fraud in the private sector.

31. See USSG § 5H1.1 (2002) (stating that age is not ordinarily relevant); *id.* § 5H2.1 (educational skills); *id.* § 5H1.5 (employment record); *id.* § 5H1.6 (family ties and responsibilities and community ties); *id.* § 5H1.10 (socio-economic status); *id.* § 5H1.11 (military, civic, charitable or public service; employment-related contributions; record of prior good works).

32. See, e.g., *id.* § 5K2.0 (Grounds for Departure); see also *Koon v. United States*, 518 U.S. 81, 110-11 (1996) (providing guidance on when departure from the Guideline range of punishment is appropriate).

33. See USSG § 5K2.0 (2002) (policy statement); see also *Koon*, 518 U.S. at 98.

34. Among other changes, the Commission modified the loss table, which is the major determinant of the offense level and thus the ultimate prison term. See USSG, § 2B1.1 (2002). The new Guidelines provide a more comprehensive definition of monetary loss: all losses that the defendant knew or reasonably should have known were a potential result of the offense in the loss calculation. See *id.* § 2B1.1, cmt. n.2.

35. See Geraldine Szott Moohr, *Federal Criminal Fraud and the Development of Intangible Property Rights in Information*, 2000 U. ILL. L. REV. 683, 689 n.31 (presenting judicial characterizations of fraud).

36. See *id.* at 689 (noting that fraud often requires the victim’s participation).

37. See MELVILLE M. BIGELOW, *THE LAW OF FRAUD AND THE PROCEDURE PERTAINING TO THE REDRESS THEREOF* 92 (Fred B. Rothman & Co. 1981) (1877) (“All fraud, properly speaking, involves something of deceit. A truly fraudulent act cannot be committed without the practice of deception.”).



## 1. Mail Fraud Before the Sarbanes-Oxley Act

The mail and wire fraud statutes apply to fraudulent schemes that involve a mailing or an electronic transmission and that are intended to harm another person or entity.<sup>38</sup> Victims may sustain a loss of money, property, or honest services that are owed by the offending actor.<sup>39</sup> Mail fraud is written broadly, and has been expansively interpreted, so that the offense now encompasses an extraordinarily wide range of deceptive conduct.<sup>40</sup> As one would expect, the statute is a favorite and much-used tool of federal prosecutors.<sup>41</sup>

The elements of the federal fraud offense are (1) devising or participating in a scheme to defraud, (2) commission of the act with intent to defraud, and (3) use of the mails or wires in furtherance of the fraudulent scheme.<sup>42</sup> Although use of the mails or wires would seem to limit applicability of the offense, that is not the case. It is not difficult to establish that the defendant mailed or caused a mailing, wire, or electronic transmission for the purposes of executing the fraud.<sup>43</sup>

38. 18 U.S.C. §§ 1341, 1343, 1346 (2001). The mail and wire fraud statutes are interpreted jointly, so decisions under one statute apply to the other. *See United States v. Fermin Castillo*, 829 F.2d 1194, 1198 (1st Cir. 1987). If a fraud involves mailing by the post office or through an interstate private carrier, mail fraud is charged; if it involves the use of wire or electronic transmission, wire fraud is charged. *Id.* For convenience, the term mail fraud as used herein includes both offenses.

Reflecting its breadth and power, mail fraud has attracted a significant body of commentary. For a useful bibliography, *see* Ellen S. Podgor, *Mail Fraud: Redefining the Boundaries*, 10 ST. THOMAS L. REV. 557, 573-77 (1998).

39. *See* 18 U.S.C. § 1346.

40. *See United States v. Handakas*, 286 F.3d 92, 101-03 (2d Cir. 2002) (tracing development of the mail fraud statute); Roger J. Miner, *Federal Courts, Federal Crimes, and Federalism*, 10 HARV. J.L. & PUB. POL'Y 117, 121 (1987) (stating that the mail fraud statute is a "vehicle for the prosecution of an almost unlimited number of offenses").

41. *See Handakas*, 286 F.3d at 108 (describing mail fraud as an "all-purpose prosecutorial expedient"). John C. Coffee, Jr., *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117, 126 (1981) (quoting the prosecutor's maxim, "when in doubt, charge mail fraud"); John C. Coffee, Jr., *The Metastasis of Mail Fraud: The Continuing Story of the 'Evolution' of a White-Collar Crime*, 21 AM. CRIM. L. REV. 1, 3 (1983) (arguing that the mail fraud statute "seems destined to provide the federal prosecutor with what Archimedes long sought—a simple fulcrum from which one can move the world"); Jed S. Rakoff, *The Federal Mail Fraud Statute (Part 1)*, 18 DUQ. L. REV. 771, 771 (1980) (noting prosecutors' reference to the statute as "our Stradivarius, our Colt 45, our Louisville Slugger, our Cuisinart").

42. *See Emery v. American Gen. Fin., Inc.*, 71 F.3d 1343, 1349 (7th Cir. 1995); *see also United States v. Altman*, 48 F.3d 96, 101 (2d Cir. 1995); *United States v. Walker*, 9 F.3d 1245, 1249 (7th Cir. 1993).

43. *See Schmuck v. United States*, 489 U.S. 705, 715 (1989) (stating the issue is whether the mailing is part of the execution of the scheme as conceived by the perpetrator); *see generally* Peter

The statute prohibits “devising” a scheme to defraud, so the government need not prove that the victim actually sustained a loss.<sup>44</sup> The prosecution must prove, however, that the defendant intended to harm the victim by depriving the victim of money, property, or honest services.<sup>45</sup> Thus, participation in a fraudulent scheme is not a crime unless it was devised with the specific purpose of defrauding another person. An aggressive business deal is not criminal even if a person recklessly disregarded the risk that the scheme will deprive another of money or property. Nor is taking advantage of accounting standards, or even gaming those standards, a crime unless undertaken with intent to defraud another person or entity. Although the intent element is often cited as a significant hurdle to conviction, this is not necessarily the case. Fact-finders may use circumstantial evidence to infer culpability.<sup>46</sup> The task is made easier when actual loss occurs because evidence of loss or gain creates an inference of a specific intent to defraud.<sup>47</sup> On the other hand, proving intent is more problematic when an attempted scheme would not necessarily result in loss.<sup>48</sup>

## 2. Mail Fraud After the Sarbanes-Oxley Act

In testament to the effectiveness of the mail and wire fraud statutes, Congress did not alter the substantive elements of mail and wire fraud. The Sarbanes-Oxley Act does, however, drastically increase penalties of these crimes. It increases by four times the maximum penalty for mail and wire fraud, from five to twenty years in prison.<sup>49</sup> The Sarbanes-Oxley Act also makes clear that the penalty for conspiracy and attempt to commit fraud is the same as the penalty for the fraud that is the object of the conspiracy.<sup>50</sup>

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J. Henning, *Maybe It Should Just be Called Federal Fraud: The Changing Nature of the Mail Fraud Statute*, 36 B.C. L. REV. 435 (1995).

44. See 18 U.S.C. § 1341.

45. See 18 U.S.C. §§ 1341, 1346.

46. See *United States v. Berndt*, 86 F.3d 803, 809 (8th Cir. 1996); *United States v. Behr*, 33 F.3d 1033, 1035 (8th Cir. 1994); *United States v. Hatch*, 926 F.2d 387, 396 (5th Cir. 1991).

47. See *United States v. D'Amato*, 39 F.3d 1249, 1257 (2d Cir. 1994). See generally Geraldine Szott Moohr, *Mail Fraud Meets Criminal Theory*, 67 U. CIN. L. REV. 1 (1998).

48. See *D'Amato*, 39 F.3d at 1257.

49. See Sarbanes-Oxley Act of 2002 § 903, 18 U.S.C. §§ 1341 & 1343 (2003). The maximum penalty for these fraud offenses was five years. *Id.*

50. Sarbanes-Oxley Act of 2002 § 902(a), 18 U.S.C. § 1349 (2003). The provision applies to all Chapter 63 frauds, which include bank fraud, health care fraud, mail and wire fraud, and the new securities fraud provision. See 18 U.S.C. § 1344 (2003) (bank fraud); *id.* § 1347 (health care fraud); *id.* § 1348 (securities fraud).

## B. Securities Fraud

Securities fraud is a specialized kind of fraud that applies to misrepresentations that are made when issuing or trading securities. After the stock market crash of 1929, the securities laws were enacted in an effort to restore confidence in the stock market and thereby to encourage investment. The type of securities fraud dealt with here is prohibited by the Securities Exchange Act of 1934, which governs trades in secondary markets and sales of already-issued securities.<sup>51</sup> The law is enforced through government regulatory actions, implied private causes of action, and the criminal law.

### 1. Insider Trading Before the Sarbanes-Oxley Act

The Exchange Act prohibits the use of manipulative and deceptive devices in connection with the purchase or sale of a security.<sup>52</sup> Rule 10b-5, authorized by the Act, provides more specific prohibitions, such as making any untrue statement of a material fact in connection with a securities trade.<sup>53</sup> Actors who willfully violate the statute or the rules adopted

51. See Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (2003). The Securities Act of 1933 regulates registering and issuing securities in the primary market, requires full disclosure by companies that sell securities, and contains a criminal provision. See Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (2003).

52. See 15 U.S.C. § 78j(b) (2001). Section 10(b) of the Exchange Act provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

53. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

pursuant to it are subject to criminal penalties.<sup>54</sup> The Department of Justice has sole authority to bring criminal charges,<sup>55</sup> but depends on the Securities and Exchange Commission (SEC) for referrals.

Perhaps the most common type of criminal securities fraud involves insider trading.<sup>56</sup> Classic insider trading occurs when an insider, such as an executive of the company, uses information that is not available to the public to buy or sell a security of that company. Acting in breach of a fiduciary duty to shareholders, the failure to disclose that material information to buyers or sellers is considered a “deceptive device.”<sup>57</sup> Under a recent Supreme Court decision, those who do not have a fiduciary obligation that runs to the buyers or sellers in the trade may also violate insider trading rules.<sup>58</sup> Insider trading now applies to any person who violates a duty that he or she owes to the source of the nonpublic information, and thus includes “outsiders.”<sup>59</sup>

In addition to identifying a proper defendant and establishing that the conduct at issue involved interstate commerce, the government must prove that the accused acted willfully in possessing and using material, nonpublic information in a securities trade.<sup>60</sup> Willfulness has been defined as a deliberate and intentional act that encompasses fraudulent intent.<sup>61</sup> Violators are subject to fines and a maximum penalty of ten years in prison.<sup>62</sup>

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(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2003).

54. 15 U.S.C. § 78ff(a) (2001).

55. Criminal actions are within the exclusive control of the Justice Department. *See* 17 C.F.R. § 202.5(f) (2001). The SEC may bring civil or administrative actions. *See* 15 U.S.C. § 78u-3 (2001).

56. *See Lynch, supra* note 30, at 33 n.31 (remarking on the frequency of insider trading prosecutions).

57. *See Chiarella v. United States*, 445 U.S. 222, 228 (1980). Courts have held that fiduciary duties run to buyers as well as to sellers of stock on the ground that buyers are prospective shareholders. *See United States v. Chestman*, 947 F.2d 551, 565 n.2 (2d Cir. 1991). Tippees of insiders and temporary insiders, such as attorneys, may also violate insider trading rules. *Id.* at 565.

58. *See United States v. O'Hagan*, 521 U.S. 642, 653 (1997).

59. *Id.* at 652-53.

60. 15 U.S.C. § 78ff(a) (2001).

61. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). The definition varies somewhat between circuits. *See United States v. Langford*, 946 F.2d 798, 802 n.13 (11th Cir. 1991) (defining willfulness as deliberate ignorance of truth); *United States v. Weiner*, 578 F.2d 757, 787 (9th Cir. 1978) (defining willfulness as reckless indifference to or disregard for truth); *see also* William H. Kuehnle, *On Sciernter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 134 n.62, 184 n.300 (1997).

62. 15 U.S.C. § 78ff(a).

## 2. Insider Trading After the Sarbanes-Oxley Act

Without otherwise disturbing this prohibition, Sarbanes-Oxley altered the penalty scheme of the Exchange Act crime: the maximum penalty of ten years in prison was doubled to twenty years and maximum fines for individuals were increased from \$1,000,000 to \$5,000,000.<sup>63</sup>

In a more significant change, the Act inserted a securities fraud provision into the federal criminal code.<sup>64</sup> The provision prohibits the knowing execution of (or attempt to execute) “a scheme or artifice to defraud any person in connection with any security” of a registered or reporting company.<sup>65</sup> The maximum prison term for violating the provision is twenty-five years.<sup>66</sup>

The new provision provides prosecutors with greater flexibility and allows them to operate independently of the SEC.<sup>67</sup> It applies to frauds that are merely in “connection with any security,” rather than being restricted to frauds in sales or purchases.<sup>68</sup> The culpability element of the new securities fraud offense requires knowledge, as opposed to the higher standard of willfulness in the Exchange Act.<sup>69</sup> Finally, the new provision is intended to have a broader application than those offenses, signaled by its text that mirrors the language of expansively interpreted fraud statutes.

### C. Obstruction of Justice

The federal criminal code addresses obstruction of justice in several independent and overlapping provisions.<sup>70</sup> The common purpose of the obstruction statutes is to protect the integrity of judicial, administrative, and legislative proceedings. Accordingly, the provisions ban altering or destroying documents, offering or promoting false testimony, and threatening or influencing witnesses, jurors, and court officials.<sup>71</sup> Like

63. See Sarbanes-Oxley Act of 2002 § 1106, 15 U.S.C. § 78ff(a) (2003) (authorizing maximum fine for corporations of \$25 million).

64. See Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348 (2003).

65. 18 U.S.C. § 1348(1) (2003). The provision also includes a false pretense subsection which bars obtaining money or property by means of false pretenses in connection with the purchase or sale of a registered or reporting company. *Id.* § 1348(2).

66. *Id.*

67. See *Legislative History of Title VIII of HR 2673: The Sarbanes-Oxley Act of 2002*, 148 CONG. REC. S7421 (daily ed. July 26, 2002) (statement of Sen. Leahy that the bill creates a “more general and less technical provision” that is “intended to provide needed enforcement flexibility”).

68. 18 U.S.C. § 1348. Note that the new provision is somewhat narrower in that it applies only to registered securities or those of issuers required to file reports with the SEC. *Id.*

69. This standard may be the operational equivalent of willfulness in some circuits. See *supra* note 61 and accompanying text.

70. See, e.g., 18 U.S.C. §§ 1503, 1505, 1510, 1512 (2003).

71. *Id.* § 1503(a). In addition to banning specific obstructive conduct, the statutes contain

perjury and false statements, obstruction is a “cover-up” crime that arises from an attempt to conceal evidence of earlier illegal activity.

### 1. Obstruction Before the Sarbanes-Oxley Act

The obstruction offense of which the firm Arthur Andersen was convicted generally prohibits interfering or tampering with witnesses, victims, or informants.<sup>72</sup> Among other acts, section 1512(b) prohibits “corruptly persuad[ing]” another person to alter, destroy, mutilate or conceal an object with intent to impair the object’s integrity or availability for use in an official proceeding.<sup>73</sup> The culpability element, “corruptly persuad[ing],” exists when the actor is motivated by an inappropriate or improper purpose to convince someone else to obstruct justice.<sup>74</sup> An “official proceed[ing]” is any proceeding before a federal court, grand jury, congressional hearing, or federal agency.<sup>75</sup> In Arthur Andersen’s case, the proceeding was an announced SEC investigation.<sup>76</sup> The maximum punishment authorized by section 1512(b) was, until passage of Sarbanes-Oxley, ten years in prison and/or statutory fines.<sup>77</sup>

### 2. Obstruction After the Sarbanes-Oxley Act

In reaction to the wholesale shredding at Enron by the Arthur Andersen auditors, Congress added three new laws prohibiting conduct that undermines government investigations. First, Sarbanes-Oxley amends the obstruction statute under which Duncan and Arthur Andersen were convicted so that it now applies to those individuals who actually destroyed documents.<sup>78</sup> This provision thus moves beyond witness tampering and corruptly persuading. Specifically applying to documents, the new provision makes it a crime for anyone to corruptly alter, destroy, mutilate, or conceal a record or document with intent to impair its use in an official proceeding.<sup>79</sup> In the Duncan/Arthur Andersen scenario, those

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broad omnibus clauses that bar any endeavor to interfere with the judicial system. *See id.* §§ 1503, 1505; *United States v. Aguilar*, 515 U.S. 593, 598 (1995) (noting that the omnibus clause of section 1503 “serves as a catchall, prohibiting persons from endeavoring to influence, obstruct, or impede the due administration of justice”).

72. 18 U.S.C. § 1512(a).

73. *Id.* § 1512(b)(2)(B). Subsection (b) also applies to witness testimony. *Id.* § 1512(b)(1)-(2).

74. *See United States v. Khatami*, 280 F.3d 907, 911-12 (9th Cir. 2001).

75. 18 U.S.C. § 1515(a)(1) (2001).

76. *See United States v. Arthur Andersen*, No. H-02-121 (D. Tex. filed Mar. 7, 2002) (Indictment).

77. *See* 18 U.S.C. § 1512(b).

78. *See* Sarbanes-Oxley Act of 2002 § 1102, 18 U.S.C. § 1512(c)(1) (2003).

79. *Id.* The provision also contains an omnibus provision. *Id.* § 1512(c)(2).

employees who corruptly shredded documents would now face criminal punishment. Violators are subject to statutory fines and a maximum term of twenty years in prison—twice the pre-Sarbanes-Oxley term of the Duncan/Arthur Andersen offense.<sup>80</sup>

Sarbanes-Oxley also adds two independent obstruction provisions to the federal criminal code. One new provision creates the crime of obstructing a federal investigation of “any matter” and specifically includes bankruptcy proceedings.<sup>81</sup> Prosecutors must establish two culpability elements: (1) the accused knowingly acted (altered, destroyed, etc.), and (2) acted with an intent to impede, obstruct, or influence a federal investigation.<sup>82</sup> Violators are subject to fines and a maximum of twenty years in prison.<sup>83</sup> Its application to *any* kind of document and *any* matter in a greater range of investigations adds considerably more breadth to the document provisions.

Finally, a second independent obstruction provision requires “[a]ny accountant” to maintain audit documents and workpapers for five years.<sup>84</sup> Knowing and willful violations of this obligation subjects the actor to fines and/or up to ten years in prison.<sup>85</sup> The prohibition is not contingent on an investigation or official proceeding, but is a flat directive to maintain documents, and is enforced through criminal sanctions.<sup>86</sup>

The new obstruction statutes differ from one another and from existing provisions in their culpability elements, the inclusion of attempts, and the character of the proceeding. Nevertheless, there is significant overlap between these offenses, and their ultimate usefulness is uncertain.

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80. *Id.* § 1512(c).

81. Sarbanes-Oxley Act of 2002 § 802, 18 U.S.C. § 1519 (2003) provides:

Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.

*Id.*

82. *Id.*

83. *Id.*

84. See Sarbanes-Oxley Act of 2002 § 802, 18 U.S.C. § 1520(a)(1) (2003).

85. *Id.* § 1520(b). The criminal provision includes violating rules promulgated by the SEC to implement the obligation. *Id.* § 1520(a)(2).

86. See 18 U.S.C. § 1520(a)-(b).

#### D. Sarbanes-Oxley's New Obligations

The criminal provisions discussed thus far cannot be characterized as “new” in the sense of imposing different obligations on businesspersons and corporations. The Sarbanes-Oxley Act does, however, create two obligations that have not been directly subject to criminal enforcement. First, chief executives and chief financial officers must personally certify that reports filed with the SEC comply with regulatory requirements.<sup>87</sup> An executive who knowingly certifies financial statements that do not fairly present the firm’s financial condition is subject to a maximum fine of one million dollars and a prison term of ten years, or both.<sup>88</sup> When the executive acts willfully, maximum penalties are increased to five million dollars and twenty years in prison.<sup>89</sup>

The second new obligation created by Sarbanes-Oxley protects employees who report wrongful conduct internally or to external investigators.<sup>90</sup> Under the Act, whistleblowers may file civil suits for damages resulting from retaliatory acts.<sup>91</sup> Moreover, executives who knowingly and intentionally retaliate against whistleblowers are subject to criminal fines and a maximum of ten years in prison.<sup>92</sup> This provision is intended to encourage employees to inform federal agencies and internal gatekeepers about suspected wrongful conduct. Accordingly, it provides attorneys fees to informers to aid in enforcing the new right.<sup>93</sup>

Nevertheless, the new provision may not be as effective at encouraging whistleblowing as it might have been.<sup>94</sup> Congress provided no incentive, such as a financial reward or punitive damages, that would stimulate

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87. See Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. § 1350(a) (2003). Before passage of Sarbanes-Oxley, executives could be liable for inaccurate financial reports under a fraud theory. See *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 (9th Cir. 2000) (holding that a CEO who signed an inaccurate SEC filing was liable under § 10(b)). The Securities Act of 1933 also requires corporate officers to sign registration statements and provides a cause of action if the statements are misleading. 15 U.S.C. § 77(k)(a) (2003).

88. 18 U.S.C. § 1350(c)(1).

89. *Id.* § 1350(c)(2).

90. See Sarbanes-Oxley Act of 2002 §§ 806, 1107, 18 U.S.C. §§ 1514A, 1513 (2003).

91. See 15 U.S.C. § 1514A (providing cause of action for wage-related damages and special damages such as attorneys fees).

92. See 18 U.S.C. § 1513(e).

93. *Id.* § 1514A(c)(2)(C).

94. Early reports were not encouraging. See Fawn H. Johnson, *Whistleblowers: Lawmakers Decry Bush's Interpretation of Whistleblower Protections in New Law*, 148 Daily Lab. Rep. (BNA) A-4 (Aug. 1, 2002) (reporting Bush administration's decision to limit applicability of the provision).



reporting.<sup>95</sup> Moreover, claims must be brought within a short ninety days of the retaliatory act.<sup>96</sup>

## II. AN EVALUATION OF SARBANES-OXLEY'S CRIMINAL PROVISIONS

The Sarbanes-Oxley Act was enacted to protect investors by improving the accuracy and reliability of corporate disclosures relating to securities laws.<sup>97</sup> Enacted in haste and out of political expediency,<sup>98</sup> it was an effort to restore confidence in securities markets in a sagging economy. Although the Act focuses on the administrative regulatory scheme, especially as to accounting standards, the criminal law is to play a major role in the effort to eradicate corporate fraud. President Bush emphasized the law's strong criminal component at the signing ceremony: there is "[n]o more easy money for corporate criminals, just hard time."<sup>99</sup> He later reinforced that characterization: "If you're a CEO and you think you can fudge the books in order to make yourself look better, we're going to find you, we're going to arrest you and we're going to hold you to account."<sup>100</sup>

95. In contrast, *qui tam* actions brought under the False Claims Act provide substantial monetary rewards for whistleblowing. See 31 U.S.C. § 3730 (2003); see generally Joan H. Krause, *Health Care Providers and the Public Fisc: Paradigms of Government Harm Under the Civil False Claims Act*, 36 GA. L. REV. 121 (2001).

The federal government has recovered approximately \$8.7 billion from fraudulent contractors since 1986. See JACK MEYER & STEPHANIE E. ANTHONY, REDUCING HEALTH CARE FRAUD: AN ASSESSMENT OF THE IMPACT OF THE FALSE CLAIMS ACT 11 (Sept. 2001), available at [www.taf.org/publications/PDF/reducing.pdf](http://www.taf.org/publications/PDF/reducing.pdf).

Following misconduct at savings and loan institutions in the 1980s, rewards for whistleblowers rather than mere protection were recommended. See Maria S. Boss & Barbara Crutchfield George, *Challenging Conventional Views of White Collar Crime*, 28 CRIM. L. BULL. 32, 55-56 (1992).

96. See 18 U.S.C. § 1514A(b)(2)(D).

97. See *Preface to Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

President Bush characterized the Act as embodying "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt." Signing Statement of President George W. Bush, (July 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/2002730.html> (last visited May 8, 2003).

98. See Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 46 (2003) (noting that neither publicly held corporations, the political parties, nor organizations and individuals interested in matters of corporate governance were able to study or seriously consider the bill).

The administration resisted reform legislation, but in the end supported it in response to reports that the business scandals were eroding its political support. See Stephen Labaton, *Handcuffs Make Strange Politics, You Say? But Not in Washington*, N.Y. TIMES, Aug. 2, 2002, at C1 (noting that a public backlash prompted a sharp about-face at the White House).

99. Signing Statement, *supra* note 97.

100. Mike Allen, *Bush Pledges More Corporate Fraud Arrests*, WASH. POST, July 30, 2002, at A10.

### A. *Substantive Criminal Laws and Enforcement*

Sarbanes-Oxley did not create radically new substantive offenses or realize genuine change in existing legal standards. Thus, one of the more interesting points about Sarbanes-Oxley is what Congress did *not* do.

The standards embodied in the federal fraud statutes were not disturbed; their broad proscription against devising a scheme to defraud already captured a wide range of fraudulent conduct, making it unnecessary to define a new type of fraud. The new securities fraud provision also does not add new substantive law; it is best viewed as codifying the practice endorsed by federal courts that treats securities fraud as a variant of mail or wire fraud offenses. Similarly, the new obstruction provisions refine existing statutes that have been used successfully by prosecutors, as evidenced by the convictions of David Duncan and Arthur Andersen.<sup>101</sup> The new obligations that relate to certification and retaliation against whistleblowers do not address underlying criminal behavior, but deal instead with its aftermath. Thus, Sarbanes-Oxley does not fundamentally change the substantive criminal standards that govern corporate insiders.

Having said that, it would be unwise to underestimate the significance of the criminal provisions. Sarbanes-Oxley strengthens the enforcement power of Justice Department prosecutors and SEC regulators, and thereby increases the exposure of corporate managers and directors to criminal sanctions. To the extent that the new crimes utilize the lower culpability element of knowing conduct rather than willful conduct, criminality will be easier to establish at trial.<sup>102</sup> Similarly, the executive certification requirement will make it easier to establish fraudulent conduct if its effect is to eliminate the defenses of lack of knowledge or good faith. Requiring officer certification and encouraging whistleblowers, along with other provisions,<sup>103</sup> should result in an increased flow of information to investigating agencies. Nevertheless, although buttressing enforcement efforts is an important initiative, the major function of the criminal law

101. See *supra* notes 3 & 72 and accompanying text.

102. Compare 18 U.S.C. § 1348 (requiring the culpability element of “knowingly” for the new securities fraud provision) with 15 U.S.C. §§ 18j(b) & 78ff (requiring the element of “willfully”).

103. See Sarbanes-Oxley Act of 2002 §§ 305, 15 U.S.C. 77t & 78u (2003); § 306, 29 U.S.C. 1021 & 1132 (2003); § 307. Section 307 obliges attorneys to disclose suspected wrongdoing. See Sarbanes-Oxley Act of 2002 § 307; see also Leslie Griffin, *Whistleblowing in the Corporate Context*, in BALA DHARAN & NANCY RAPOPORT, ENRON: CORPORATE FIASCOS AND LEGAL IMPLICATIONS (forthcoming 2003) (manuscript at 36, on file with author) (explaining attorney’s obligations under Sarbanes-Oxley and SEC rules). Title III (Corporate Responsibility) and Title IV (Enhanced Financial Disclosure) of the Act generally impose more obligations on firms and officers and give the SEC increased administrative authority. See Sarbanes-Oxley Act of 2002 tits. III & IV.

under Sarbanes-Oxley is to deter future crime through the threat of severe punishment.

### B. *The Penalty Provisions*

The overwhelming characteristic of Sarbanes-Oxley's new criminal provisions is the severity of its prison terms.<sup>104</sup> For the individuals involved, the certification offense carries a maximum penalty of twenty years<sup>105</sup> and the whistleblower statute has a ten year penalty.<sup>106</sup> Similarly, the new obstruction provisions carry ten and twenty year terms,<sup>107</sup> an increase of 200% in the offense for which Arthur Andersen was convicted. The penalties for mail and wire fraud were increased by 400%.<sup>108</sup> The maximum prison term for insider trading was increased from ten to twenty-five years, a 250% increase.<sup>109</sup> Conspiracy to commit such fraud carries twenty and twenty-five year penalties—an increase of at least 400%.<sup>110</sup> In cases of fraud involving pensions, penalties were increased 1000%, the maximum term of imprisonment rising from one year to ten years.<sup>111</sup> These punishment schemes are comparable to such heinous crimes as attempted murder, which carries a maximum of twenty years in prison; torture, which carries a maximum punishment of twenty years, and sexual abuse of a minor, which carries a maximum punishment of fifteen years.<sup>112</sup>

104. The approach contrasts markedly with amendments to the mail and wire fraud statutes that followed the savings and loan scandals of the 1980s, which increased penalties only for frauds that involved financial institutions. *See* 18 U.S.C. § 1341 (2003) (providing maximum of thirty years in prison and/or fines of up to \$1,000,000 for frauds involving a financial institution).

105. *See* Sarbanes-Oxley Act of 2002 § 906(c)(2), 18 U.S.C. § 1350 (2003).

106. *See* Sarbanes-Oxley Act of 2002 § 1107, 18 U.S.C. § 1513 (2003).

107. *See* Sarbanes-Oxley Act of 2002 § 802, 18 U.S.C. § 1519 (2003).

108. One report sheds light on the fourfold increase in maximum prison terms for mail and wire fraud. *See* Joseph F. Savage, Jr. & Stephanie R. Pratt, *Sarbanes-Oxley: New Ways to Solve Old Crimes*, 9 BUS. CRIMES BULL. 1 (2002). In April 2002, the House refused to increase prison sentences for mail and wire fraud. *Id.* By July, as the scandal and public outrage peaked, the White House successfully urged the Senate to double the maximum sentence to ten years. *Id.* The House, not to be outdone, then doubled that penalty, resulting in the maximum twenty year prison term. *Id.*

109. *See* Sarbanes-Oxley Act of 2002 § 807, 18 U.S.C. § 1348 (2003).

110. *See* Sarbanes-Oxley Act of 2002 § 902, 18 U.S.C. § 1349 (2003).

111. *See* Sarbanes-Oxley Act of 2002 § 904, 29 U.S.C. § 1131 (2003) (Employee Retirement Income Security Act). Criminal fines are increased from \$5,000 to \$100,000 and in the case of organizations, from \$100,000 to \$500,000. *Id.*

112. *See* 18 U.S.C. § 1113 (2003) (attempted murder, maximum of twenty years in prison); *id.* § 2340A (torture, twenty years); *id.* § 2243 (sexual abuse of a minor, fifteen years); *id.* § 111 (2003) (assault with a deadly weapon, twenty years); *id.* § 1112 (2003) (voluntary manslaughter, ten years).

As Ira Lee Sorkin, former federal prosecutor and director of the New York office of the SEC put it: "If a CEO commits a willful fraud, he can get 25 years. If he commits manslaughter, he's going to get 15." *See* Alex Berenson, *A U.S. Push on Accounting Fraud*, N.Y. TIMES, Apr. 9, 2003,

The extraordinarily severe penalties of Sarbanes-Oxley are a telling indication of the depth of public outrage and the seriousness with which the community regards fraud and other corporate misconduct. But how likely is it that more severe penalties will deter similar conduct in the future? Raising prison terms by 400% is unlikely to result in a 400% increase in deterrence; at best, it will result in some marginal degree of deterrence.<sup>113</sup> Moreover, raising prison terms may have no effect at all. As a former SEC official remarked, “[i]f they’re willing to risk five years, they’re going to risk [ten] years.”<sup>114</sup>

The criminal charges brought thus far against Enron executives demonstrate that there was no scarcity of criminal laws “on the books.” The federal fraud statutes are universally recognized as flexible tools that offer inclusive and comprehensive application. Penalties for fraud and obstruction, while not as draconian as sanctions under Sarbanes-Oxley, were already significant, especially when coupled with money laundering and RICO charges. Finally, the Sentencing Guidelines ensure a certain term of imprisonment.<sup>115</sup>

at C1.

113. The magnitude of effect is measured not only by time in jail, but also by other factors such as age. Consider a thirty-year-old felon who is expected to live to age eighty. With a five year sentence, the thirty-year-old will have forty-five free years of life. With a twenty year sentence, our felon can expect thirty free years, or two-thirds as much. In contrast, a fifty-year-old serving a five year sentence would have twenty-five free years, while a twenty year sentence would allow only ten free years. I am grateful to Roger Sherman, Professor of Economics, University of Houston, who provided this example. See generally A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. LEGAL STUD. 1 (1999) (explaining that cost of imprisonment to the offender declines over time).

114. Marcia Coyle, *Tough New Laws—Substance or Show?*, NAT’LL.J., July 22, 2002, at A1; see also Floyd Norris, *How Pitt Could Make Fraud Less Tempting*, N.Y. TIMES, July 19, 2002, at C1 (writing that “the possibility of long prison terms won’t end corporate fraud any more than it has halted the sale of heroin”).

These common sense notions are corroborated by research. See Erling Eide, *Economics of Criminal Behavior*, in V ENCYCLOPEDIA OF LAW AND ECONOMICS 345 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) [hereinafter V ENCYCLOPEDIA] (presenting various explanations of criminal behavior).

115. See *supra* text accompanying notes 25-34 (discussing Guidelines). The Sentencing Commission has issued temporary guidelines and called for comments before permanently adopting them in November 2003. See Press Release, U.S. Sentencing Commission, Sentencing Commission Stiffens Penalties for White Collar Criminals (Jan. 8, 2003), available at <http://www.ussc.gov/PRESS/rel010803.htm>.

To avoid the unintended result of skewing penalties for those frauds that do not result in widespread harm, the temporary guidelines resist an overall increase in penalties for fraud. See Eric Lichtblau, *Panel Clears Harsher Terms in Corporate Crime Cases*, N.Y. TIMES, Jan. 9, 2003, at C1 (noting that the measures raise penalties for frauds involving great sums of money).

This approach has been criticized by the Justice Department, which is aggressively lobbying for a more comprehensive overall increase in the penalty scheme for fraud. See Eric Lichtblau, *Bush Officials Vowing to Seek Tough Penalties in Wall St. Cases*, N.Y. TIMES, Dec. 19, 2002, at C1.

Yet longstanding federal criminal laws, substantial penalties, and increased certainty of punishment did not deter serious business misconduct at an astonishing number of corporations. Wrongdoers were not deterred by the possibility of contact with the criminal justice system's enforcement agents and mechanisms—judges, prosecutors, police officers, courtrooms, fingerprinting, perp walks, and bail hearings. Nor were they deterred by the stigma and societal condemnation that attaches to a felony conviction or even to an indictment.<sup>116</sup> Instead, they forfeited their reputations and their standing in the local and national business community. This evidence suggests that penal sanctions alone will not prevent future Enrons. With these considerations in place, the following discussion surveys the role of criminal law in encouraging law-abiding behavior and applies those models of law-abiding behavior to the corporate setting.

### III. USING CRIMINAL LAW TO ENCOURAGE LAW-ABIDING BUSINESS CONDUCT

Criminal law is thought to encourage law-abiding behavior in two ways: people either comply with the law after a conscious evaluation of the risks of disobeying it or they comply out of an unconscious instinct to obey the law. The two models are counterposed as external or internal control mechanisms, as instrumental or normative, and based on either self-interest or moral values. In the case of Enron, neither conscious calculation nor unconscious instinct appears to have operated to prevent harmful and immoral conduct.

#### A. *A Conscious Choice to Obey the Law*

The rational choice theory of law-abiding behavior suggests that people comply with the law because they decide, after a calculation of the likely costs and benefits of the crime, to forego the criminal conduct.<sup>117</sup> This

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116. As a colleague wryly remarked on the day the Houston Chronicle's front page featured a picture of Andrew Fastow in handcuffs, "How much would it be worth to keep your son from seeing that?"

Reputations are not always destroyed by felony convictions. See John Markoff, *Poindexter's Still a Technocrat, Still a Lightning Rod*, N.Y. TIMES, Jan. 20, 2003, at C1 (reporting that Poindexter, convicted on five felony counts that were overturned on procedural grounds, is currently heading the Pentagon's Total Information Awareness project).

117. This utilitarian theory rests on the work of Jeremy Bentham and is associated with law and economics scholars. See generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (updating Jeremy Bentham's utilitarian model of criminal law); Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1 (explaining how criminal law promotes social norms of individual behavior by shaping the preferences of criminals and the general population); Richard

calculation of risk includes the likelihood of being caught and the severity of punishment. To achieve an optimal level of deterrence, the community could increase enforcement efforts, thus increasing the likelihood of detection. Or theoretically, the community could achieve the same level of prevention by increasing the penalties for those who are caught and convicted.<sup>118</sup> Although it may be less expensive to choose severe penalties over enforcement, this strategy is less than fair because it intends that only some offenders will be punished. The severe penalties of Sarbanes-Oxley's criminal provisions appear to reflect the core proposition that increasing the severity of the penalty is an efficient and effective way to deter future crime.

The role played by the criminal law in this model is coercive: law-abiding behavior is achieved through threats of punishment and disgrace. Research supports the suggestion that behavior may be shaped to some degree by estimates of the likelihood and severity of punishment.<sup>119</sup> Other studies suggest, however, that this calculation has only a minor influence and that law-abiding behavior is only weakly correlated to the risk of punishment.<sup>120</sup> The following discussion reviews refinements to the rational choice theory and certain characteristics of white collar crime, both of which reveal that increasing the severity of criminal penalties may not deter business misconduct.

### 1. A More Complete Rational Choice Model

The rational choice theory of law-abiding behavior has some resonance in the area of business crime.<sup>121</sup> White collar crimes typically require

A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193 (1985) (suggesting that distinctive substantive doctrines of criminal law promote economic efficiency); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232 (1985) (presenting theoretical model that indicates that the purpose of nonmonetary sanctions is deterrence and analyzing their efficient use).

118. See A. Mitchell Polinsky & Steven Shavell, *Public Enforcement of Law*, in V ENCYCLOPEDIA, *supra* note 114, at 307.

119. See, e.g., Michael K. Block & Robert C. Lind, *An Economic Analysis of Crimes Punishable by Imprisonment*, 4 J. LEGAL STUD. 479 (1975).

120. See Tom R. Tyler & John M. Darley, *Building a Law-Abiding Society: Taking Public Views About Morality and the Legitimacy of Legal Authorities into Account When Formulating Substantive Law*, 28 HOFSTRA L. REV. 707, 712-13 (2000) (summarizing research results).

121. See Sally S. Simpson & Nicole Leeper Piquero, *Low Self-Control, Organizational Theory, and Corporate Crime*, 36 LAW & SOC'Y REV. 509, 539-44 (2002) (providing an extensive bibliography of studies applying the theory to white collar and corporate crime).

For other articles that focus on punishment of white collar criminals, see generally Dan M. Kahan & Eric A. Posner, *Shaming White-Collar Criminals: A Proposal for Reform of the Federal Sentencing Guidelines*, 42 J.L. & ECON. 365 (1999); John R. Lott, Jr., *Do We Punish High Income Criminals Too Heavily?*, 30 ECON. INQUIRY 583 (1992); Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409 (1980); Joel Waldfogel, *Are Fines and Prison*

advance planning, which provides an opportunity for reflection and an assessment of the risk of detection and punishment.<sup>122</sup> Yet the individuals at Enron apparently never made that calculation or, if they did, grossly underestimated the risk that their business dealings implicated criminal laws and punishment. Behavioral economists and psychologists offer insights that explain such behavior and that identify limitations of the rational choice theory of deterrence.<sup>123</sup>

Individuals differ in their tendencies to be optimistic and confident in their ability to control future events. A few are so optimistic and confident that their ability to assess reality becomes impaired and amounts to a judgment bias.<sup>124</sup> Such individuals also may operate from an inflated sense of self-esteem that assigns success to skill and failure to bad luck.<sup>125</sup> Biased judgment, over-confidence, and an inflated sense of self-esteem interfere with the capacity to perceive risk. Yet the rational choice theory of motivation for law-abiding behavior depends upon the actor's realization that planned conduct might result in punishment. Whether characterized as self-deception, hubris, or biased judgment, some individuals may not recognize that their behavior is approaching, or even crossing, the line that separates lawful from unlawful conduct. Thus, they either do not calculate the risks of their behavior or, if they do balance costs and benefits, they may not assess the risk accurately.

Overconfidence, optimism, and resulting misjudgments also may postpone the timing of a rational calculation until it is too late. Market

*Terms Used Efficiently? Evidence on Federal Fraud Offenders*, 38 J.L. & ECON. 107 (1995).

122. See Brown, *supra* note 23, at 1325 (noting that deterrence theory seems appropriate in the context of corporate wrongdoing); Lynch, *supra* note 30, at 45 (noting the probability that rational calculation is more common in white collar context than in others).

123. See, e.g., JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982) (presenting essays by economists and psychologists on how people make decisions); Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999); Craig R. Fox & Amos Tversky, *Ambiguity Aversion and Comparative Ignorance*, 110 Q. J. ECON. 585 (1995); see also Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1500-02 (1998) (providing summary of recent scholarship in the field). Daniel Kahneman received a Nobel Prize in economics in 2002 for his work in the emerging field of behavioral economics.

124. See generally Donald C. Langevoort, *The Organizational Psychology of Hyper-Competitions: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002) [hereinafter *Organizational Psychology*] (applying psychological research to competitive firms); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) (suggesting that some executives may be more confident about their ability to control future events than an objective evaluation of the situation calls for).

125. See Langevoort, *Organizational Psychology*, *supra* note 124, at 969-71; Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 19-22 (2002).

situations change constantly, and the environment that presented a modest risk yesterday may turn to catastrophe today. By the time an executive understands the full implications of risky or aggressive dealings, the situation is precarious.<sup>126</sup> Unless the deception is continued, the firm will fail to meet investor and market expectations. The alternate course of action, disclosure, brings certain disgrace. In an excess of confidence, the executive embarks on a third option, to continue in the same course of conduct.<sup>127</sup>

Biased judgment does not justify or excuse criminal conduct, but it may explain why the deterrence model of criminal law does not always prevent criminal behavior. In the case of Enron, observers note that optimism, self-confidence, and risk-taking were hallmarks of the corporate culture and were rewarded.<sup>128</sup> The point for our purposes is that realization, and thus a calculation, of risk can be totally absent or come well after harmful conduct begins. When realization comes, the overconfident actor may rationally decide to continue the deception in the hope that the crisis will pass.

## 2. An Impediment from White Collar Crime

The second impediment that stands in the way of the operation of the rational choice model lies in the nature of white collar crime. Compared to other forms of criminal activity, white collar crime is famously written in shades of gray.<sup>129</sup> In this realm, conduct that is immoral or harmful is not

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126. See Ribstein, *supra* note 125, at 21 (suggesting that hyper-motivated and super-optimistic insiders could persuade themselves that any setbacks were temporary and that cover-ups needed only to work for a short time).

127. See *id.* at 22-23 (suggesting also that views about the accuracy of stock prices play a role in a decision to “ride-out” a stock price that is considered inaccurately low).

128. See *infra* Part III.C.

129. Cf. As Chief Justice Burger commented on antitrust law: “[T]he behavior proscribed by the [Sherman] Act is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct.” *United States v. U.S. Gypsum Co.*, 438 U.S. 422, 440-41 (1978).

In the context of bribery, see Daniel H. Lowenstein, *Political Bribery and the Intermediate Theory of Politics*, 32 UCLA L. REV. 784 (1985) (noting that corruption blurs into accepted practice). For a historical perspective, see JOHN T. NOONAN, JR., *BRIBES* (1984). See also *United States v. Sawyer*, 85 F.3d 713, 741-42 (1st Cir. 1996) (stating in fraud case involving bribery that the line between “unattractive and actually criminal conduct is blurred”). In the context of federal conspiracy law, see the classic treatment by Abraham S. Goldstein, *Conspiracy to Defraud the United States*, 68 YALE L.J. 405 (1959).



always criminal fraud,<sup>130</sup> while conduct that is not obviously immoral or harmful may be criminal fraud.<sup>131</sup>

One of the chief distinctions between white collar crime and other crimes is that often neither the accused nor the prosecutor knows whether a criminal act has occurred, even after conduct has been identified.<sup>132</sup> Laws are broadly written in nonspecific, general terms in order to capture a broad range of conduct. One result is that such laws fail to provide notice that certain conduct is criminal. In the context of fraud, ambiguous and vague statutory prohibitions can reach such proportions as to implicate the constitutional requirement of fair notice.<sup>133</sup> What we deal with here is the pragmatic effect of vague prohibitions: if individuals do not realize that their conduct is criminal or even borders on it, they will not engage in a rational calculation.

These observations are not offered to justify or excuse criminal conduct. It has long been established that the community may subject those who work within certain industries to proscriptions whose moral content is not written in black ink.<sup>134</sup> Nevertheless, the ambiguous nature of many

130. For instance, executives with sensitive corporate information who sold stock according to pre-arranged trading plans probably do not violate insider trading laws, even when they possess information about the falling value of the company. See 17 C.F.R. 240.10b5-1 (2003); see also *United States v. Cochran*, 109 F.3d 660, 662 (10th Cir. 1997) (stating that in fraud cases “greed and criminal liability are not necessarily synonymous”).

131. See *Cochran*, 109 F.3d at 662. Consider the extensive literature that seeks to explain why insider trading is a crime. See, e.g., LEO KATZ, *ILL-GOTTEN GAINS: EVASION, BLACKMAIL, FRAUD, AND KINDRED PUZZLES OF THE LAW* (1996); Kim Lane Schepple, “*It’s Just Not Right*”: *The Ethics of Insider Trading*, 56 *LAW & CONTEMP. PROBS.* 123 (1993).

132. See Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 *MINN. L. REV.* 1095, 1147 (1991) (providing examples). Immoral and harmful conduct, even when all facts are established, may not constitute mail or wire fraud. See, e.g., *United States v. Cleveland*, 531 U.S. 12, 16 (2000); *United States v. Handakas*, 286 F.3d 92, 96 (2d Cir. 2002); *United States v. Brown*, 79 F.3d 1550, 1558 (11th Cir. 1996).

133. See Geraldine Szott Moohr, *Mail Fraud and the Intangible Rights Doctrine: Someone to Watch Over Us*, 31 *HARV. J. ON LEGIS.* 153, 190-97 (1994) (discussing legality, notice, and vagueness in context of honest services fraud). Recent opinions have reconsidered the issue of vagueness in mail and wire fraud. See *Handakas*, 286 F.3d at 96 (stating that if it were the first panel to address the issue, it would find honest services mail fraud (18 U.S.C. § 1346) unconstitutionally facially vague and finding its application in present case was void for vagueness); *United States v. Rybicki*, 287 F.3d 257, 264 (2d Cir. 2002) (agreeing fully with the *Handakas* panel’s observations concerning the vagueness of the term honest services, but finding statute was not unconstitutionally vague as applied) (currently being reconsidered en banc); *United States v. Brumley*, 116 F.3d 728, 733 (5th Cir. 1997) (conceding that some defendants “on the outer reaches of the [wire fraud] statute” may be without notice); *United States v. Czubinski*, 106 F.3d 1069, 1077 (1st Cir. 1997) (noting defendant in wire fraud case was without notice that his actions could lead to criminal sanctions).

134. See *United States v. Park*, 421 U.S. 658, 671 (1975) (affirming conviction of chief executive officer of supermarket chain for the strict liability offense of food adulteration); *United States v. Dotterweich*, 320 U.S. 277, 280-82 (1943).

white collar offenses may explain the failure of criminal penalties to deter recent business misconduct. Unless individuals recognize that proposed conduct triggers criminal sanctions, they will not pause to evaluate the risk of detection and punishment. Even if they do pause to calculate such risks, judgment biases may impair that evaluation.

Another limitation of the rational choice model lies in the difficulty of enforcing white collar crimes. In addition to the ambiguity of conduct that can confuse prosecutors as well as the accused,<sup>135</sup> it simply is difficult to ferret out fraud. Fraud occurs in secret, often by those who are able to control and conceal information that might lead to detection. The inherent difficulty of identifying fraudulent conduct affects the rational calculation made by corporate actors, who may accurately assess the chances of detection as slim. Yet if criminal penalties are increased enough to account for a low probability of detection, the penalties are likely to reach unacceptable levels.<sup>136</sup> The point here is not to debate the fairness issues inherent in increasing punishment as opposed to enforcement efforts, but merely to note another impediment to the rational choice model. Taken together, the new behavioral theories and the problems regarding enforcement of white collar crimes suggest greater attention be paid to the second theory of law-abiding behavior.

### B. *An Unconscious Instinct to Obey the Law*

The second theory that explains how criminal law supports law-abiding behavior suggests that people obey the law without conscious reflection, because of an instinct to do the right thing.<sup>137</sup> The role of the criminal law in this model is to embody and communicate the social norm of the community that defines “the right thing.” This model posits that law-

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135. See, e.g., *United States v. Walters*, 997 F.2d 1219, 1226-27 (7th Cir. 1993) (stating that government had indicted the wrong party to the fraud).

136. See Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. U. L. REV. 453, 463 (1997) (calculating that, when only 1.6 % of burglars go to prison, a 250 year sentence is necessary to deter burglary and to keep the quantum of punishment around that of a four year sentence).

137. See generally PAUL H. ROBINSON & JOHN M. DARLEY, *JUSTICE, LIABILITY & BLAME* (1995) (investigating ordinary peoples’ notions about criminal liability and punishment); TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990) (presenting research that explores reasons for law-abiding behavior); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349 (1997) (explaining phenomena of social influence and social meaning and identifying their implications for criminal law); Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338 (1997) (advocating use of norms, defined as informal social regularities, in economic analysis of the law); Robinson & Darley, *supra* note 136 (examining role of criminal law in creating and maintaining community norms); Tyler & Darley, *supra* note 120 (applying psychological models of social values to creation of a law-abiding society).

abiding behavior results when individuals have internalized the prevailing social norms and are, in effect, self-regulators.<sup>138</sup> In contrast to the rational choice theory, which relies on external social control, this model is based on an internal control system.<sup>139</sup>

Individuals gradually develop personal codes of conduct at a young age through interactions with other individuals in their family, school, and social circles.<sup>140</sup> A person has internalized a social norm when it has become part of the internal motivation system that guides individual behavior even in the absence of external authority.<sup>141</sup> Individuals then unconsciously regulate their behavior so that it is consistent with the internal principles and values by which they define themselves.<sup>142</sup>

In this model, criminal laws and their enforcement communicate societal standards, and violations trigger universal condemnation. Laws thus have an educative function that influences the development of norms.<sup>143</sup>

### 1. The Limitations of the Social Norm Model

The social norm model, like the rational choice model, has inherent limitations that impede its effectiveness in encouraging law-abiding

138. A related theory suggests that people obey the law because they fear the disapproval of their social group. See Robinson & Darley, *supra* note 136, at 468 (noting that social scientists categorize compliance as produced by social influence or internalized morals standards). This theory seems to be inherent in both the rational choice and internalized value models. As to rational choice, individuals would consider disgrace and stigmatization as a cost of criminal conduct. As to the self-regulated, internalized norm theory, individuals have internalized the external social control of the community.

139. See Tyler & Darley, *supra* note 120, at 714 (stating that behavior is determined by a set of internal values about the morality of behavior).

140. See *id.* at 718 (noting that children are trained by a powerful socialization process into internalizing the beliefs represented in the culture to which they belong).

141. *Id.* at 715 (quoting Martin L. Hoffman, *Moral Internalization: Current Theory and Research*, in 10 *ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY* 85, 85-86 (Leonard Berkowitz ed. 1977)).

142. See *id.* at 714 (contrasting internalized social values with the contemporaneous, self-interested calculations of the rational choice model). It has been suggested that external directives, such as legal prohibitions through criminal law, are not as effective in guiding conduct as internalized moral codes. *Id.* at 717.

143. See Johannes Andenaes, *General Prevention—Illusion or Reality?*, 43 *J. CRIM. L. CRIMINOLOGY & POLICE SCI.* 176, 179-80 (1952) (noting secondary effects of punishment include forming and strengthening the public's moral code); Harry V. Ball & Lawrence M. Friedman, *The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View*, 17 *STAN. L. REV.* 197, 220 (1965) (claiming that "social sanctions can be used to change beliefs, attitudes, and personal values and goals"); John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 *B.U. L. REV.* 193, 200 (1991) ("[T]he public learns what is blameworthy in large part from what is punished.").

behavior. The commonly-held notion that it is difficult to instill moral values and ethical codes solely through law<sup>144</sup> is supported by studies indicating that criminal law does not directly influence individual behavior.<sup>145</sup> The effect of criminal law on individuals seems to be indirect and attenuated; at best it influences and strengthens the norms of the social group, which individuals then internalize.<sup>146</sup> In the end, criminal laws may have a greater impact on reinforcing behavior of the good citizen than changing behavior of the bad citizen.<sup>147</sup>

The criminal law is not, however, without influence on people. Criminal laws may indirectly influence individuals by confirming and maintaining existing values.<sup>148</sup> Further, values are not frozen in childhood experience; encounters with the law in adulthood probably have some influence, albeit reduced, on the formation of individual norms.<sup>149</sup> This notion emphasizes the significance of even-handed enforcement and interest-free, transparent legislation. If the system is viewed as morally credible and legitimate, individuals tend to obey the law in marginal situations when conduct is ambiguous or of borderline criminality.<sup>150</sup> If people respect the criminal law system, they are likely to defer to the authority of the law even in the absence of a strong internalized norm. But of course, criminal laws, or for that matter laws in general, are not the only influences on behavior.

## 2. The Influence of Subgroups

The public outrage that followed disclosure of Enron's true financial condition demonstrates general community views about the conduct of

144. See Robert Prentice, *An Ethics Lesson for Business Schools*, N.Y. TIMES, Aug. 20, 2002, at A19 (stating that if students did not get a sense of right and wrong from their families or their faith, it is unlikely a business school professor can instill it); Jeffrey L. Seglin, *Will More Rules Yield Better Corporate Behavior?*, N.Y. TIMES, Nov. 17, 2002, at BU4 (“[y]ou don’t legislate morality,” quoting David A. Nadler, chairman of a New York consulting firm).

145. Robinson & Darley, *supra* note 136, at 470-71 (citing research by Harold Grasmick & Donald Green, Harold Grasmick & Robert Bursik, Raymond Paternoster & Lee Ann Iovanni, Robert Meir & Weldon Johnson, and Tom Tyler).

146. See *id.* at 471-77 (explaining influence of criminal law on social forces that produce compliance).

147. See Lynch, *supra* note 30, at 46-47 (noting the need for occasional reminders that society-at-large continues to abide by shared norms, which provide respect for the good and shame for the bad).

148. See Michael C. Harper, *Comment on The Tort/Crime Distinction: A Generation Later*, 76 B.U. L. REV. 23, 25 (1996) (stating that the “more significant” educative force of criminal law “operates not to change morals or values, but rather to confirm them in such a way as to insure that they become more deeply internalized or inculcated in the public psyche”).

149. Tyler & Darley, *supra* note 120, at 717-18 (noting people also are influenced by their adult experiences).

150. See Robinson & Darley, *supra* note 136, at 468.

Enron's officers. The alleged conduct at Enron—insider trading, misleading investors, misstating financial results—is viewed by most as immoral, harmful, and blameworthy. Yet the conduct of the Enron actors suggests that they had not internalized this community norm against self-dealing and manipulative behavior. Even when a person understands that others would condemn certain conduct, or knows that certain behavior is prohibited, he or she may not have internalized the underlying value in a way that changes behavior.<sup>151</sup> Then those individuals will not instinctively constrain themselves and may even adopt values that are contrary to those of the greater community.

Although we speak of the “community” to mean the entire citizenry, that “community” is actually made up of various groups.<sup>152</sup> Opinions about wrongdoing can vary with positions of individuals in the social structure of the community. Thus, general social norms may not be shared by specific subgroups, and corporate cultures may form a localized culture that is distinct from the mainstream. Individuals, whether executives or ordinary employees, may be influenced by a specific corporate culture.

Companies may develop distinctive characteristics that set them apart from their counterparts.<sup>153</sup> Indeed, a specific business culture may embrace values that are inimical to those of the greater community and may even encourage its members to break the law.<sup>154</sup> Loyal individuals may also be motivated by a conviction that their actions are good for the company. In that case, they are even less likely to consider those acts as dangerously close to unlawful.<sup>155</sup> Moreover, when the subgroup is strong and cohesive, efforts to stigmatize certain conduct by applying criminal law may even be counterproductive.<sup>156</sup>

151. See Coffee, *supra* note 143, at 232 (noting the distinction between knowing what the public morality is and internalizing that morality).

152. See Ball & Friedman, *supra* note 143, at 207 (commenting on various conceptions of the “public” and pointing out the infirmity of relying on notions of “prevailing morality”).

153. See Bucy, *supra* note 132, at 1123-25 (providing research of organizational theorists to this effect).

154. See *id.* at 1127-50 (providing factors that define corporate ethos). For an example from current events, see Floyd Norris & Diana B. Henriques, *3 Admit Guilt in Falsifying CUC's Books*, N.Y. TIMES, June 15, 2000, at C1 (explaining that fraud at Cendant was a result of “a culture that had been developing over many years” that was ingrained in employees by superiors).

The demand of shareholders for high profits may also encourage aggressive dealings that border on negligent or criminal conduct. The effect of American companies' emphasis on maximizing shareholder profits also poses other dilemmas. See LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 4-11 (2001).

155. See Ribstein, *supra* note 125, at 21 (noting that actors who are convinced they “are doing the right thing” in maintaining their company's value may not be subject to moral constraints).

156. See Kahan, *supra* note 137, at 373-77 (recounting experience of authorities with juvenile gangs); Robinson & Darley, *supra* note 137, at 481 (stating that the use of stigmatization in absence of consensus about morality of the conduct is likely to be ineffective because “it offends rather than

### C. *The Enron Experience*

Reports indicate that, like many other corporations, Enron had developed a localized subculture.<sup>157</sup> The Enron culture is eerily reminiscent of Tom Wolfe's fictionalized account, in which securities traders, or "Masters of the Universe," produced amazing profits in a single morning.<sup>158</sup> Enron "masters" seem to have produced profits out of fictional trades in sometimes nonexistent products.<sup>159</sup> In order to reach its profit goals, Enron management encouraged aggressive competitive behavior where success was measured by contributions to corporate wealth. Reports characterize Enron as a corporate culture that disdained regulation and pressured middle managers to produce profit.<sup>160</sup> As in fiction, Enron executives were rewarded extremely well for this work.

The extraordinary sums paid to executives in salary and stock options are now generally viewed as misplaced incentives that skewed the loyalty of executives.<sup>161</sup> Instead of aligning their interest with investors, stock options seem to have encouraged aggressive tactics that enhanced the company's stock price in order to increase the personal wealth of executives. Although the debate over the effect of stock options is unsettled,<sup>162</sup> at a minimum such extraordinary rewards communicate a not-so-subtle message that a result favorable to the company justifies any method used to achieve it.

The Enron culture also was marked by the use of a Darwinian market discipline to evaluate employees. Enron's policy was to replace each year all employees who were ranked in the lowest fifteen percent of their

educates the moral code of the community").

157. See ROBERT BRYCE, *PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON* 12 (2002) (stating that the reason Enron failed "was the culture, stupid"); PETER C. FUSARO & ROSS M. MILLER, *WHAT WENT WRONG AT ENRON* 43 (2002) (noting Enron was an "extremely dysfunctional organization"); MIMI SWARTZ WITH SHERRON WATKINS, *POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON* 56 (2003).

A similar story is told about Arthur Andersen. See generally BARBARA LEY TOFFLER & JENNIFER REINGOLD, *FINAL ACCOUNTING: AMBITION, GREED AND THE FALL OF ARTHUR ANDERSEN* (2003).

158. TOM WOLFE, *THE BONFIRE OF THE VANITIES* (1987).

159. One deal involving video on demand and the Blockbuster video chain has been described as "absurd," "a sham from its inception," and, most damning: "Not only did the emperor have no clothes, there was no emperor." See Floyd Norris, *Maybe the Most Dubious of the Deals*, N.Y. TIMES, Mar. 13, 2003, at C6 (quoting sources).

160. See BRYCE, *supra* note 157, at 12; FUSARO & MILLER, *supra* note 157, at 43.

161. See generally JOSEPH BLASE ET AL., *IN THE COMPANY OF OWNERS: THE TRUTH ABOUT STOCK OPTIONS (AND WHY EVERY EMPLOYEE SHOULD HAVE THEM)* (2003).

162. See Gretchen Morgenson, *When Options Rise to Top, Guess Who Pays*, N.Y. TIMES, Nov. 10, 2002, § 3, at 1 (reporting a recent study that disproves two rationales for options).

group.<sup>163</sup> This system contributed to an environment in which employees were afraid to express their opinions or to question unethical and potentially illegal business practices.<sup>164</sup> These disincentives led to acquiescence and compliance as junior executives avoided encounters that could negatively effect their semi-annual evaluation and may have discouraged employees from reporting misgivings about borderline deals. Enron's end shows that rewarding aggressive tactics invites fraud in; squelching employees' misgivings shuts the door behind it.

The Enron culture probably influenced the behavior of its executives and employees. One commentator has charged the Enron culture with creating a "Machiavellian, narcissistic, prevaricating, pathologically optimistic, free from self-doubt and moral distractions," and risk-taking business executive.<sup>165</sup> If the individuals who engaged in wrongdoing were influenced by this socially-destructive corporate culture, then relying only on criminal sanctions may not be effective in containing its effects. Punishing those caught up in such cultures, without changing the environment that influenced them, will not prevent other individuals from being similarly influenced. Remedying an environment that encourages law-breaking is one reason for levying criminal sanctions against the corporate entity itself.<sup>166</sup>

#### IV. A COMPREHENSIVE APPROACH TO ENCOURAGE LAWFUL BUSINESS CONDUCT

The current embrace of criminal penalties seems to rest on the proposition that the Enron experience is the product of a few "bad apples" who were not deterred by existing criminal sanctions when tempted by an opportunity to enrich themselves.<sup>167</sup> The "bad apple" assumption, however,

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163. See FUSARO & MILLER, *supra* note 157, at 51-52 (explaining Enron's "rank-and-yank" evaluation system in which the lowest fifteen percent of employees were replaced every six months); SWARTZ & WATKINS, *supra* note 157, at 59-60 (describing the review system as the star chamber combined with fraternity rush). Enron was known for hiring intelligent, ambitious, aggressive self-starters who had a capacity for hard work. See BRYCE, *supra* note 157, at 121-22; FUSARO & MILLER, *supra* note 157, at 48-50.

164. See BRYCE, *supra* note 157, at 128 (stating that the review system "perverted Enron's internal risk management systems").

165. See Ribstein, *supra* note 125, at 9.

166. Although the focus of this inquiry is on the unlawful conduct of individuals, this is not to ignore the possibility that the threat of corporate criminal sanctions can motivate businesses to shape and to monitor the conduct of its officers and executives. *But see* Michael K. Block, *Optimal Penalties, Criminal Laws, and the Control of Corporate Behavior*, 71 B.U. L. REV. 395 (1991) (arguing against the use of criminal as opposed to civil penalties for corporations).

167. See Adam Cohen, *Before WorldCom, the Funeral Industry Set the Standard for Venality*, N.Y. TIMES, Sept. 3, 2002, at A18 (recounting President Bush's argument that the executive misdeeds were ethical lapses of a few bad actors, and that the solution was criminal prosecutions).

is unsatisfactory. Rather than being confined to a few individuals, the criminal conduct at Enron appears to have involved many people in a wide range of fraudulent activity. Evidence disclosed thus far indicates that the conduct was prevalent, and indeed, may have been endemic to the firm. As is now known, the wrongdoing extended to Enron's accountants, auditors, and bankers.

Moreover, the misconduct was not confined to Enron. Although Enron stands out because of its serious and dramatic consequences, what happened there was not an isolated case. Investigators have uncovered unlawful conduct at a number of firms, including Intel, Adelphia, World Com, Sunbeam, Waste Management, Xerox, and Global Crossing.<sup>168</sup> The Enron saga has not yet completely unfolded, as investigators uncover evidence of fraud in the California energy market and in Enron's telecommunication division.<sup>169</sup>

Finally, the view of Enron as an exception wrought by bad actors ignores a rich history of fraud and misconduct in American business. The major frauds of the South Sea Bubble in the early 1700s and those that contributed to the market crash of 1929 are well-known.<sup>170</sup> Recent incarnations involve price fixing in the electrical equipment industry, fraud in the savings and loan and banking industries, and a massive insider trading episode.<sup>171</sup> More recently, criminal antitrust violations occurred in the international commodities markets and by a prestigious auction house.<sup>172</sup> The evidence of widespread misconduct at Enron and other companies and the historical record of corporate frauds indicates that a systemic failure, rather than bad apples, is at work.

168. See Stoller, *supra* note 1 (noting that fifty-four firms were under investigation in October 2002).

169. See sources cited *supra* note 11 (noting continuing prosecutorial efforts).

170. These have been characterized as inevitable results of boom to bust business cycles. Kurt Eichenwald, *After a Boom, There Will Be Scandal. Count On It*, N.Y. TIMES, Dec. 16, 2002, at C3 (quoting John C. Coffee Jr., who notes that the constant re-emergence of scandal "goes back at least 300 years . . . [i]t's just part of capitalism").

171. See generally JAMES B. STEWART, *DEN OF THIEVES* (1991) (recounting insider trading and junk bond scandals); see also Ball & Friedman, *supra* note 143, at 219 (discussing public outrage directed at trusts that led to passage of the Sherman Act and the price-fixing scandal in the electricity industry); Boss & George, *supra* note 95, at 35 (reacting to the savings and loan scandal of the 1980s).

In a similar episode, increased penalties failed to deter insider trading by Milken, Boesky, Drexel Burnham, and others. See *id.* at 42-49 (providing legislative history that chronicled legislators' surprise).

172. See generally KURT EICHENWALD, *THE INFORMANT* (2000) (chronicling the price-fixing scheme of Archer Daniels Midland); JAMES B. LIEBER, *RATS IN THE GRAIN: THE DIRTY TRICKS AND TRIALS OF ARCHER DANIELS MIDLAND* (2000) (same); Carol Vogel, *Court Accepts Sotheby's Guilty Plea in Price-Fixing*, N.Y. TIMES, Feb. 3, 2001, at C14.



The “bad apple” interpretation of events at Enron suggests that it is a simple story of purposeful criminal conduct based on greed. Although there is no doubt some truth in the greed hypothesis,<sup>173</sup> an alternate account provides a more complete explanation. The alternate theory, based on evidence from the firm's practices and research on rational behavior and social norms, suggests a more complex narrative that has implications for the role of criminal penalties in encouraging law-abiding conduct in the business world. The expression of public values through criminal law does not necessarily lead to law-abiding behavior when powerful subgroups create opposing values. Criminal law is not particularly effective against such subgroups and may not create the internalized social norms that are necessary for compliance. Nor does the threat of stigmatization or punishment always trigger the rational calculation that might deter wrongdoers. Conduct that is perilously unlawful may not be recognized or the risk of punishment may not be accurately assessed. And even when the danger is recognized, it may be too late to change behavior.

A broader, more inclusive strategy would utilize a greater range of enforcement mechanisms than that provided by criminal law. After all, criminal law exists within an enforcement structure that also includes government-administrative regulation, market incentives, and private actions.<sup>174</sup> A comprehensive strategy should include all of these tools. They provide several sources of intervention and many opportunities to signal the possibility of unlawful conduct and to maintain and strengthen the social norms that lead to law-abiding behavior.

#### A. *Market Incentives and Private Actions*

Private actors, such as gatekeepers and investors, can encourage law-abiding business conduct. The wholesale failure of every monitor of corporate conduct to identify and report wrongful or suspicious business dealings is a prominent feature of the Enron debacle.<sup>175</sup> The failure of its

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173. The self-dealing aspect of Enron's special purpose entities, which concealed the firm's true financial condition while directing windfall profits to executives, certainly speaks of greed. Yet, the greed narrative does not explain the absence of Swiss bank accounts and a flight plan. Both Fastow and Kopper had involved their families and friends in the special purpose entities. These factors speak of hubris, in addition to greed.

174. See Brown, *supra* note 23, at 1325 (noting corporate criminal law is part of an elaborate regulatory regime governing firms and commercial activity).

175. Judge Sporkin's question, following the Lincoln Savings & Loan fraud, echoes in the aftermath of Enron:

Where were these professionals . . . when these clearly improper transactions were being consummated? . . . What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one

board, bankers, accountants, and lawyers to identify misrepresentations or to inform regulatory agencies and the public was exacerbated by the failure of outside gatekeepers, such as securities analysts and credit-rating agencies, to alert investors of Enron's true financial condition. Professor Coffee has remarked on the wholesale failure of market monitors to alert investors of the true financial condition of Enron.<sup>176</sup> My reason for focusing on gatekeepers is to credit their significant function: they can encourage law-abiding behavior.

Effective gatekeepers provide a counterweight to the norms that may develop in corporate subcultures and to the judgment biases that lead to inaccurate assessments of the risks of criminal sanctions. Monitors provide an important measure of outside control, if only because they can increase the chances of "getting caught" in civil or criminal actions. Thus, they may deter those who engage in a rational calculation of risk and benefit. Market monitors may also sound a timely warning that can signal corporate actors that they are treading treacherously close to the line, leading them to make the rational calculation in time to avoid or abandon potentially harmful acts. At a minimum, early warnings by outside gatekeepers signal that the company is the subject of a scrutiny that has market implications. Finally, gatekeepers insert a countervailing pressure of community norms into the firm's local culture.

A second private enforcement mechanism is the civil lawsuit brought by investors who seek damages for negligence and civil fraud. Private suits also express community norms, and the threat of civil litigation enhances the risks of engaging in marginally-lawful conduct. Congress generally handicapped the use of private lawsuits in the 1990s, however, and reduced the incentive of gatekeepers to monitor firms aggressively.<sup>177</sup> Perhaps because of the focus on criminal penalties following Enron, there has been

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professional would not have blown the whistle to stop the overreaching that took place in this case.

Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990). Before being appointed to the federal bench in 1985, Judge Sporkin served for many years as Director of the Enforcement Division of the SEC.

The failure of gatekeepers may provide a defense for wrongdoers. To the extent that gatekeepers, lawyers, accountants, and analysts blessed the creation of Enron's special purpose entities and other deals, executives may colorably claim a lack of intent to defraud. See *supra* text accompanying notes 60-69 (discussing culpability element in criminal fraud).

176. See John C. Coffee, Jr., *Understanding Enron: "It's All About the Gatekeepers, Stupid,"* 57 BUS. LAW 1403 (2002); John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990's* 4 (2003), available at [http://ssrn.com/abstract\\_id=373581](http://ssrn.com/abstract_id=373581).

177. See Michael H. Granof & Stephen A. Zeff, *Unaccountable in Washington*, N.Y. TIMES, Jan. 23, 2000, at A19; Stephen Labaton, *Now Who, Exactly, Got Us Into This?*, N.Y. TIMES, Feb. 3, 2002, § 3, at 1; Don Van Natta, Jr., *Bipartisan Outrage But Few Mea Culpas in Capital*, N.Y. TIMES, Jan. 25, 2002, at C5.

little interest in or hope of reversing this weakening of the civil lawsuit remedy for corporate malfeasance.<sup>178</sup>

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA).<sup>179</sup> One provision of the PSLRA eliminated the practice of using securities fraud as the basis for civil RICO actions.<sup>180</sup> Plaintiffs who won such suits had been entitled to triple damages.<sup>181</sup> However, these were thought to encourage frivolous suits and coercive settlements.<sup>182</sup> In protecting businesses from coercive settlements, the PSLRA also eliminated a significant deterrent mechanism. The Supreme Court reduced the deterrent element of civil RICO actions when, in 1993, it restricted plaintiff's use of civil RICO suits against consulting, auditing, and legal firms that had advised corporations accused of fraud.<sup>183</sup>

The PSLRA also discouraged investor lawsuits that do not involve RICO. It made it more difficult to bring class action suits, limited joint and several liability, expanded safe harbors for certain company statements, and toughened pleading requirements for fraud.<sup>184</sup> The Supreme Court took similar action when, in 1994, it eliminated civil liability for aiding and

178. *The Collapse of Enron Corporation: Hearing Before the U.S. Senate Comm. On Commerce, Science & Transportation*, 106th Cong. 9 (2001) (testimony of John C. Coffee, Jr.) (noting that the PSLRA was an intensely lobbied statute that Congress would not wish to repeal or modify); Hamilton, *supra* note 98, at 72-73 (suggesting repeal or modification of the PSLRA and the SLUSA); see generally Melissa Harrison, *The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants Off the Hook?*, 65 U. CIN. L. REV. 473 (1997).

179. See Pub. L. No. 104-67, 109 Stat. 737 (1995). The controversial bill was enacted over President Clinton's veto. See Harrison, *supra* note 178, at 518.

180. Private Securities Litigation Reform Act of 1995 §§ 107, 108, 18 U.S.C. § 1964(c) (2003).

181. See 18 U.S.C. § 1964(c) (providing civil cause of action). The purpose of the triple damages was not only to compensate those injured by racketeering activity, but also to discourage such activity. See *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 487-88 (1985).

182. 141 CONG. REC. 42, H2770-H2773 (daily ed. Mar. 7, 1995) (statement of Rep. Cox) (also available at 1995 WL 91687).

183. See *Reves v. Ernst & Young*, 507 U.S. 170, 185 (1993) (holding that civil RICO's "operation and management" test to determine whether defendant participated in a pattern of racketeering activity required proof of some level of operating or managing the enterprise).

In 1991, the Court announced a uniform statute of limitations for securities cases. See *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991) (holding that limitations period for private actions was within one year of discovery but not more than three years after the transaction occurred).

To provide investors an expanded opportunity to bring suit, Sarbanes-Oxley extended the limitations period to two years after discovery of the violation. See *Sarbanes-Oxley Act of 2002* § 804, 28 U.S.C. § 1658 (2003).

184. See Linda D. Fienberg, et al., *Safer Harbors: Securities Litigation After the Reform Act of 1995*, 5 BUS. L. TODAY 24 (May/June 1996); see also, e.g., *In re K-tel Int'l., Inc.*, 300 F.3d 881, 899-900 (8th Cir. 2002) (affirming dismissal of class action for failing to allege accounting violations with requisite particularity and failure to plead facts giving rise to a strong inference of culpability).

abetting fraudulent conduct involving securities laws.<sup>185</sup> By narrowing civil lawsuits against accountants and attorneys to cases of actual participation, the Court reduced the incentive of such gatekeepers to monitor their clients closely.

Congress also restricted plaintiffs' ability to file securities fraud cases in state courts.<sup>186</sup> The Securities Litigation Uniform Standards Act (SLUSA), enacted in 1998, reduced securities fraud litigation in state courts by making federal courts the exclusive venue for class actions involving securities fraud.<sup>187</sup> The combined effect of these actions was to make it more difficult for private plaintiffs to bring allegations of securities fraud against gatekeepers.

Although the long-term effect of these initiatives on the number and nature of securities suits is subject to debate,<sup>188</sup> their immediate effect was to raise substantive standards and to heighten procedural hurdles to investor civil suits against companies and gatekeepers. Two repercussions, related to encouraging law-abiding business behavior, may be registered. First, restricting the availability of a civil remedy expresses a counterproductive community norm to corporate actors. An executive might understandably reason that if conduct is not subject to suit in tort, it is not unlawful; if the conduct is not unlawful, then it could not be criminal. Second, the restrictive legislation may enter into the risk calculation of the rational decisionmaker. If the risk of civil liability is low, then there is even less risk of criminal action. Reducing civil liability also removed an enforcement mechanism that had operated to deter wrongful conduct. On the whole, the message inherent in the restriction of civil fraud suits is inconsistent with and thus undercuts the effectiveness of parallel criminal laws.

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185. See *Cent. Bank of Denver, N. A. v. First Interstate Bank of Denver, N. A.*, 511 U.S. 164, 191 (1994).

The PSLRA restored aiding and abetting liability in SEC enforcement actions. See *Private Securities Litigation Reform Act of 1995* § 104(f), 15 U.S.C. § 78t (2003).

186. Another obstacle to private suits is the arbitration agreement that investors must sign in order to do business with broker-dealers. Investor contracts typically mandate arbitration, rather than adjudication, of securities claims. See *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

187. See 15 U.S.C. §§ 77p, 78bb(f) (2003); see also *Newby v. Enron*, 302 F.3d 295, 303 (5th Cir. 2002) (holding that defendant's attempts to avoid the SLUSA were not in themselves an abuse of the courts).

188. See Harrison, *supra* note 178, at 532-37; James A. Kassis, *The Private Securities Litigation Reform Act of 1995: A Review of its Key Provisions and an Assessment of its Effects at the Close of 2001*, 26 SETON HALL LEGIS. J. 119, 148 (2001) (presenting data and concluding that the PSLRA has not curbed meritless class action suits).

### B. Government Administrative Actions

A second type of enforcement comes from government regulatory actions.<sup>189</sup> One drawback of such actions is that they can breach the due process rights of individuals subject to civil-administrative punishment.<sup>190</sup> Notwithstanding the need to avoid that serious dilemma, administrative enforcement offers an effective way to induce law-abiding behavior.<sup>191</sup> Less costly to the public fisc than are criminal trials, government regulation can reach more offenders in a way that achieves a degree of horizontal equality between them. In addition, administrative enforcement avoids the “psychology of resentment” that accompanies harsh punishment and, instead, fosters self-regulation, voluntary compliance, and a sense of social responsibility.<sup>192</sup>

On the regulatory front, Sarbanes-Oxley addresses weaknesses in the present administrative scheme, especially those that pertain to accountants and auditors. Those weaknesses were perceived as contributing to the fraud at Enron and other firms. In creating the Public Company Accounting Oversight board, the Act strengthens the ability of government regulators to monitor and enforce administrative remedies.<sup>193</sup> It also reshapes

189. See Lynch, *supra* note 30, at 34-36 (presenting theoretical rationale for use of administrative remedies).

190. Civil sanctions that are essentially punitive raise substantial due process concerns. See Mary M. Cheh, *Constitutional Limits on Using Civil Remedies to Achieve Criminal Law Objectives: Understanding and Transcending the Criminal-Civil Law Distinction*, 42 HASTINGS L.J. 1325, 1325-26 (1991); Susan R. Klein, *Redrawing the Criminal-Civil Boundary*, 2 BUFF. CRIM. L. REV. 679, 680-81 (1999); Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 YALE L.J. 1795, 1869-71 (1992); Carol Steiker, *Punishment and Procedure: Punishment Theory and the Criminal-Civil Procedural Divide*, 85 GEO. L.J. 775, 777-78 (1997).

191. In order to buttress their effectiveness, most regulatory statutes include criminal sanctions. Securities laws are one example; another is environmental statutes that have criminal sanctions for air and water pollution. See 42 U.S.C. § 7413(c) (2003); 33 U.S.C. § 1319(c) (2003).

Imposing criminal sanctions for technical violations of regulatory statutes has been met with significant criticism. See Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 421 (1958); see also HERBERT L. PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* 273 (1968); Coffee, *supra* note 144, at 200; Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423 (1963). But see Stuart P. Green, *Why It's a Crime to Tear the Tag Off a Mattress: Overcriminalization and the Moral Content of Regulatory Offenses*, 46 EMORY L.J. 1133, 1535-37 (1997) (rejecting one critique on the ground that engaging in conduct prohibited by the sovereign has a moral dimension).

192. See Brown, *supra* note 23, at 1313 (citing IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 8, 49 (1992)).

193. Congress mandated that the SEC complete the administrative restructuring by April 26, 2003. That process has gotten off to a slow and unpromising start. The first appointment to head the accounting board, which is to formulate accounting rules, was mired in conflict when one popular candidate, John H. Biggs, was by-passed. The selected candidate, William Webster, resigned after it became public that he had chaired the audit committee of a company that had

executive incentives by limiting corporate loans. The Act encourages vigilant monitoring by limiting conflicts of interest in boards and by requiring lawyers to report evidence of securities law violations. Sarbanes-Oxley also expands the flow of information to the public by shortening the time that corporate insiders have to disclose stock trades. Thus, the Act promises to use regulatory law to control corporate misconduct.

To be effective, however, administrative agencies must have adequate budgets and personnel. Several authorities have noted the declining rate of enforcement by the SEC, which has faced increased filings and decreased capability for a decade.<sup>194</sup> Budgetary concerns have been alleviated by increased funding for SEC enforcement, \$711.7 million for the current year.<sup>195</sup> The ultimate effectiveness of Sarbanes-Oxley in encouraging lawful business conduct largely depends upon implementation and enforcement of its regulatory reforms.

### C. *A Modest Role for Criminal Law*

Depending solely upon criminal law to control corporate crime is misguided, at best. The threat of criminal penalties is not an adequate deterrent given the limitations of the rational choice model of law-abiding behavior.<sup>196</sup> Judgment biases, created by optimism and risk-taking, may impair an individual's decisions. The deterrent threat is also not effective when the risk of apprehension is slight and when it is aimed at actors who control information and who may discount the costs of incarceration.

Changing the criminal laws and increasing penalties also does not directly lead to an unconscious instinct to comply.<sup>197</sup> Although the criminal law has an important expressive function, reliance on criminal law alone is not an effective way to create internalized norms. The criminal law can only influence, not form, individual norms. In a corporate setting, contrary

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issued questionable financial statements. See Floyd Norris, *S.E.C. Picks a Fed Banker to Lead Panel*, N.Y. TIMES, Apr. 16, 2003, at C1.

194. Filings grew by 61%, from 61,295 in 1991 to 98,745 in 2000; during that time, the SEC staff had grown from 125 to 161, an increase of only 29%. In the 1980s, the SEC gave in-depth review to company filings once every three years; by 2000 that level of review occurred only once in seven years. See Hamilton, *supra* note 98, at 6-7 n.16; see also U.S. GOV'T ACCOUNTING OFFICE, SEC OPERATIONS: INCREASED WORKLOAD CREATES CHALLENGES GAO-02-302, 3 (2002).

195. Following criticism of the administration's backpedaling on its commitment to fund the agency, Congress gave the SEC \$170 million more than the White House had requested. For next year's budget, the White House requested \$841.5 million, a 92% increase over last year's budget. See Stephen Labaton, *S.E.C. Chief Says Fixing the Agency Will Take Time*, N.Y. TIMES, Mar. 14, 2003, at C1.

196. See *supra* text accompanying notes 121-36 (discussing limitations of rational choice theory).

197. See *supra* text accompanying notes 144-50 (discussing limitations of social norm model).

values may have a greater influence on individuals than those of the community.

The punishment approach, which properly places blame on individual actors, has a tendency to mask the need for a more comprehensive solution. Criminal law's emphasis on personal accountability does not address systemic characteristics of business crime, such as judgment biases and corporate subcultures that might actually encourage illegal conduct. Moreover, reliance on criminal law may lead legislators to neglect initiatives that could be more productive in preventing future fraud. Recourse to the criminal law alone is not an effective response to the type of wrongdoing exemplified by the corporate scandals of 2002.

In the scheme endorsed here, enforcement through criminal law is one part of a comprehensive approach. Criminal laws are the ultimate expression of social norms that condemn immoral or harmful conduct. But civil enforcement through private suits and government-regulatory actions similarly express the community's values. Moreover, using criminal law as a last resort, instead of as a primary mechanism, reinforces its legitimacy. Legitimacy is an important factor in encouraging law-abiding behavior because when the system is viewed as morally credible, even those who have not internalized the social norm are inclined to obey the law.<sup>198</sup>

Constructing a viable structure in which these systems interact for maximum effectiveness and minimum intrusion upon due process rights of the accused requires the participation of all stakeholders and enforcers, as well as Congress. My point here is to emphasize the importance of consistency in communicating a common standard. Each part of the comprehensive scheme should reinforce the message sent by the other enforcers. A consistent and forceful message is more likely to encourage law-abiding conduct under either the rational choice or the unconscious instinct models of compliance with the law. It is counterproductive to include contrary messages, such as those arguably embodied in legislation that hamstring plaintiffs or in inadequate funding for administrative enforcement. Thus, in the end, the regulatory provisions of the Sarbanes-Oxley Act may be more significant in controlling business misconduct than its criminal provisions.

In sum, Enron and related scandals demonstrate the need for structural reform that will encourage law-abiding behavior by corporations and those who serve them. Although the competitive impulse is the engine that drives a free market system, a strong regulatory structure is necessary "to prevent the ideal from consuming itself."<sup>199</sup> The ultimate challenge is to

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198. *See id.*

199. *See Kadish, supra* note 191, at 425.

create systems within corporations to ensure that “fairly decent people cannot be put under these hidden pressures again.”<sup>200</sup> The most effective way to encourage law-abiding conduct is through a combination of market-motivated gatekeepers, private remedial suits, government administrative actions, and finally, criminal punishment.

## V. CONCLUSION

Recent cheating scandals at major educational institutions show that it is short-sighted to neglect the framework that makes cheating difficult and to rely instead on honor systems that impose harsh penalties.<sup>201</sup> Studies show that honor systems are more effective if supported by procedures such as monitoring of examinations, grading by professors, and warning students about plagiarism and cheating. In the absence of such devices, it is disingenuous for college administrators to express surprise and shock when widespread cheating is uncovered.

Relying on criminal law as the chief means to prevent business misconduct is like relying on honor codes to prevent student cheating. Criminal laws, like harshly punished honor codes, are not sufficient in and of themselves to prevent bad conduct. Like a college, we need structural support for the values reflected in criminal laws. That support is provided when the law works in concert with other regulatory devices, namely private suits and government regulatory actions. Criminal law plays an important role in regulating business conduct, but it is not the only player.

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200. Kurt Eichenwald, *Even if Heads Roll, Mistrust Will Live On*, N.Y. TIMES, Oct. 6, 2002, § 3, at 1 (quoting Professor John M. Darley).

201. See Stuart P. Green, *Plagiarism, Norms, and the Limits of Theft Law: Some Observations on the Use of Criminal Sanctions in Enforcing Intellectual Property Rights*, 54 HASTINGS L.J. 167, 191-94 (2002) (noting startling increase in student plagiarism).

Cheating scandals have caught officials at prestigious institutions by surprise. See Glenn C. Altschuler, *College Prep: Battling the Cheats*, N.Y. TIMES, Jan. 7, 2001, § 4A at 15; Amy Argetsinger, *U-Md. Says Students Use Phones to Cheat; Text Messaging Delivers Test Answers*, WASH. POST, Jan. 30, 2003, at B1; Elissa Gootman, *Columbia Students Charged in High-Tech Cheating*, N.Y. TIMES, Nov. 20, 2002, at B1; Diana Jean Schemo, *U. of Virginia Hit by Scandal Over Cheating*, N.Y. TIMES, May 10, 2001, at A1.

One college professor has linked the increase of corporate fraud with widespread academic dishonesty. See Miguel Roig, *In School, at Work, Lessons in Cheating*, N.Y. TIMES, June 5, 2002, at A26 (stating that one way of reducing tomorrow’s white-collar crime is to hold today’s students to higher academic ethical standards).



