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# The Fallout of Too Big for Trial: Advocating Control Person Liability

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# COMMENT

# THE FALLOUT OF *TOO BIG FOR TRIAL*[1]: ADVOCATING CONTROL PERSON LIABILITY

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## INTRODUCTION

"Do you think they know that you think something is a piece of crap when you sell it to them and then bet against it, do you think they know that?"[2]

The Subprime Mortgage Crisis of 2008 (Subprime Crisis or Crisis) caused an unprecedented worldwide recession.[3] Between 2007 and

[1] *Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections: Hearing Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*, S.Hrg. 113-3 (Feb. 14, 2013), www.gpo.gov/fdsys/pkg/CHRG-113shrg80387/pdf/CHRG-113shrg80387.pdf (phrase coined by Elizabeth Warren, Senator of Massachusetts, stated to Elisse Walter, chair of the Securities and Exchange Commission).

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[2] *Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the U.S. Senate Permanent Subcommittee on Investigations*, S.Hrg. 111-674 (Apr. 27, 2010) [hereinafter *Hearing*] (question of Carl Levin, Senator of Michigan, posed to Lloyd Blankfein, Chief Executive Officer of Goldman Sachs).

2010, the global financial services sector lost 325,000 jobs.[4] In the United States, consumer household net worth decreased by $11 trillion.[5] Meanwhile, C-level executives (hereafter, executives or corporate officers)[6] from sixteen of the firms most closely associated with the Subprime Crisis were eligible to receive golden parachute payments approaching $1 billion if their firms' failures had resulted in their terminations.[7] Because of the government bailout program,[8] that money would have been indirectly funded by United States taxpayers.

The Subprime Crisis presented the U.S. government with an opportunity to establish new responses to financial crises through reassessments of control person liability. To avoid repeating the types of failure that precipitated the Subprime Crisis and caused the worst national recession since the Great Depression,[9] legislators attempting to stabilize a financial system that has become characterized by products of unfathomable complexity[10] should take novel steps, in addition to implementing regulations, to achieve their goals.

While this Comment later outlines at least one viable model for legislators to follow, this introduction first sets the stage by discussing inadequate past responses to crises, the general nature of the failures of corporate leadership, and the inefficacy of the current corporate liability model in deterring the kinds of failures that brought down the economy in 2008. Two cases will be introduced to provide context and, from there, the discussion will proceed.

Government responses to the Subprime Crisis followed familiar patterns, predictably similar to responses to past crises. The pattern is as follows: legislative committees hold hearings in which enraged public

[3] *See* Jean Imbs, *The First Global Recession in Decades*, HEC LAUSANNE SWISS FINANCE INSTITUTE CEPR PRELIMINARY (October 12, 2009), http://sta.uwi.edu/conferences/09/salises/documents/J%20Imbs.pdf.

[4] Charles Roame, *Prior CEO Summits 2008-2009*, TIBURON STRATEGIC ADVISORS, www.tiburonadvisors.com/Prior-CEO-Summits-2008-2009.html (last visited Mar. 6, 2013).

[5] *Id.*

[6] This article uses the term "C-level executives" to define the highest level managers within corporate structures, generally including, but not limited to, chief executive officer, chief financial officer, chief marketing officer, and general counsel. *See, e.g.*, Boris Groysberg et al., *The New Path to the C-Suite*, HARVARD BUSINESS REVIEW, March 2011, http://hbr.org/2011/03/the-new-path-to-the-c-suite/ar/1.

[7] *See Subprime Golden Parachutes Could Cost Shareholders More Than $1 Billion*, MARKET WIRE (Nov. 15, 2007, 1:33 PM), www.marketwire.com/press-release/subprime-golden-parachutes-could-cost-shareholders-more-than-1-billion-793604.html.

[8] Emergency Economic Stabilization Act of 2008, Pub.L. No. 110–343, 122 Stat. 3765 (Westlaw 2014).

[9] *See* Imbs, *supra* note 3.

[10] *See infra* notes 196-197.

officials question regulators[11] and business leaders.[12] New legislation to protect consumers is proposed and strict regulations are imposed to encourage stability and restore consumer confidence in the markets;[13] then, because increased regulation leads to higher product costs for consumers and, surprisingly, decreased transparency to regulators, the legislature passes laws that relax regulatory authority. The judiciary then tries to work with regulations weakened by vague statutes.

Attempts to increase transparency have historically translated into higher costs for consumers,[14] while also providing incentives for managers to obscure information that might be deemed negative.[15] Because regulations have been reactive in nature, and because regulators rarely possess the expertise necessary to constrain innovators of industry (nor would they want to discourage innovation), the application of prudential regulations in isolation to provide industry-wide stability following a financial crisis has repeatedly proven futile.[16] Thus, legislators must think outside the box, not only to monitor behavior and appropriately punish those who violate laws, but actually to prevent violations through a policy of deterrence.[17]

Legislators must draw well-defined distinctions between cognitive and moral failures before attempting to delineate any deterrent policy.[18] The essence of cognitive failure is that if an executive at Company X does not fully understand the complexity of Product X, and neither does Consumer X, then when that product proves to be worthless, there is no

[11] *See, e.g.*, *SEC Regulators on Defense at SEC Hearing*, NBC NEWS (Jan. 27, 2009, 7:19 PM), www.nbcnews.com/id/28872450/.

[12] *Hearing*, *supra* note 2.

[13] *See* Ronald Borod, *Belling the Cat: Taming the Securitization Beast Without Killing It*, 31 REV. BANKING & FIN. L. 643, 643-645 (2012) (enumerating eleven specific factors mentioned by various commentators as contributing to the financial meltdown of 2008).

[14] *See infra* note 243.

[15] *Id.*

[16] *See, e.g.*, Michael Perelman, *The Futility of Financial Regulation: Lessons from Science and Professional Football*, UNSETTLING ECONOMICS BLOG (Sep. 13, 2009), http://michaelperelman.wordpress.com.

[17] *See* Michael A. DiMedio, Comment, *A Deterrence Theory Analysis of Corporate RICO Liability for "Fraud in the Sale of Securities"*, 1 GEO. MASON L. REV. 135 (1994), for a discussion of deterrence theory in relation to RICO liability in the context of securities litigation; *see also* Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185, 1193-94 (2003) ("It is this layering of authority, fragmentation of responsibility, and decentralization that has made it possible for the chairman, CEO and board of directors of Enron, as well as the lawyers, to claim that they did not know much about what was going on in their own company.").

[18] *See* Arnold Kling, *The Financial Crisis: Moral Failure or Cognitive Failure?*, 33 HARV. J.L. & PUB. POL'Y 507 (2010).

accountability attendant to Executive X.[19] *Caveat emptor*. The consumer is left footing the bill.

The characterization of a failure, as either cognitive on the one hand, or moral on the other, should determine legislative strategy, because the complexity of the response must be dictated by the complexity of the failure. If those who hold all the chips do not know any better, then perhaps their failures are of less serious scope than if they fully understand the implications of their actions. If, however, they understand that the complex financial products they sell to investors have the potential to cause widespread economic devastation,[20] then perhaps their actions should invoke liability more easily, and perhaps the government would be justified in allowing novel remedies for suffering investors.[21]

In the case of the Subprime Crisis, pointing to the complexity of mortgage-backed securities (MBS) has been the get-out-of-jail-free-card for executives who might otherwise be held accountable.[22] Because of heightened pleading standards,[23] the executives most responsible for the failures associated with MBS could simply declare that incredible complexities associated with their products created voids of accountability, voids that compliance departments either could not or would not address.[24] Executives could affirmatively claim good faith, because under current law, for fraud to have occurred, they would have had to misrepresent the facts or act with scienter.[25] Claiming the complexity of products has allowed executives to deny misrepresentation of facts, for if the products were too complex to understand, then certainly misrepresentation was impossible to prove; similarly, if corporate structures were too complex for plaintiffs to understand, then

[19] *See id.*at 508 ("[M]arket mistakes went unchecked not because regulators lacked the will or the institutional structure with which to regulate, but because they shared with the financial executives the same illusions and false assumptions.").

[20] Robert D. Piliero, *The Credit Rating Agencies: Power, Responsibility and Accountability*, THOMSON REUTERS NEWS & INSIGHT (Jul. 19, 2012), http://newsandinsight.thomsonreuters.com/Legal/Insight/ViewInsight.aspx?id=52525&LangType=1033 ("The financial impact on investors . . . has been devastating.").

[21] *See* discussion *infra* Part II.D.I-II.

[22] Piliero, *supra* note 20.

[23] *See* discussion *infra* Part II.B.I.

[24] *See, e.g.*, Ben Protess & Azam Ahmed, *MF Global's Risk Officer Said to Lack Authority*, N.Y. TIMES DEAL BOOK (Dec. 14, 2011, 9:53 PM), http://dealbook.nytimes.com/2011/12/14/mf-globals-risk-officer-said-to-lack-authority/ ("MF Global . . .stripped critical powers from its top executive in charge of controlling risk, according to a person briefed on the matter.").

[25] *See* discussion *infra* Part II.B.I-II.

the prospect of simply *pleading* control person liability proved too difficult.

But what about the failure inherent in representing a position on complex products without fully understanding the consequences; would such a failure be cognitive only, or also moral?[26] The answer to this question is important, for the law has historically treated various actors differently depending on their moral turpitude.[27]

If there is a legal distinction to be drawn between cognitive and moral failures as they relate to crises in the financial sector, that distinction ought to apply only to low-level employees of the companies that cause economic loss. The Supreme Court in *Hertz Corp. v. Friend* elevated the legal status of corporate headquarters, specifically discussing the heightened command and control elements inherent in such places.[28] By defining command and control as corporate leadership "direct[ing], control[ling], and coordinat[ing] the corporation's activities" from, specifically, corporate headquarters, Justice Breyer's opinion implied that it is precisely because corporate officers work at corporate headquarters that such locations are properly described as the principal places of business.[29] Thus, by extension of reason from *Hertz*, there ought to be a distinct liability standard for corporate officers, one that recognizes their heightened levels of command and control.[30] There is no justice in characterizing the Subprime Crisis as pure cognitive failure; accountability lies with everybody upstream of the sale of toxic products, resting most squarely upon executives at the toxic product

[26] Kling, *supra* note 18, at 508-509 (describing moral failure by analogy to a fire started by delinquent teenagers whose parents were disinclined to supervise, and cognitive failure by analogy to authorities providing the lighter fluid, matches, and newspapers to start the fire, yet unaware of the inherent dangers in doing so).

[27] *Discharge, Exceptions to Discharge, and Objections to Discharge*, NATIONAL BANKRUPTCY REVIEW COMMISSION 179, 179 (1997), http://govinfo.library.unt.edu/nbrc/report/07consum.pdf ("Many nondischargeable debts involve "moral turpitude" or intentional wrongdoing . . . . Society's interest in excepting those debts from discharge outweighs the debtor's need for a fresh economic start.").

[28] *See* Hertz Corp. v. Friend, 559 U.S. 77, 92-93 (2010) (interpreting the statutory phrase, "principal place of business").

[29] *Id*. ("We conclude that 'principal place of business' is best read as referring to the place where a corporation's officers direct, control, and coordinate the corporation's activities. It is the place that Courts of Appeals have called the corporation's 'nerve center.' And in practice it should normally be the place where the corporation maintains its headquarters—provided that the headquarters is the actual center of direction, control, and coordination, i.e., the 'nerve center,' and not simply an office where the corporation holds its board meetings (for example, attended by directors and officers who have traveled there for the occasion).").

[30] For the purposes of this article, the term "command and control" is analogous to the actions of corporate officers as they "direct, control, and coordinate" the corporation's activities, as described in *Hertz*.

companies who knew or should have known that they were selling pieces of crap.[31] It is these executives who reaped the most compensation[32] and these executives who should have comprehended the risks involved with availing the markets of whatever products their companies sold.[33] It is under the direction of these executives that corporate cultures were formed,[34] with these executives that shareholders, employees, and investors placed their trust, and, this article argues, with these executives that courts should assign ultimate liability through control-person doctrine.[35] The failure to understand a product by an executive who then directly or indirectly promotes that product is, of course, a cognitive failure;[36] but worse, the failure by a society to clearly define a standard of care owed to the investing marketplace as a whole, not just to shareholders and employees, is a moral failure.[37] Moral failures from corporate boardrooms to ratings agencies to regulatory bodies enabled the Subprime Crisis;[38] in order to right past wrongs and prevent future evils, it is essential that the lawmakers of this country remember the Utilitarian principles espoused by Bentham to the Founders, and act accordingly.[39]

The doctrine of corporate liability presents an unsustainable legal paradox.[40] While the corporation is now symbolic of American capitalism, the corporate structure has not always been in favor;[41] so,

[31] *Hearing*, *supra* note 2.

[32] *See* discussion *infra* Part II.C.

[33] *See infra* notes 196-197.

[34] *See* discussion *infra* Part I.A.

[35] *See* Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296, 2311 (2011) (Breyer, J., dissenting) ("There is a dearth of authority construing Section 20(b), which has been thought largely superfluous in 10b–5 cases.") (internal citation omitted).

[36] Kling, *supra* note 18, at 508.

[37] *See* JEREMY BENTHAM, A FRAGMENT ON GOVERNMENT (1776), www.constitution.org/jb/frag_gov.htm ("[I]t is the greatest happiness of the greatest number that is the measure of right and wrong.").

[38] *See* Kling, *supra* note 18, at 508.

[39] Bentham, *supra* note 37.

[40] Kathleen F. Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 RUTGERS L.J. 593 (1988) ("Corporate criminal liability is a paradox [that] suggest[s] art imitating life [or] life miming art False Through this anthropomorphic sleight of hand, the common law subtly transformed the inanimate 'corporation' into a 'person' capable of committing criminal delicts and harboring criminal intent.").

[41] Letter from Thomas Jefferson to George Logan (Nov. 12, 1816), *in* 12 THE WORKS OF THOMAS JEFFERSON 310 (Paul Leicester Ford ed., 1905), *available at* http://oll.libertyfund.org/title/808 (follow "EBook PDF" hyperlink; then search "corporation") ("I hope we shall take warning from the example and crush in it's [sic] birth the aristocracy of our monied corporations which dare already to challenge our government to a trial of strength, and to bid defiance to the laws of their country.").

while the continuing presence of corporations is likely to go unchallenged, there is current debate over how corporations should be held liable, with Senator Elizabeth Warren interpreting Attorney General Eric Holder's testimony to Congress as an admission that "the biggest banks are too-big-to-jail."[42] The victim of corporate misdeeds is the broader corpus of the U.S. economy, and the main perpetrator is the pervasive corporate culture that continues to allow big banks to plead cognitive failures. If justice is the ultimate goal of a civilized society,[43] then, within that society, the existing doctrine of corporate liability creates the unsustainable paradox of protecting individual executives who may act with impunity because, when harm is inflicted, they are able to hide behind the corporate veil.

The corporate structure has promoted economic growth precisely because it provides limited liability to individual corporate employees. Risk-taking has been favored as a result, and should continue to curry favor, so long as accountability correlates with decision-making. While most corporations are still small-scale, family-run operations, a relatively small number of inordinately powerful corporations have grown so large[44] that many of the original justifications for the inception of corporations no longer apply to them. "The classical model of corporations no longer accurately reflects the realities of corporate governance for large, publicly traded corporations."[45] Under the classical model, shareholders are owners who elect board members who in turn hire officers to manage the corporation.[46] However, when a corporation goes public, the power of the original owners (shareholders) to control the fate of the corporation is diluted as the capital of general investors is exchanged for stock, resulting in the separation of control from original ownership.[47] "The realist model of corporate structure . . . [holds] that companies are management controlled because shareholder dispersion ha[s] reached extremes which permitted decisions to be taken by management in disregard of shareholders' interests."[48] Under the

[42] Andrew Ross Sorkin, *Realities Behind Prosecuting Big Banks*, N.Y. TIMES, Mar. 12, 2013, at B1.

[43] THE FEDERALIST NO. 51, at 289 (Alexander Hamilton) (E. H. Scott ed., 1898) ("Justice is the end of government. It is the end of civil society.").

[44] *See* William Arthur Wines & Thomas M. Fuhrmann, *An Inquiry into CEO Compensation Practices in the United States and Proposals for Federal Law Reform*, 43 NEW ENG. L. REV. 221, 235 (2009) (stating that Mobil-Exxon, if it was a country, has revenues, if they were GDP, that would make it the twentieth wealthiest country on earth).

[45] *Id*. at 233.

[46] *Id*.

[47] *Id*. at 234.

[48] *Id*. at 235.

realist model, there is a bi-linear relationship that gives controlling powers to the CEO and top management, and leaves shareholders with little or no actual power in corporate decision-making.[49] Unsurprisingly, executive compensation has skyrocketed,[50] but liability ultimately remains with shareholders.

If justice is the goal of a civil society, then any system that protects individuals from deserved liability is flawed. Take the following two cases, for example. These lawsuits, filed against two high-profile corporations, provide a glimpse of the means by which the government has responded to the Subprime Crisis, but the results of these actions raise troubling questions about the failures of corporate leadership and control person liability.

In a 2009 criminal action, the United States filed eleven counts of fraud against defendant Bernard L. Madoff.[51] Presumably because Madoff had already openly admitted to running a Ponzi scheme, he pled guilty and was sentenced to 150 years in prison.[52] In a related civil complaint against Madoff and Bernard L. Madoff Investment Securities (BMIS),[53] the Securities and Exchange Commission (SEC) filed claims for relief including fraudulent interstate transfers[54] under the Securities Act of 1933 (Securities Act)[55] and employment of manipulative deceptive devices[56] under the Securities Exchange Act of 1934 (Exchange Act).[57]

In a 2010 civil action against Goldman Sachs & Co. (Goldman Sachs or Goldman)[58] and a Goldman employee, Fabrice Tourre, the SEC claimed similar violations under the Securities Act and the Exchange

[49] *Id*.

[50] *See* discussion *infra* Part II.A.

[51] U.S. v. Madoff, No. 08 Mag. 2735 (S.D.N.Y. Dec. 11, 2008).

[52] Diana Henriques, *Madoff Sentenced to 150 Years in Prison*, N.Y. TIMES, June 29, 2009.

[53] SEC v. Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC, No.08 Civ. 10791 (S.D.N.Y. Dec. 15, 2008).

[54] 15 U.S.C. §§ 77q(a)(1), (2), & (3) (Westlaw 2014).

[55] Securities Act of 1933, 48 Stat. 74 (1933) (codified at 15 U.S.C. § 77a) (Westlaw 2014).

[56] 15 U.S.C. §78j(b), section 10(b), &17 C.F.R. §240.10b-5 promulgated thereunder [Rule 10b5].

[57] Securities Exchange Act of 1934, 48 Stat. 881 (1934) (codified at 15 U.S.C. § 78a) (Westlaw 2014).

[58] Goldman Sachs is the most profitable securities firm in Wall Street history. Patricia Hurtado & Christine Harper, *Tourre Says He Relied on Goldman, Denies SEC Fraud Claims*, BLOOMBERG (Jul. 19, 2010), www.bloomberg.com/news/2010-07-20/tourre-says-he-relied-on-goldman-sachs-compliance-denies-sec-fraud-claims.html.

Act.[59] In response, but without admitting or denying the allegations, Goldman Sachs paid a record $550 million to settle the SEC charges.[60] Goldman returned $250 million to harmed investors through a Fair Fund distribution and paid $300 million in fines to the United States Treasury.[61] The settlement also required Goldman to implement remediation of its review and approval processes of certain mortgage securities, including fortifying the role and responsibilities of internal legal counsel, compliance personnel, and outside counsel in the review of written marketing materials.[62] Furthermore, the settlement required Goldman to strengthen its education and training programs, and Goldman acknowledged that it was conducting a comprehensive, firm-wide review of its business standards.[63] In many ways, part of the settlement required that Goldman reassess and reshape its corporate ethos.[64]

Because neither civil case went to trial, it is impossible to know how defendants would have constructed legal arguments, how judges would have ruled on contested testimony, or how rules of evidence would have impacted outcomes. What is clear, however, is that both BMIS and Goldman Sachs suffered from failures of leadership that led to the firms having to disgorge ill-gotten gains and pay penalties. Madoff's guilt in perpetrating the Ponzi fraud had been established by his guilty plea in the earlier criminal case; in the subsequent civil case, the SEC was therefore not required to establish intent to prove Madoff's liability.[65] In the Goldman Sachs litigation, the SEC named Tourre, a mid-level manager, rather than a corporate officer, as co-defendant with the corporation. While the firm's record settlement reflected a tacit acknowledgment of minor failures in marketing materials, Goldman fell

[59] S.E.C. v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011) motion to certify appeal denied, 10 CIV. 3229 BSJ, 2011 WL 4940908 (S.D.N.Y. Oct. 17, 2011) and motion for relief from judgment denied, 10 CIV. 3229 KBF, 2012 WL 5838794 (S.D.N.Y. Nov. 19, 2012).

[60] Press Release, S.E.C., Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (Jul. 15, 2010), www.sec.gov/news/press/2010/2010-123.htm [hereinafter *Release*].

[61] *Id.*

[62] *Id.*

[63] *Id.*

[64] *See* discussion *infra* Part I.A.

[65] Eugene Volokh, Comment to *Criminal Liability and Civil Liability*, VOLOKH CONSPIRACY (Sept. 4, 2008, 1:40 PM), www.volokh.com/posts/1220550026.shtml ("If you get criminally convicted, then this conviction will usually make a civil plaintiff's case against you much easier. Under the doctrine of collateral estoppel . . . , if a fact has been decided against a party in one judicial proceeding, then that fact is generally binding against the same party in future proceedings . . . even in other jurisdictions and other court systems.") (internal quotations omitted).

short of acknowledging liability for the charges of fraud reflected in the complaint.[66]

Senator of Oklahoma Tom Coburn expressed doubt that a mid-level manager such as Tourre had the type or level of responsibility at Goldman that would enable him to perpetrate the type of fraud reflected in the complaint, saying "if I worked for Goldman Sachs, I'd be real worried that somebody has made a decision, '[I am] going to be a whipping boy, [I am] the guy that's getting hung out to dry.'"[67] Even if evidence unequivocally established that Tourre did operate independently, the results of his conduct strongly implicate shortcomings in corporate culture and leadership from corporate headquarters. The remaining questions about control person liability,[68] then, revolve around rationales for assigning liability to corporate officers and the methods that may be employed to establish that liability.[69]

As the global economy was engulfed by a tsunami of toxic debt[70] and the United States legislature called on taxpayer funds to save financial institutions that were deemed "too big to fail,"[71] stewards of these same institutions enjoyed the security of bloated compensation and severance packages,[72] yet remained free of liability to the ruined consuming public.[73]

This Comment's argument is divided into three main parts. Part One sets the scene by discussing the background of corporate criminal liability and briefly outlining three laws passed shortly after the Great

[66] Hurtado, *supra* note 58.

[67] *Hearing*, *supra* note 2 (statement of Tom Coburn, Senator of Oklahoma, to Blankfein); *Id.*

[68] 15 U.S.C.A. § 78t(a) (Westlaw 2014) ("Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.").

[69] *See generally* Darryl P. Rains, *The Future of Control Person Liability After Janus*, 9:2 THOMSON REUTERS SECURITIES LITIGATION REPORT, Feb. 2012, at 10-16, *available at* www.mofo.com/files/Uploads/Images/120227-Liability-after-Janus.pdf (predicting the increased use, and describing the implementation, of control person liability in private securities litigation).

[70] *The 'Toxic Debt' Tsunami*, THE WEEK (Mar. 12, 2009), http://theweek.com/article/index/94172/the-toxic-debt-tsunami.

[71] "Too big to fail" is a doctrine that originated with the 1913 establishment of central banking, that was included in the 1950 amendment to the Federal Deposit Insurance Act of 1934 (as the "essentiality doctrine"), and, finally, was given its current name in 1984, when the U.S. government began to pursue a deliberate policy of bailing out large commercial banks that were deemed "too big to fail." *See* Richard M. Salsman, *Banking Without the Too-Big-to-Fail Doctrine*, Address at the Federal Reserve Bank of Dallas Conference (May 12, 1992), *available at* www.fee.org/the_freeman/detail/banking-without-the-too-big-to-fail-doctrine/#axzz2NXKz6g2p.

[72] *See* discussion *infra* Part II.A.

[73] *See* discussion *infra* Part II.B.I.

Depression. Part Two narrows the discussion of corporate liability onto executives by reviewing laws, enacted shortly before the Subprime Crises, which facilitated both increased executive compensation and decreased exposure to liability. It reviews a claim filed after the Subprime Crisis by a private institution against the most profitable securities firm in Wall Street history, then explores measures taken by the federal legislature to try to address the causes of the crisis. Part Three recommends securities industry self-regulation through a policy of deterrence, facilitated by changes to current law, an immensely powerful new regulatory agency with a highly articulated strategy of assessing blameworthiness, and a judicial reinterpretation of corporate civil liability based on existing corporate criminal liability doctrine.

## I. BACKGROUND

Corporations have been imputed with legal personhood.[74] In a healthy economic system, corporate decision-making can be designed not only to benefit shareholders, but also to contribute to the greater good.[75] When decisions lead to criminal acts, corporations can be subjected to criminal liability.[76] When decisions proximately cause economic loss, corporations can be subjected to civil liability.[77] There is a logical fallacy in this progression, which is that corporations are not actual persons and, therefore, do not actually possess the capacity for choice. The corporation itself is a legal construct. In the case of a corporation operated by altruistic employees, corporate liability rightly shelters from potentially ruinous penalties those employees who make honest mistakes. In the case of a corporation operated by leaders whose actions amount to fraud or misrepresentation or any other statutorily proscribed act, the corporation and any individual employees responsible can be subjected to criminal liability.[78] Whereas corporations of the past enabled officers to benefit from the corporate structure, modern financial services corporations often develop such intricate structural complexities

[74] Kiobel v. Royal Dutch Petroleum Co., 2011 WL 6780141 (U.S.), 25-26 (U.S. 2011) ("All legal systems also recognize corporate personhood . . . recognize that corporate legal responsibility is part and parcel of the privilege of corporate personhood.") (citation omitted).

[75] Paul B. Brown, *Strategic Corporate Altruism*, N.Y. TIMES, Dec. 23, 2006, ("The essential test that should guide corporate social responsibility . . . is not whether a cause is worthy but whether it presents an opportunity to create shared value — that is, a meaningful benefit for society that is also valuable to the business.") (citation omitted).

[76] *See* Kiobel, 2011 WL 6780141, at 25-26.

[77] *Release*, *supra* note 60, at 8 (Goldman $550 million civil settlement).

[78] *See* discussion *infra* Part I.A.

that they end up providing shelter to executives whose actions appear to disparage the collective good, even if they cannot be proven to amount to fraud.[79]

These most basic principles provide relevant guidance to legislators and business leaders. Clearly delineated rules created by a legislature, driven by consumer interests, consonant with the greater good, provide clear signposts for businesses to follow. Clearly delineated rules within a corporation can create a corporate culture, an ethos,[80] whereby neither mistakes nor bad acts are likely to reach the consuming public, generally through the administration of a robust compliance department.[81] The shorter the distance between corporate management and the investing public, the less likely it is that mistakes or violations will escape detection. That is, the bigger the corporation and the more intricate its structural complexities, the more difficulties management face in maintaining and controlling corporate culture.

Part One addresses the background of corporate criminal liability and securities law. Both the courts[82] and the legislature[83] have recognized the important role that corporations play in the business world, while also providing clearly delineated rules for corporations to follow in order to work within the confines of the law. Although corporate criminal liability is outside the scope of this article, the development of this area of law is relevant. Also relevant to any background discussion of modern securities litigation is a review of three laws passed in the 1930s that created the framework for sustainable development of the modern financial system.[84]

[79] It is hard to imagine how a highly-publicized, multi-million dollar settlement to a U.S. regulatory agency is good for either corporate shareholders or for the broader investing public. *See, e.g., S.E.C. v. Goldman Sachs*.

[80] *See* discussion *infra* Part I.A.

[81] *See, e.g.*, News Release, Wells Fargo Names Yvette Hollingsworth Chief Compliance Officer, Wells Fargo (May 14, 2012), https://www.wellsfargo.com/press/2012/20120514_WellsFargoNamesYvetteHollingsworth ("As chief compliance officer, Hollingsworth will be responsible for ensuring that all areas of the company meet compliance management responsibilities and abide by all applicable laws and regulations. Her team will continue to provide independent oversight of business-based compliance management activities.").

[82] *See* discussion *infra* Part I.A.

[83] *See* discussion *infra* Part I.B.

[84] *See* discussion *infra* Parts I.A-B.

### A. CORPORATE CRIMINAL LIABILITY:DEVELOPED FROM TORT LAW'S VICARIOUS LIABILITY PRINCIPLE

In 2006, the Thompson Memorandum's[85] policy, favoring federal prosecutors' capacity to pressure corporations to cooperate with investigations against their own employees, came under criticism by Judge Lewis Kaplan of the Southern District Court of New York.[86] Within a year of Kaplan's scathing critique of prosecutorial policies in *United States v. Stein*, Assistant United States Attorney Preet Bharara responded in writing in the American Criminal Law Review.[87] Whereas Kaplan's opinion had focused on alleged abuses of prosecutorial discretion, Bharara effectively argued that prosecutors had gained leverage not by abuses, but rather by 100 years of court-sanctioned expansion of corporate criminal liability.[88]

Unchecked prosecutorial discretion has the potential to "threaten the functioning of entire industries and subject work forces the size of cities to unemployment as a collateral consequence of . . . do[ing] what the law permits."[89] However, the Court has never upheld checks on prosecutorial discretion.[90] Rather, courts "repeatedly concluded that the scourge of corporate crime requires rules that are different, tough, and effective in ferreting out wrongdoing."[91] In other words, courts have given more latitude to prosecutorial discretion where corporate crime is involved.

Corporate criminal liability developed from its origin in the landmark case *New York Central v. United States*.[92] Before that, corporations were not indictable, but the Court in *New York Central* looked to the law of torts for guidance, settling upon the concept of vicarious liability as a leading principle. "The act of the agent . . . may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is

[85] *See* Memorandum from Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components, U.S. Dep't of Justice (Jan. 20, 2003), *available at* www.usdoj.gov/dag/cftfbusiness_organizations.pdf.

[86] United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

[87] Preet Bharara, *Corporations Cry Uncle and their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53 (2007).

[88] *Id*. at 54-55.

[89] *Id*. at 59.

[90] *Id*.

[91] *Id*. at 60.

[92] New York Cent. & H.R.R. Co. v. United States, 212 U.S. 481, 29 S. Ct. 304, 53 L. Ed. 613 (1909).

acting in the premises."[93] The Court appears to have reasoned its holding on the premise that at least one way to prevent illegal acts from being committed by individuals was to give their corporate employers powerful incentives to self-police.[94] The corporate defendant's prescient argument in *New York Central*, that to punish a corporation was actually to punish its innocent shareholders, was dismissed by the Court.[95]

As a consequence of the Court adopting the principle of vicarious liability, a doctrine known as "collective knowledge" emerged in *United States v. Bank of New England*.[96] Under the collective knowledge doctrine, the aggregate knowledge of a corporation's employees, knowledge used to further the purpose of the corporation, is attributable to the corporation itself for purposes of criminal liability.[97] The potency of the collective knowledge doctrine derives from the fact that it exposes a corporation to criminal liability even if no individual actor can be identified for the purpose of proving intent.[98]

The broader impacts of *New York Central* and *Bank of New England* are three-fold. First, corporations can be held criminally liable even if criminal conduct is undertaken without the knowledge of top management. Second, corporations can be held criminally liable even if the agent responsible for the crime cannot be identified. Third, corporations can be held criminally liable even if the offending employees are all acquitted of the same offense.[99] Therefore, if a law-breaking employee can act discreetly enough to avoid detection by a corporate compliance program, and prosecution under the law, and yet the corporation is still criminally liable for the employee's misconduct, then the legal pendulum has swung too far away from its primary purpose of providing justice. While "it is a logical paradox that this creature of the law—the corporate entity—is created by the law with the power to violate the law,"[100] it is an even greater logical paradox that this creature of the corporation—the management executive—is created by the corporation with the power to destroy it.

[93] Bharara, *supra* note 87, at 61.

[94] *Id.* at 81.

[95] *Id.* at 61.

[96] United States v. Bank of New England, 821 F.2d 844, 855 (1987) ("[I]ts knowledge is the sum of the knowledge of all of the employees . . .[t]hat is, the bank's knowledge is the totality of what all of the employees know within the scope of their employment.").

[97] Bharara, *supra* note 87, at 64-65.

[98] *Id.* at 63-64.

[99] *Id.* at 64-65.

[100] Standard Oil Co. of Tex. v. United States, 307 F.2d 120, 127 (5th Cir. 1962).

In his article, Bharara recognized the need for tightening rules for corporate criminal liability.[101] He offered three approaches, one of which is relevant to this discussion. Bharara attributed his coverage of the *corporate culture approach* to "an influential article" wherein the author "overcomes difficulties of attributing mens rea and assigning blame to . . . an artificial entity by developing a corporate 'ethos' theory . . . by which prosecutors . . . and the public can identify the blameworthiness of the corporation."[102] According to this approach, the values that Bharara focused on, namely the difficulties of finding intent and the need to identify blameworthiness, are both met if a corporate "ethos" can be identified. If "ethos" is defined as "the set of beliefs or ideas about the behavior and relationships of a person or group" and "most companies have a corporate ethos,"[103] and if executives comprise the command and control components of a corporation, then a corporate ethos should always be attributable to its executives. It follows that if a corporation is found to be criminally liable for fraud, its command and control executives should always be civilly liable, even if they are not considered to possess the requisite specific intent to be found guilty under criminal law. Executives that are criminally liable should be civilly liable because they set the corporate ethos that propagated the violation in the first place.

Just as corporate criminal liability doctrine developed with a keen eye to the relationship between the corporation and the corporate employee, so too should contemporary corporate *civil* liability doctrine develop. Proscribed acts transgressed by individual employees can rightly subject corporations to criminal sanctions (because of blameworthiness and the need for justice in criminal issues), and the collective knowledge doctrine thereby takes center stage. Similarly, acts that cause financial crises, but without apparent intent on the part of any individual, should also be attributable to the corporation, but, as in *Hertz*, that attribution should be directed at the principal place of business. The corporate ethos, after all, is what determines the direction of the

[101] Bharara, *supra* note 87, at 107.

[102] *Id.* at 107-108; *see* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1099 (1991) ("[T]he standard proposed herein imposes criminal liability on a corporation only if the corporation encouraged the criminal conduct at issue. If it did, the criminal conduct is not an accident or the unpredictable act of a maverick employee. Instead, the criminal conduct is predictable and consistent with corporate goals, policies, and ethos. In the context of a fictional entity, this translates into intention.").

[103] *Ethos Definition*, CAMBRIDGE BUSINESS ENGLISH DICTIONARY, http://dictionary.cambridge.org/dictionary/business-english/ethos?q=ethos (last visited Mar. 22, 2013).

corporation. The corporate officers who have overseen Goldman Sachs' emergence as the most profitable securities firm in Wall Street history are the same corporate officers whose alleged malfeasance resulted in the largest settlement ever paid in an SEC action. These officers take compensation for the first result, but are not held liable for the second result.

### B. POST-STOCK MARKET CRASH LEGISLATION: BANKING, SECURITIES, AND EXCHANGE ACTS

Modern securities law can be traced to the government's response to the Stock Market Crash of 1929 (Crash). In the wake of the massive speculation and frauds that precipitated the Crash,[104] the federal legislature addressed public concern about future financial industry problems by enacting three laws, the Banking Act of 1933 (Banking Act),[105] the Securities Act of 1933 (Securities Act),[106] and the Securities Exchange Act of 1934 (Exchange Act).[107]

Taken separately, each of these laws reflects the awareness by government of independent causative factors for the Crash. The Banking Act was aimed at providing solutions to a problematic banking industry structure, designed to address the problem of speculation[108] and to restore faith in commercial banking by establishing the Federal Deposit Insurance Corporation (FDIC).[109] The Securities Act and Exchange Act were more related to regulating behaviors. The goal of the Securities Act was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."[110] To accomplish this goal, the Act required issuers of securities to make full material disclosures about their products and to register them with the SEC.[111] The purpose of the Exchange Act was to regulate the secondary trading

[104] Deepa Sarkar, *Securities Law History*, CORNELL UNIVERSITY LAW SCHOOL LEGAL INFORMATION INSTITUTE, www.law.cornell.edu/wex/securities_law_history (last visited Mar. 14, 2013).

[105] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (Westlaw 2014).

[106] Securities Act of 1933, 48 Stat. 74 (codified at 15 U.S.C. § 77a) (Westlaw 2014).

[107] Securities Exchange Act of 1934, 48 Stat. 881 (codified at 15 U.S.C. § 78a) (Westlaw 2014).

[108] *See* Edwin J. Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88:6 BANKING LAW JOURNAL 483–528 (1971).

[109] *See* Carter Golembe, *The Deposit Insurance Legislation of 1933: An Examination of its Antecedents and its Purposes*, 75:2 POLITICAL SCIENCE QUARTERLY 181 (Jun., 1960).

[110] § 77a.

[111] *Id.*

of securities by brokers or dealers.[112] The Act established the SEC, which became the "primary overseer and regulator of the U.S. securities markets."[113]

While each of these laws established separate guidelines, when taken together, they represent clearly defined policy-making. In aggregate, these three laws were enacted in order to ensure that the investing public would never again be subjected to the types of speculative investing, fraud, or misrepresentation that created the 1929 Crash. In light of the extraordinary complexity of financial products and corporate structures, both of which contributed to the Subprime Crisis, one must consider whether each of these laws is still effective, or whether they require slight or significant modification. One must also question whether speculative investing, fraud, or misrepresentation are still the benchmarks of liability or, rather, if concepts of liability ought to be simplified.[114] Although these questions are technically outside the scope of this Comment, this legislation is still highly relevant to the discussion to come.

*1. Banking Act of 1933*

The Banking Act has been commonly referred to by another name, the Glass-Steagall Act (Glass Steagall).[115] The Glass-Steagall provisions within the Banking Act,[116] those which required separation of commercial and investment banking activities, were repealed in 1999 by the passage of the Gramm-Leach-Bliley Act (GLBA).[117] Critics of the GLBA attribute responsibility for the Subprime Crisis to the fact that commercial banks in 1999 were suddenly deregulated, liberated to use

[112] § 78a.

[113] SEC, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION (2013) [hereinafter *Investor's Advocate*].

[114] *See e.g.*, James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, N.Y. TIMES, Oct. 22, 2011, at B1 (statement of Paul Volcker) ("I'd write a much simpler bill. I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I'd have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them.").

[115] Glass-Steagall refers to the two proponents of the bills that were eventually combined an enacted as the Banking Act of 1933, specifically Virginia Senator Carter Glass and Alabama Representative Henry B. Steagall. *See The Long Demise of Glass-Steagall*, PBS FRONTLINE (May 8, 2003), www.pbs.org/wgbh/pages/frontline/shows/wallstreet/weill/demise.html.

[116] *See* Arthur E. Wilmarth, *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1161 (1990).

[117] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (codified at 15 U.S.C. § 6801) (Westlaw 2014) (also known as the Financial Services Modernization Act of 1999).

investor deposits to underwrite complex and risky products, thereby exposing the entire deposit banking system to the type of risk previously reserved for sophisticated investors through investment banks.[118] While this view is attractive for its simplicity, it is also worth noting two other points: first, by 1935, Senator Glass himself had become dissatisfied with these same provisions[119] and second, present-day supporters of the GLBA such as Bill Clinton argue that it actually softened the impact of the Subprime Crisis.[120]

The legislative history of the Banking Act reveals the driving factors behind its passage through both houses of Congress, while the heavy involvement of President Franklin Roosevelt in the final drafting process underscores the view that its passage was considered vital to the health of the nation's economy.[121] While Senator Glass initially advocated the separation of commercial banking activities from investment banking activities, he also sought to create a unified banking system, whereby all banking institutions, whether large national banks with branches in several states, or state chartered unit banks with only one location, would be subject to the same measures of regulation under the Federal Reserve System.[122]This unified banking system approach was Senator Glass' response to a rush of unit bank closures that threatened the banking industry during the early 1930s.[123] The bill passed Congress with minor changes to these two provisions by an

[118] *See generally* Damian Paletta & Kara Scannell, *Ten Questions for Those Fixing the Financial Mess*, THE WALL STREET JOURNAL (Mar. 10, 2009), http://online.wsj.com/article/SB123665023774979341.html (stating President Barack Obama blamed the GLBA's deregulation for the financial crisis); *see also* Marcus Baram, *Who's Whining Now? Gramm Slammed by Economists*, ABC NEWS (Sept. 19, 2008), http://abcnews.go.com/print?id=5835269.

[119] Arthur E. Wilmarth, *Did Universal Banks Play a Significant Role in the U.S. Economy's Boom-and-Bust Cycle of 1921-33? A Preliminary Assessment*, GWU LEGAL STUDIES RESEARCH PAPER NO. 171, 4 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 559, 590 (2005), *available at* http://sgfsrn.com/abstract=8382674.

[120] *See* Maria Bartiromo, *Bill Clinton on the Banking Crisis, McCain, and Hillary*, BUSINESSWEEK, Sept. 23, 2008, *available at*www.businessweek.com/stories/2008-09-23/bill-clinton-on-the-banking-crisis-mccain-and-hillary.

[121] *See* Lyndon H. LaRouche, *How FDR Reversed the 1933 Banking Crisis*, 34:9 EXECUTIVE INTELLIGENCE REVIEW 40, 41 (Mar. 2, 2007), *available at*www.larouchepub.com/eiw/public/2007/eirv34n09-20070302/eirv34n09-20070302.pdf (statement of Franklin Roosevelt) ("[W]e were busy drafting this legislation in conference with the Congressional leaders, and also devoting ourselves to devising arrangements to permit the banks to meet certain essential payments during the banking holiday.").

[122] *See* SUSAN ESTABROOK KENNEDY, THE BANKING CRISIS OF 1933 205-207 (Univ. Press of Ky. 1st ed. 1973) [hereinafter *Kennedy*]; *see also* HELEN BURNS, THE AMERICAN BANKING COMMUNITY AND NEW DEAL BANKING REFORMS, 1933-1935 71-72 (Greenwood Press 1974).

[123] See KENNEDY, *supra* note 122, at 207.

overwhelming 54-9 vote on January 25, 1933.[124] In the House of Representatives, Representative Steagall had been fighting to protect unit banks by establishing federal deposit insurance, which would allow smaller banks to compete for deposits with larger banks,[125] and to preserve the "dual banking system."[126] The House passed the bill by an overwhelming 262-19 vote on May 23, 1933, and on June 16, 1933, President Roosevelt signed H.R. 5661 into law, establishing the Banking Act.[127]

In 1999, nearing the end of the Clinton presidency, a period characterized at least in part by its economic stability and growth,[128] the GLBA repealed the provisions of the Banking Act that had separated commercial and investment banking activities. The stated goal of the GLBA, as indicated by its full title, was "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, and other financial service providers."[129] The bill passed the Senate on May 6, 1999 by a slim margin of 54-44. On July 30, 1999, the bill passed the House by a margin of 241-132.[130]

Neither the Banking Act nor the GLBA is cited in the case law discussed below, as neither was enacted to provide guidelines for behavior, but rather to define the structures within which financial institutions must operate. However, the Banking Act and GLBA could inform the aspirations of current government leadership. The Banking Act enjoyed overwhelming support during its run through both houses of Congress, due to the urgent need to restore faith in the United States banking system. The GLBA was proposed and passed by a slim margin during a period of economic prosperity. Whether it was a vehicle for increased competition or rather, as some have suggested, a bill strong-

[124] 12 U.S.C. § 227; *see also* KENNEDY, *supra* note 122, at 73.

[125] *See* Eugene White, *World Bank Policy Research Working Paper 1541: Deposit Insurance*, WORLD BANK, www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1995/11/01/000009265_3961019154935/Rendered/PDF/multi_page.pdf (last visited Feb. 8, 2013).

[126] Christine E. Blair and Rose M. Kushmeider, *Challenges to the Dual Banking System: The Funding of Bank Supervision*, FDIC, www.fdic.gov/bank/analytical/banking/2006mar/article1/article1.pdf (last visited Feb. 8, 2013).

[127] 12 U.S.C. § 227.

[128] See David Greenberg, *Memo to Obama Fans: Clinton's Presidency was not a Failure*, SLATE (Feb. 12, 2008, 3:34 PM), www.slate.com/articles/news_and_politics/history_lesson/2008/02/memo_to_obama_fans.single.html, discussing the economic strength created during the Clinton Presidency.

[129] 15 U.S.C. § 6801.

[130] *Id*.

armed into Congress by special interests, is debatable.[131] What is clear, however, is that the economic climate dominated by a handful of wealthy corporations in 2014 is more akin to the early 1930s than the late 1990s,[132] and as such, Congress should continue pushing for reform. No good crisis should go to waste.[133]

*2. Securities Act of 1933*

The Securities Act required that any offer or sale of securities using the "means and instrumentalities of interstate commerce" be registered with the SEC.[134] Thus, given the broad interpretation of "means and instrumentalities of interstate commerce," the Securities Act applied to the offer or sale of most securities traded in the United States.[135]

The adoption of the Securities Act replaced the so-called "blue sky laws."[136] Whereas blue sky laws had conditioned the issuance of securities on their merits,[137] the Securities Act rested on the idea that disclosure of material information about a security from its issuer to its consumer was a preferable means for registering securities offerings.[138]

The main objective of the Securities Act was to ensure that buyers of securities received complete and accurate information before investing.[139] Issuers of bad investments would not be liable for damages, as long as they provided full disclosure about the securities before offering them for sale. Thus, "investors who purchase[d] securities and suffer[ed] losses ha[d] important recovery rights if they c[ould] prove that there was incomplete or inaccurate disclosure of important information."[140] By requiring issuers to create highly detailed registration statements about the securities and the companies offering

[131] Financial Services Modernization Act: Hearings Before the Committee on Banking and Financial Services, 106th Cong. 1 (1999) (statement of Consumer Program Director Miervinski).

[132] *See* Imbs, *supra* note 3.

[133] "A crisis is a terrible thing to waste" is attributed to Paul Romer, a Stanford economist, in his comments at a November, 2004 meeting of venture capitalists. Jack Rosenthal, *A Terrible Thing to Waste*, N.Y. TIMES, Aug. 2, 2009, at MM12, *available at* www.nytimes.com/2009/08/02/magazine/02FOB-onlanguage-t/html.

[134] § 77a.

[135] § 77a.

[136] Richard I. Alvarez and Mark J. Astarita, *Introduction to the Blue Sky Laws*, SEC LAW, www.seclaw.com/bluesky.htm (last visited Mar. 21, 2013).

[137] *Id*.

[138] § 77a.

[139] *Id*.

[140] SEC, THE LAWS THAT GOVERN THE SECURITIES INDUSTRY: SECURITIES ACT OF 1933 (2013).

them,[141] the SEC intended to "enable[] investors, not the government, to make informed judgments about whether to purchase a company's securities."[142] The intended result necessarily relies upon full disclosure by the issuing company, without which a sustained high level of investor confidence in the financial services market would be impossible.

The Securities Act contain provisions for litigation that can lead to civil liability for the issuer and underwriters under sections 11 (material misrepresentations and omissions in registration statements), 12(a)(2) (misrepresentation in published materials), and 17(a)(1) (anti-fraud provisions).[143]

*3. Securities Exchange Act of 1934*

The Exchange Act established the SEC, the agency whose current mission "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[144] The Exchange Act, and its related statutes and regulations, form the framework within which the investing public, through the SEC, can hold corporations and their officers accountable.[145] The Exchange Act provides the right of an individual private citizen to sue an issuer of stock through section 10(b) (anti-fraud provisions)[146] of the Exchange Act and corresponding SEC Rule 10b-5 ("employment of manipulative and deceptive devices").[147] While the Securities Act was designed to regulate primary issuers of securities, the Exchange Act regulates the secondary markets, which include financial institutions of all sorts, as well as the physical exchanges.[148]

It has been said that novel problems demand novel solutions. But sometimes this colloquialism is most forceful when turned on its head. Sometimes old problems require novel solutions, while other times novel problems demand old solutions. Financial crisis is nothing new in the brief history of American Capitalism. Regulations alone have not slowed the frequency, nor reduced the depth, of each successive financial crisis. This Comment explores novel solutions to the familiar problem of

[141] *See id.*

[142] *Id.*

[143] § 77a.

[144] *See* INVESTOR'S ADVOCATE, *supra* note 133.

[145] See SEC, THE LAWS THAT GOVERN THE SECURITIES INDUSTRY: SECURITIES EXCHANGE ACT OF 1934 (2013) for coverage of corporate reporting, proxy solicitations, and tender offers.

[146] § 78j(b).

[147] § 240.10b5.

[148] *Id.*

recurring financial crises by interpreting old securities laws in new ways and by redefining corporate civil liability doctrine with an appreciation for the development of century-old corporate criminal liability doctrine.

## II. DISCUSSION

Part Two raises the issue of greed in the context of executive compensation. It argues that laws have allowed executives to behave with disregard for the greater good, costing U.S. taxpayers trillions of dollars. This section specifically discusses two legislative acts that have manifestly contributed to increased executive compensation and decreased executive accountability, respectively. The case of *Dodona v. Goldman Sachs* is reviewed in order to explain the current complexities of both the marketplace and corporations. The *Dodona* discussion squares up the element of scienter, while also touching on the related issue of control person liability. Part Two continues the discussion by reviewing some specific sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and concludes the discussion by highlighting the promise of the newly established Consumer Financial Protection Bureau (CFPB or Bureau).

### A. MATERIAL APPRECIATION, AKA GREED: THE CORPORATE EXECUTIVE

Early during his presidency, George W. Bush began pushing for initiatives that would make it easier for every United States citizen to enjoy the benefits of homeownership.[149] In addition to loosening credit and documentation requirements for borrowers, another, unexpected result was the psychological impact that the idea of homeownership had upon the consuming public.[150]

In the early 2000s, homeownership was made virtually inevitable for anybody who had a pen and was ready to sign a document. Because status could increase by way of homeownership, and because attaining ownership of a home was made so easy, those who didn't have a home were stigmatized; their understandable response was to attempt to join

[149] *See* Jo Becker, Sheryl Gay Stolberg, & Stephen Labaton, *Bush Drive for Home Ownership Fueled Housing Bubble*, N.Y. TIMES, Dec. 21, 2008, at B1.

[150] *See* Nestor M. Davidson, *Property and Identity: Vulnerability and Insecurity in the Housing Crisis*, 47 HARV. C.R.-C.L. L. REV. 119, 120 (2012) ("[I]f property is classically understood as a font of security, the stability property provides can ground people not only literally but also emotionally.").

the home-owning populace.[151] Under this atmosphere of haves and have-nots, the have-nots could so easily join the ranks of the haves that they had little moment to pause to consider the consequences.

Meanwhile, executive compensation skyrocketed. In 2007, a handful of executives at the largest firms in the United States took $613 million in compensation;[152] the CEO earned 400 times the income of the average employee at the same firm in 2009.[153] Just as the apparent economic status of the new homeowner grew with each home purchase, so did the actual economic status of the executives grow with the rewards from selling risky new products associated with the debt on those houses.[154]

The aspirational psychology of both groups, new and prospective homeowners on the one hand, and executives at financial institutions on the other, served to encourage a race to the top. While the madness that accompanied non-stop material accumulation decreased any consideration of accountability on either side of the transactions,[155] the no-accountability atmosphere was almost assured as a result of actions taken by Congress and the SEC.

### B. PRECIPITATING THE SUBPRIME CRISIS:THE PRIVATE SECURITIES LITIGATION REFORM ACT AND RULE 10B5-1 PLANS

Between the 1930s, when the securities laws were enacted, and 2008, when the Subprime Crisis decimated the United States economy, long periods of stable growth were interspersed with lesser crises.[156] Then, in 2008, the United States economy suddenly teetered on the brink

[151] *See id.*at 135; *see also* Leaf Van Boven et al., *Stigmatizing Materialism: On Stereotypes and Impressions of Materialistic and Experiential Pursuits*, 36 PERSONALITY & SOC. PSYCHOL. BULL. 551, 551 (2010) (discussing research on social stigmatization of the materially deficient).

[152] *See* Del Jones & Edward Iwata, *Top Executives Pay Takes a Hit: Bailout Plan Seeks to Rein in Compensation, Exit Packages*, USA TODAY, Oct. 2, 2008, at Money 4B.

[153] *See* Janice K. McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. BUS. L. 131, 174 (2009); *see also* Carl Levin, *Pay Gap Between CEOs and Workers Now a Chasm*, STATE NEWS SERVICE, June 8, 2007, www.levin.senate.gov/newsroom/in_the_news/article/?id=bf04517b-4fd3-4818-8575-64961bbbaf1d ("[T]oday, the average CEO is paid nearly 400 times as much as the average worker.").

[154] *See infra* notes 196-197.

[155] The lack of accountability shows most glaringly in the spike in foreclosures, the result of both imprudent lending and borrowing. *See* Mark Zdechlik, *All Things Considered: Congress Takes Aim at Predatory Lending as Foreclosures Hit Minneapolis, Other Cities*, MINNESOTA PUBLIC RADIO (Feb. 7, 2007), www.thecurrent.org/feature/2007/02/07/foreclosures.

[156] *See, e.g.*, CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (Wiley 5th ed. 2005).

of another "Great Depression."[157] Whereas some commentators have assigned blame for the Subprime Crisis on the GLBA of 1999,[158] other changes to Federal law significantly altered the behaviors of investors on one side and executives on the other.

The Private Securities Litigation Reform Act of 1995 (PSLRA) was passed "as a response to the alleged proliferation of securities class action lawsuits that were perceived to be frivolous and instituted for the purpose of attempting to unearth fraud through the discovery process after filing the action or to secure a settlement."[159] The aim of the law was to stop frivolous lawsuits, but the effect of the law may have been to make it more difficult for private litigants to state claims in what would have otherwise been *bona fide* fraud cases.[160]

In 2000, the SEC adopted Rule 10b5-1 to provide executives with a safe harbor from insider trading, as defined in Rule 10b5.[161] The goal of the 10b5-1 plan was to enable executives to liquidate stocks while in possession of inside information. Rule 10b5-1 plans were created for the benefit of executives, who, it was thought, might have legitimate reasons for liquidation, including the need to diversify holdings or contribute significant capital to the economy by way of large purchases.[162] However, the construct of Rule 10b5-1 was flawed, so the end result of the new rule did not meet its intended goal.

### *1. Private Securities Litigation Reform Act of 1995: Preventing Private Securities Claims Since 1995*

Over a presidential veto, Congress passed the PSLRA, amending the Exchange Act to include unique, and heightened, pleading requirements for private claims alleging securities fraud.[163] The Court has interpreted the "twin goals of the PSLRA" to be "to curb frivolous,

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[157] Lynton Weeks, *Are We Teetering On The Edge Of Depression 2.0?*, NPR (Oct. 16, 2008, 3:27 PM), www.npr.org/templates/story/story.php?storyId=95798378.

[158] Bartiromo, s*upra* note 120.

[159] Charles Alan Wright et al., 5A Federal Practice and Procedure § 1301.1 (3d ed. 2012).

[160] *See supra* note 58.

[161] Insider trading is defined as:

[A] manipulative and deceptive device[] [to] include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the cource of the material nonpublic information.§ 240.10b5-1(a).

[162] *See* Karl T. Muth, *With Avarice Aforethought: Insider Trading and 10b5-1 Plans*, 10 U.C. DAVIS BUS. L.J. 65, 66 (2009).

[163] Wright, *supra* note 159.

lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims."[164] Lower courts have pointed to the harm that fraud claims potentially pose to businesses.[165] The PSLRA appears to represent a strong Congressional intent to side with business.

The PSLRA does not apply to public actions such as those initiated by the SEC,[166] and also does not apply to violations of law under the Securities Act that do not require scienter as an element.[167] In relevant part, the PSLRA reads: "(b) Requirements for securities fraud actions.-

> (2) Required state of mind.-In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[168]

It is clear why establishing control person liability has proven so difficult: top management is often insulated from the day-to-day communications[169] that might inform pleading requirements in securities claims alleging "misleading statements and omissions."[170] The discussion now turns to the pleading requirement for scienter, or "required state of mind."

Courts were split on the level of particularity in the pleader in regard to the statute's "strong inference" requirement. There were three approaches before the Court settled on a single interpretation in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* in 2007. In the Second Circuit, the pre-PSLRA standard remained, stating that plaintiffs could sufficiently plead scienter by alleging, with particularity, facts "that 1) establish that the defendant had a motive and opportunity to defraud, or 2) constitute

[164] Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 309 (2007).

[165] Robert N. Clemens Trust v. Morgan Stanley DW, Inc., 485 F.3d 840, 847 (6th Cir. 2007).

[166] S.E.C. v. Mercury Interactive, LLC, 2010 WL 3790811, *2 n.2 (N.D. Cal. 2010) ("The more stringent pleading requirements of the Private Securities Litigation Reform Act . . . do not apply to actions brought by the SEC."), citing S.E.C. v. ICN Pharmaceuticals, Inc., 84 F. Supp. 2d 1097, 1099 (C.D. Cal. 2000).

[167] In re Enron Corp. Secs., Derivative & ERISA Litigation, D.C.Tex.2002, 235 F. Supp.2d 549 (Harmon, J.) ("Where claims under Sections 11 and 12 of the Securities Act are grounded in negligence rather than fraud, there is no scienter requirement and it need only satisfy the liberal pleading requirements of Rule 8.").

[168] Private Securities Litigation Reform Act, Pub.L. 104-67, §101(b)(2), 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) (Westlaw 2014).

[169] Wright, *supra* note 159.

[170] § 101(b)(1).

circumstantial evidence of either reckless or conscious behavior."[171] The Ninth Circuit interpretation of the PSLRA was stricter than the Second Circuit, requiring the plaintiff to plead deliberately reckless conduct, thus demanding a heightened standard of recklessness.[172] Finally, other courts advocated for various standards between the Second and the Ninth Circuits, but held generally that motive and opportunity "'are not substitutes for . . . recklessness, [but] can be catalysts to fraud and so serve as external markers to the required state of mind,' thus accepting that motive and opportunity might establish scienter, but only insofar as it establishes recklessness."[173] Meanwhile, a court in the Tenth Circuit held that "allegations of motive and opportunity may be important to the totality but are typically not sufficient in themselves to establish a 'strong inference' of scienter."[174] Thus, when it decided *Tellabs* in 2007, the Court attempted to resolve the issue of how to interpret the term "strong inference," but within that issue the Court also had to deal with the considerations of motive, opportunity, and recklessness raised in the lower courts.

In deciding *Tellabs*, the majority distilled the discussion into a consideration of whether courts ought to "consider competing inferences in determining whether an inference of scienter is strong."[175] On this issue, the majority said that courts "must take into account plausible opposing inferences"[176] and that "to qualify as 'strong,' an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent."[177] Thus, in deciding the "strong inference" issue, the Court solved one problem, but opened the door to several, more difficult causes for concern, including: (1) because of the multiple complexities of facts in securities fraud case, courts have difficulties determining the relevant strengths of various facts;[178] (2) because the PSLRA is a pleading statute, courts are faced with comparisons of plausibility based

[171] Wright, *supra* note 159.

[172] Siracusano v. Matrixx Initiatives, Inc., 585 F.3d 1167, 1180 (9th Cir. 2009) ("To establish scienter, a complaint must allege that the defendants made false or misleading statements either intentionally or with deliberate recklessness.") (quotations omitted).

[173] Wright, *supra* note 159 (quoting Helwig v. Vencor, 251 F.3d 540, 550 (Merritt, J.)).

[174] City of Philadelphia v. Fleming Companies, Inc., 264 F.3d 1245 (C.A. 10th 2001).

[175] Tellabs, 551 U.S. at 309.

[176] *Id.* at 323.

[177] *Id.* at 313.

[178] *See* In re Ceridian Corp. Secs. Litigation, 542 F.3d 240 (8th Cir. 2008) ("When a party asserts, for example, that six factors collectively warrant a particular conclusion, we do not assume the district court failed to view the six collectively merely because it discussed them one at a time.").

on competing factual inferences provided by only one side;[179] (3) whether the *cogent* and *at least as compelling as* prongs comprise a rigid two-part test or whether a compelling inference implies cogency;[180] and (4) what weight to give to confidential[181] sources.[182]

Application of the PSLRA remains a source of discord among the courts, especially in light of the Court's post-*Tellabs* characterization of what is necessary for "strong inference" of scienter. This is due to the inherent complexities of modern securities products and services as much as it is due to the complex structures of modern corporations.[183] Yet there exists an impetus to address and potentially amend the PSLRA because "[t]his level of litigation intensity against a single industry is unprecedented since the passage of the 1995 Reform Act.' Nearly a third of all large financial institutions—representing more than half of the financial sector's total market capitalization—were sued in a securities class action filed in 2008."[184] While much of this litigation has been brought under sections 11 and 12(a)(2) of the Securities Act, which provide causes of action for misrepresentations in registration statements, thus obviating the need to prove scienter, the difficulty in showing control person liability under the Securities Act because of the need to prove actual conduct means that the best avenue for litigants trying to sue officers remains fraud under the Exchange Act.

### *2. Rule 10b5-1 Plans: Inviting Market Manipulation*

The Exchange Act holds that it is "unlawful . . . [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

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[179] Fed. R. Civ. P. 12(b)(6).

[180] *Compare* In re Countrywide Financial Corp. Derivative Litigation, 554 F. Supp. 2d 1044 (C.D. Cal. 2008) (applying a two-step approach by first concluding that the inference of scienter against each defendant was cogent and then proceeding to test whether it was more plausible than opposing inferences),*with* Higginbotham v. Baxter Int'l Inc., 495 F.3d 356 (7th Cir. 2007) (completely foregoing any comparison or making comparisons implicitly).

[181] *Compare* Higginbotham, 495 F.3d at 356 (discounting confidential sources),*and* New Jersey Carpenters Pension & Annuity Funds v. Biogen IDEC Inc., 537 F.3d 35 (1st Cir. 2008) ("[T]here must be a hard look at [the allegations of confidential sources] to evaluate their worth.").

[182] Wright, *supra* note 159.

[183] *See supra* pp. 369-70.

[184] Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research, *Securities Class Action Filings 2008: A Year in Review* at 1, 4 (Jan. 2009), *available at* http://securities.stanford.edu.

rules and regulations as the [SEC] may prescribe."[185] However, 10b5-1 plans provide executives with a safe harbor against prosecution for insider trading.[186] The crux of the 10b5-1 plan is that it "allows the actual liquidation transaction to occur while the plan participant is in possession of inside information, as long as the orders or instructions causing the trade were created as part of a plan that predates the insider's acquisition of the pertinent information."[187] It therefore requires executives to set a predetermined schedule for the liquidation of their holdings. This is designed to remove the element of control from the executive, such that if trades are predetermined, then the existence of insider information is irrelevant in the context of "manipulation" as mentioned in the Exchange Act.[188]

The rule is flawed, however, because it fails to address the command and control that the privileged executive maintains over factors, not categorized as inside information, which can affect stock prices.[189] For common investors who do not have access to inside information, the time to buy or sell is driven by personal speculation or solid research. However, the theory of Rule 10b5-1 is that for an executive whose holdings are in a 10b5-1 plan, the time to buy or sell has already been determined by the scheduled liquidation of the holdings, so inside information that becomes available is worthless. For the corporate officer who is able to exert sufficient control over the company, there are factors that can be influenced in order to make the price of a stock meet a predetermined plan, including the timing of the release of company information,[190] creative structuring of financial information,[191] and the manipulation of public expectations about stock price.[192] Each of these factors can and do affect market dynamics.[193]

In the wake of disproportionate executive compensation, Rule 10b5-1 has been the subject of much heated discussion. For instance, a simple and easy solution to 10b5-1 plan problems could be to require executives

[185] § 78j(b).

[186] *See* § 240.10b5-1(c).

[187] Muth, *supra* note 162, at 66.

[188] § 240.10b5-1(a).

[189] *See* Muth, *supra* note 162, at 75-76.

[190] *Id*. at 70.

[191] *Id*. at 73.

[192] *Id*. at 75.

[193] "Market dynamics describes the dynamic, or changing, price signals that result from the continual changes in both supply and demand of any particular product or group of products. Market dynamics is a fundamental concept in supply, demand and pricing economic models." *Market Dynamics*, INVESTOPEDIA, www.investopedia.com/terms/m/market-dynamics.asp (last visited Mar. 22, 2013).

to hold themselves accountable to the SEC by making their plan criteria known before implementing their plans.[194] Increased transparency would make it easier for authorities to police malfeasance associated with those tempted to circumvent Rule 10b5.

The PSLRA made it much more difficult for private securities litigants to sustain pleas and win cases. Though Rule 10b5 had originally been drawn to provide executives with lawful and sensible ways to tie compensation to performance,[195] the effect of the rule's safe harbor provision was to encourage executives to abuse the power of their positions to possibly manipulate information, thereby increasing compensation by attaining predetermined performance plans. The *Dodona* case, presented below, illustrates how manipulation of market dynamics allowed one firm to benefit from inside information at the expense of another.

### C. ASSESSING SCIENTER AND CONTROL PERSON LIABILITY: DODONA V. GOLDMAN SACHS

In 2012, Dodona, an institutional investor in residential MBS[196] issued as part of two synthetic collateralized debt obligations (CDOs),[197] filed a putative class action suit against Goldman Sachs, its subsidiary companies, and its officers alleging securities fraud and common law fraud.[198] The court's reasoning provides a clear roadmap of how to address the element of scienter in securities law violations pursuant to the Exchange Act.[199] It also addresses control person liability.

For the purposes of this discussion only, the following factual allegations are taken as true. By 2006, Goldman Sachs was "long" on

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[194] Muth, *supra* note 162, at 60.

[195] *See* Wines, *supra* note 44 for a full discussion on Rule 10b5-1 plans.

[196] "A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a[n] accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution." *Mortgage-Backed Security (MBS)*, INVESTOPEDIA, www.investopedia.com/terms/m/mbs.asp (last visited Mar. 22, 2013).

[197] "CDOs are unique in that they represent different types of debt and credit risk. In the case of CDOs, these different types of debt are often referred to as 'tranches' or 'slices'. Each slice has a different maturity and risk associated with it. The higher the risk, the more the CDO pays." *Collateralized Debt Obligation – CDO*, INVESTOPEDIA, www.investopedia.com/terms/c/cdo.asp (last visited Mar. 22, 2013).

[198] Dodona v. Goldman Sachs, 847 F.Supp.2d 624 (2012).

[199] The plaintiffs charged, and the court addressed, securities fraud under the Exchange Act, common law fraud, and unjust enrichment. Those charges, as well as the other elements of securities fraud, are outside the scope of this article. *See* Dodona, 847 F. Supp. at 636-652.

subprime mortgage-backed securities.[200] Also, by that time, Goldman realized that the subprime mortgage-backed securities market was doomed.[201] In response, Goldman embarked on a risk-reduction program. In December of 2006, Goldman's chief financial officer directed a reduction in Goldman's exposure in the subprime market, stating in an email that "Goldman should be 'aggressive' in shedding subprime assets, and predicting that 'there will be very good opportunities as the market goes [south] . . . and we want to be in a position to take advantage of them.'"[202] By August of 2007, Goldman informed the SEC that it had reduced its exposure to subprime mortgage-backed securities from $7.2 billion to $2.4 billion.[203]

One strategy Goldman employed to reduce risk was to stop going "long" in the subprime market and start acquiring "short" positions.[204] Along the way, Goldman created the synthetic Hudson CDOs,[205] which it took short positions on, then marketed to clients through a marketing book by declaring, through veiled language, that it was actually long on them.[206] In relevant terms, "Goldman's strategic shorting allowed it to profit from the loss in value in the Hudson CDOs."[207]

### *1. Scienter: Establishing Motive and Recklessness; More Like Res Ipsa Loquitur?*

Under the authority of the Exchange Act, "Dodona allege[d] 1) misrepresentations or omissions of material fact and 2) market manipulation."[208] Scienter, "a mental state embracing intent to deceive,

[200] A "long" position indicates that the investor believes the security is a good long-term investment.

[201] Dodona, 847 F.Supp. at 631.

[202] *Id.* at 632.

[203] *Id.* at 633.

[204] *Id.*

[205] Synthetic CDOs are essentially the opposite of CDOs. That is, while CDOs are based on pools of asset-backed securities, synthetic CDOs are merely derivative of the value of CDOs and are based on nothing more than the idea that the value of the CDOs might go down. Essentially, a synthetic CDO is a bet against CDO, used for leverage. *See Goldman's Abacus: The Difference Between a CDO and a Synthetic CDO*, SEEKING ALPHA (Apr. 22, 2010, 2:56 PM), http://seekingalpha.com/article/200264-goldman-s-abacus-the-difference-between-a-cdo-and-a-synthetic-cdo.

[206] Dodona, 847 F.Supp. at 634 (the Marketing Book reported that "Goldman ha[d] aligned incentives with the Hudson program by investing in a portion of equity and playing the ongoing role of Liquidation Agent.").

[207] *Id.* at 635.

[208] *Id.* at 636.

manipulate, or defraud,"[209] was a necessary element for Dodona to prove in both allegations. In accordance with the PSLRA, private litigants such as Dodona are required to plead a "strong inference" of scienter, which means that plaintiffs must allege *with particularity* either (a) "facts to show that the defendant had both motive and opportunity to commit fraud[;]" or (b) "facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness."[210] With regard to corporations and corporate officers, courts assume that opportunity to commit fraud exists.[211] However, motives that normally incent corporate officers generally do not establish scienter.[212] In order to prove scienter, then, on the part of Goldman or its officers, Dodona had to show strong circumstantial evidence of conscious misbehavior or recklessness. Such evidence may exist where the plaintiff can show "conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."[213] In terms of the Hudson CDOs, Dodona would sufficiently plead scienter by showing that Goldman had access to information contradicting the statements in its marketing book.[214]

Difficulties in proving scienter in private litigation of securities law violations under the Exchange Act relate to the requirement that the plaintiff plead *with particularity* that a corporate officer either 1) had motive to defraud, or 2) bore the requisite conscious recklessness related to the commission of a fraud. Not every case will have the type of smoking gun evidence, such as the emails from Goldman Sachs, present in *Dodona*; and even where this evidence does exist, *Dodona* shows that implicating control persons is difficult given the current pleading standards. In public actions, the SEC is permitted to plead scienter to a lower standard than in private matters governed by the PSLRA. There is strong rationale for extending these lower standards to private actions.

[209] Tellabs, 551 U.S. at 319.

[210] Dodona, 847 F.Supp. at 638 (quoting Kalnit v. Eichler, 264 F.3d 131, 138 (2d Cir. 2001)).

[211] *Id*.

[212] *Id*.

[213] Kalnit, 264 F.3d at 142.

[214] *Id.* (quoting Novak v. Kasaks, 216 F.3d 300, 308 (6th Cir. 1999)).

### *2. Control Person Liability: Culpable Participation via the Corporate Ethos*

Section 20(a) of the Exchange Act imposes derivative liability on controlling persons for the actions of controlled persons, "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[215] A plaintiff must "show that the controlling person was in some meaningful sense [a] culpable participant[ ] in the fraud perpetrated."[216]

Difficulties associated with claiming derivative control person liability in the context of private claims of securities law violations not only suffer under the higher PSLRA-dictated standards of pleading, but also under the near impossibility of proving that a corporate officer maintained direct and timely control over, or was a culpable participant in, the fraud perpetrated. In the case of Goldman's chief financial officer who sent the email stating that "Goldman should be aggressive in shedding subprime assets, and predicting that there w[ould] be very good opportunities as the market [went south]],"[217] no rational person could fail to understand the subtext of the message; that Goldman's costly holdings should be dumped on unassuming investors and that Goldman would make a lot of money in the process. But while the rational person is the standard by which courts almost universally discern rightful conduct, in the case of establishing control person liability, the subtext of the email is meaningless. Without being able to plead with particularity, and then attempt to prove, the specific actions that sprang from that email, the private securities litigant will fail to ascribe liability to the author of that email under current securities law.

*Dodona* provides a glimpse into the complexities of post-Subprime Crisis securities fraud litigation. Claims filed against Goldman Sachs benefit from the fairly widely-held understanding of the factual allegations described above.[218] The example of the Hudson CDOs outlined for this discussion is just one of several similar schemes employed by Goldman Sachs between 2006 and 2007 during its "risk-

[215] 15 U.S.C. § 78t.

[216] § 78t.

[217] Dodona, 847 F. Supp. at 632.

[218] Goldman Sachs has been sued several times on several different mortgage-related securities claims relating to CDOs, including ABACUS 2007 AC-1, Hudson Mezzanine Funding 2006-1, The Anderson Mezzanine

Funding 2007-1, and Timberwolf I. *See, e.g.*, Richman v. Goldman Sachs Group, Inc., 868 F. Supp. 2d 261 (S.D.N.Y. 2012).

reduction" period.[219] The high-profile nature of the firm and its well-documented alleged violations of securities laws raise the issue why its top management has not been the subject of more serious litigation efforts by private parties.

One explanation is offered above: because of corporate structural complexities that, by design, protect the interests of corporate officers even to the detriment of shareholders and clients, there is no way to tie control persons as culpable participants to malfeasance conducted by subservient employees. However, in a civil society, where justice is the end of the government, the solution to the problem of such unjust results must be a novel response by government itself. *Hertz* has provided courts with guidance as to where to find command and control, and the doctrine of corporate criminal liability reflects an understanding that every corporation has its own ethos. The next logical step for Congress and the judiciary to take is to impute corporate officers, those with whom the architecture of corporate ethos lies, with ultimate liability for decisions the corporation makes at the expense of the common good.

### D. LEGISLATORS: DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

Legislators have begun to take aim at solutions. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is the most comprehensive set of financial regulations since the Banking Act of 1933.[220] The lofty goals and massive scope of Dodd-Frank inform its full title: "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial practices."[221] Dodd-Frank, simply put, affects every aspect of the financial services industry by overhauling the American financial regulatory environment. Most aspects of Dodd-Frank are beyond the scope of this Comment, but several sections are relevant to the recommendations below.

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[219] *Id.*

[220] See James S. Henry & Laurence J. Kotllikoff, *Financial Reform, R.I.P.*, FORBES (Jul. 15, 2010, 1:20 PM), www.forbes.com/2010/07/15/dodd-frank-failure-regulation-opinions-contributors-james-henry-laurence-kotlikoff-wall-street.html, for a discussion of the magnitude of the Dodd-Frank legislation.

[221] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (Westlaw 2014) (codified at 15 U.S.C. § 78o).

The Volcker Rule, under Title VI, is a modern-day corollary of the Glass-Steagall provisions of the Banking Act.[222] In the simplest terms, it provides a partial prohibition on proprietary trading[223] by separating banking institutions from the types of risky, complex, and ethically questionable incentives that allegedly drove Goldman Sachs' conduct with regard to the type of trading exemplified in *Dodona*. The Executive Compensation Clawback Full Enforcement Act of 2012 (Clawback Act),[224] which died in committee, nonetheless represented a novel legislative approach that is worthy of further consideration. Also, it is worth noting that the Investor Protection and Securities Reform Act of 2010 (Investor Protection Act), under Title IX, subtitle E, specifically addresses accountability alongside executive compensation.[225]

### *1. Volcker Rule: A Ban on Proprietary Trading*

The Volcker Rule bears the imprimatur of its author,[226] who previously argued that commercial banks provide stability for the greater financial system and that schemes such as derivatives trading, which involve high-risk speculative investing, pose an impermissible level of systemic risk.[227]

The proposed Volcker Rule would have resulted in a complete ban on proprietary trading, but in order to gain passage through Congress, allowances were granted that weakened the bill considerably, which may indicate that Congress has failed to grasp the implications of its responsibility to the people, rather than to corporate interests. The

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[222] *See* Louis Uchitelle, *Glass-Steagall vs. the Volcker Rule*, N.Y. TIMES ECONOMIX (Jan. 22, 2010, 4:47 PM), http://economix.blogs.nytimes.com/2010/01/22/glass-steagall-vs-the-volcker-rule/ (discussing the similarities between how Glass-Steagall and the Volcker Rule are both regarded as fixes to major causes of the two large crises).

[223] *Proprietary Trading*, FINANCIAL TIMES LEXICON, http://lexicon.ft.com/term?term=proprietary-trading (last visited Jun. 14, 2014) ("When a bank, brokerage or other financial institution trades on its own account rather than on behalf of a customer . . . . In simple terms, proprietary or prop trading is where a trading desk, using the bank's own capital and balance sheet, carries out trades in various instruments, often for speculative purposes.").

[224] H.R.5860, 112th Cong. (Westlaw 2014), *available at* www.doddfrankupdate.com/Resource.ashx?sn=ExecutiveCompensationClawbackFullEnforcementAc2012 [hereinafter *Clawback*].

[225] Pub. L. No. 111-203, §§ 951-957 (Westlaw 2014).

[226] Paul Volcker is an economist and former Chairman of the United States Federal Reserve. *See Paul Volcker Fast Facts*, CNN (Jan. 30, 2013, 6:39 PM), www.cnn.com/2013/01/30/us/paul-volcker-fast-facts.

[227] *See* Paul Volcker, *How to Reform Our Financial System*, N.Y. TIMES, www.nytimes.com/2010/01/31/opinion/31volcker.html?pagewanted=all (last visited Feb. 8, 2013).

Volcker Rule was aimed at precisely the type of institutional behavior exemplified in the discussion of *Dodona*. In fact, Volcker would have preferred a much simpler bill, saying, "I'd love to see a four-page bill that bans proprietary trading and makes the board and chief executive responsible for compliance. And I'd have strong regulators. If the banks didn't comply with the spirit of the bill, they'd go after them."[228]

*2. Clawback Act: A Novel Legislative Approach*

In 2012, Representative Barney Frank drafted the Clawback Act, the stated purpose of which was "to prohibit individuals from insuring against possible losses from having to repay illegally-received compensation or from having to pay civil penalties."[229] Insurance brokerages in 2011 launched new products through which executives could protect themselves from claw-back settlements due to non-fraud-related violations for which they were deemed personally liable.[230] When Frank introduced the bill to the House, he stated "the creation of insurance policies to insulate financial executives from claw-backs is one more effort by some in the industry to perpetuate a lack of accountability."[231] The Clawback Act, if adopted, would have essentially forced executives to pay judgments out of pocket, rather than being able to pay premiums to cover judgments in the events of findings of accountability.

The specific language Frank used illustrates the broad effects he hoped to achieve by introducing the bill:

> (a) an officer, director, employee, or other institution-affiliated party of a depository institution, depository institution holding company, or nonbank financial company who is required by the Federal financial regulatory law that provides for personal liability, or any rule or order promulgated by a Federal financial regulatory agency thereunder, to repay previously earned compensation or pay a civil money penalty– (1) shall be personally liable for the amounts so owed; and (2) may not, directly or indirectly, insure or hedge against, or otherwise

[228] *See* James Stewart, *Volcker Rule, Once Simple, Now Boggles*, N.Y. TIMES, www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?pagewanted=all&_r=0 (last visited Feb. 8, 2013).

[229] Clawback, *supra* note 224.

[230] *See* Alexandra Alper & Ben Berkowitz, *Representative Frank Offers Bill to Bar Insurance on Claw-Backs*, REUTERS(May 30, 2012), http://reuters.com/assets/print?aid=USBRE84T15720120530.

[231] *Id.* (quoting Rep. Frank).

> transfer the risks associated with, personal liability for the amounts so owed.[232]

The Clawback Act, if adopted, would have had the capacity to reach into every type of regulated financial institution in the United States to touch any employee found to have been personally liable in contravention of "Federal financial regulatory law that provides for personal liability, or any rule or order promulgated by a Federal financial regulatory agency thereunder."[233] The Bill specifically defined Federal financial regulatory law as most major banking laws, including in relevant parts ". . . (C) the Dodd-Frank Wall Street Reform and Consumer Protection Act . . . and (Q) the securities laws (as defined under section 3(a) of the Securities Exchange Act of 1934), to the extent that such laws apply to depository institutions, depository institution holding companies, or nonbank financial companies."[234] The Clawback Act would have extended to personal liability resulting from all types of remunerative measure, and such a deterrent might have prevented the Subprime Crisis.

That one of Congress' higher profile representatives would actually draft and propose a bill such as the Clawback Act offers promise that, at the very least, the legislature is considering anew remedies as to corporate officers. There is no guarantee that a law such as the one proposed would have actually impacted the behavior of corporate officers, but in the current economic climate, it is this type of new thinking that will be required to affect real change.[235] It would have forced executives to consider the full magnitude of their actions, to fully embrace the possibility that they might be held personally liable for losses incurred in their professional duties. However, the failure of Congress to pass the Clawback Act illustrates the continuing need for legislative action in the area of executive liability.

### *3. Investor Protection Act: Accountability and Executive Compensation*

The Investor Protection Act forms Title VI of the Dodd-Frank Act. Its main purpose is to amend the powers and structure of the SEC in

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[232] Clawback, *supra* note 224, at §§ 2(a) & (b).

[233] § 2(a).

[234] § 5.

[235] *See Bill Summary & Status, 112th Congress (2011 - 2012), H.R.5860*, THOMAS, http://thomas.loc.gov/cgi-bin/bdquery/z?d112:hr5860: (last visited March 22, 2013); *see alsoH.R. 5860 (112th): Executive Compensation Clawback Full Enforcement Act*, GOVTRACK, www.govtrack.us/congress/bills/112/hr5860 (last visited Feb. 8, 2013).

order to better delineate the acceptable relationships between consumers and broker-dealers or investment advisers.[236] Subtitle E specifically addresses the need for the SEC to define issues surrounding accountability and executive compensation.

Among the measures contained under subtitle E are reporting requirements about executive compensation,[237] periodic shareholder voting opportunities for approval of executive compensation packages,[238] oversight of Golden Parachutes,[239] accounting provisions related to the ratios between CEO compensation and average employee compensation,[240] permissibility of special compensation plans involving hedging financial instruments,[241] and rules about who may occupy seats on Compensation Committees.[242] Subtitle E also requires covered companies to be ready to disclose information on all incentive-based compensation packages to regulators for the purposes of determining whether they pose significant risk of loss to the company or reflect excessive compensation for the employee.

Through subtitle E, the Investor Protection Act attempts to address by legislation and regulation many of the concerns surrounding the important issue of executive compensation. However, the provisions are too vague because they propose only dates for compliance by the SEC to fulfill its obligations, rather than hard rules, and also fail to address enforcement and penalties associated with violations of the provision. While they have not all been implemented, together the Volcker Rule, Clawback Act, and Investor Protection Act reflect Congressional intent to reduce risky behaviors on the part of executives by increasing their exposure to liability.

### E. REGULATORS:CONSUMER FINANCIAL PROTECTION BUREAU

*Ex post* prudential regulation has proven an inadequate measure in effectuating behavioral change at the upper levels of management.[243] In

[236] Pub. L. No. 111-203, §§ 951-957 (Westlaw 2014).

[237] § 953.

[238] § 951.

[239] § 954.

[240] § 956.

[241] § 955.

[242] § 952.

[243] *See generally* Elisa Kao, *Moral Hazard During the Saving and Loan Crisis and the Financial Crisis of 2008-2009: Implications for Reform and the Regulation of Systemic Risk Through Disincentive Structures to Manage Firm Size and Interconnectedness*, 67 N.Y.U. ANN. SURV. AM. L. 817 (2012) (providing a general overview of systemic risk and traditional regulatory practices).

fact, as the previous discussion of Rule 10b5-1 shows, regulations can be reinterpreted to provide unintended benefits to those meant to be regulated. The government would best serve the interests of common investors by establishing a broad policy of deterrence aimed at the C-level suites of financial institutions. The recently established and independently operated CFPB[244] already drafts legislation and works directly with consumers,[245] so it is uniquely positioned to efficiently and substantially implement this policy of deterrence.

The CFPB is "the most powerful agency in the history of American politics . . . a stand-alone agency, allow[ed] to write any regulation it wants, to sue anybody it wants, under broadly delegated powers without any oversight from anybody."[246] The Bureau's jurisdiction largely preempts state agency jurisdiction, which means that covered persons in all 50 states are subject to the Bureau's jurisdiction,[247]and most consumer financial products and services that relate to the capacity of corporate officers are currently included under the Bureau's jurisdiction.[248] Its authority to collect information extends to requiring filing of special reports "or answers to specific questions, and to make public such information as is in the public interest."[249]

The CFPB's modern internet platform gives consumers direct lines of communications with the agency. These are channels that open to the consuming public when complaints are logged, and if enough people join together, the CFPB has the discretionary power to file an inquiry on their behalf. Never before has the consumer had such unfettered access to the investigative and prosecutorial power of the federal government against malfeasants whose behavior has reaped so much damage. Never has the consumer been so empowered to lead the discussion on what might be the best avenues for regulation of malfeasance within the sector.

One thing is clear: the traditional role of government as regulator must evolve to more fully impact toxic influences in the financial system. The long-term effects of the Subprime Crisis are the subject of ongoing debate. While every crisis is identifiable by its distinct causes and effects, each of America's financial crises has been enabled by

[244] H.R. 3126, 111th Cong. (Westlaw 2014).

[245] *Will Consumers and the Economy Benefit from the Consumer Financial Protection Bureau*, Discussion from The Federalist Society's 2011 National Lawyers Convention, 15 J. CONSUMER & COM. L. 86, 87 (2012) (statement of Leonard Kennedy, General Counsel, CFPB).

[246] *Id*. at 3 (statement of Todd Zywicki, Professor of Law, George Mason University School of Law).

[247] *Id*.

[248] *Id*. at 106.

[249] *Id*. at 208.

combinations of factors that include investor overconfidence, investor ignorance, systemic risk, and a regulatory environment purposely relaxed by government legislation.[250] The CFPB is charged with monitoring consumer confidence and given the responsibility of looking ahead for risky products and services.[251] Through its close connection to the consuming public,[252] its budgetary independence,[253] and its mandate to create new powers for itself,[254] the CFPB is uniquely positioned to implement the recommendations discussed below.

## III. RECOMMENDATIONS

Part Three advocates securities industry self-regulation through a policy of deterrence, to be facilitated through novel interpretations of the doctrine of corporate civil liability and the legal concepts of scienter and control person liability. A policy of deterrence would address the root cause of financial crises: the ease with which executives, insulated from both the consuming public and legal consequences, can operate with impunity within the confines of highly complex corporate structures. Just as "an ounce of prevention is worth a pound of cure,"[255] so too is a new policy of deterrence the most productive means by which the government of the people can protect itself against the next conflagration of corporate financial malfeasance.

Specifically, this part advances in three subparts. First, it advocates that Congress reform the PSLRA to state a lower standard for pleading scienter in civil cases of securities fraud. Second, it argues that the CFPB is the regulatory agency best suited to represent the interests of consumers in the financial services industry, and it advocates for the CFPB to establish consumer-friendly access to courts, such that private litigants will feel more empowered to use the court system to find remedies. Within the context of the CFPB, this Comment argues that consumers should specifically focus on corporate officers by pursuing control person liability. Class-action lawsuits against individual executive defendants would enable common investors, for whom individual litigation would involve prohibitive costs, to join as classes to

[250] *See* Kao, *supra* note 243, at 821-828.

[251] H.R. 3126.

[252] *Id.*

[253] *Id.*

[254] *Id.*

[255] "An ounce of protection is worth a pound of cure" is attributed to Benjamin Franklin in his capacity as founder of the Philadelphia Union Fire Company in 1736. PHILADELPHIA FIRE DEPARTMENT, EMS HISTORY (2013).

gain remuneration from executives whose compensation was directly related to broad economic losses. Third, this section encourages Congress to draft another Clawback Bill and then quickly to enact it.

### A. AMEND THE PRIVATE SECURITIES LITIGATION REFORM ACT: STATE A LOWER STANDARD FOR PLEADING SCIENTER

Legislators should amend the PSLRA in order to ease pleading standards for private investors so as to better facilitate their ability to pursue remedies. Specifically, Congress should amend the clause—"state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"[256]—by eliminating the words *with particularity* and *strong*.

The functional result of this change would be to shift the burden of proof from plaintiff to defendant. This would force defendants to disclose facts, thereby relieving courts of having to interpret the relevant strength of various facts provided by plaintiffs who do not have the benefit of a thorough fact finding investigation at the pleading stage. Although the goal of the PSLRA in 1995 was to reduce frivolous lawsuits, the current *too large for trial* climate justifies a reevaluation of how class-action suits can best serve the consumers who have suffered the largest share of economic loss.

The PSLRA worked well in achieving one of its twin goals, protecting business, but made it nearly impossible for classes of honest consumers to even initiate private litigation.[257] The judiciary has been moving slowly in favor of plaintiffs; the legislative branch should take notice of the direction of the courts and adjust pleading standards accordingly.

### B. EMPOWER COMMON INVESTORS TO PURSUE LITIGATION: DEFINING THE IDENTITY OF THE CONSUMER FINANCIAL PROTECTION BUREAU

The Consumer Financial Protection Bureau should seize on its mandate to assert "independent authority under the Dodd-Frank Act . . . [over] banking organizations with assets of $10 billion, with respect to which the Bureau [has] exclusive rulemaking[,] examination, and primary enforcement [] authority under Federal consumer financial

[256] Pub.L. 104-67.

[257] *See* discussion *supra* Part II.B.I.

law."[258] Specifically, the Bureau should take the initiative to identify the financial institutions that caused the most damage to the system and focus its powers on filing class-action suits on behalf of consumers against those institutions' corporate officers.

*1. Narrow Focus on the C-Level Suites*

If consumers seek to assign liability where it truly belongs, and if they have a real capacity to dictate the terms of investigations and prosecutions, then they should begin to focus on the executives whose decisions were the most devastating, and whose compensation are the most ill-gotten. Golden parachutes allowed failed executives to escape failed companies without accountability. Consumers would be well-served to utilize the broad powers of the CFPB to ensure control person accountability.[259]

*Hertz* established that command and control dictate jurisdiction. U.S. Attorney Preet Bharara advocated a *corporate culture approach* to assigning blameworthiness, declaring that corporate ethos can be identified as a surrogate in the absence of an identifiable actor within the artificial entity that is a corporation. Because corporate ethos is shaped within command and control centers, this is where litigants should focus their energies.

*2. Advocate Class-Action Suits Against Individual Executives*

Through the CFPB, common investors should form classes to pursue remuneration from individual executives whose unjustifiable risk-taking damaged the economy so deeply. Private lawsuits by consumers often amass into class-action lawsuits against corporations, but under such circumstances, the settlements that are reached are either too small to affect the corporate identity or so large that they destroy the company. With every destroyed company, there is a cost in terms of shareholder value destruction and job losses.

It would therefore be both rational and feasible for the CFPB to pursue class-action suits against individual executives. Where a single litigant might fail against an executive defendant based purely on cost-analyses basis to both parties, a class of litigants would likely not be

[258] *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010*, 2010 WL 3417176 105 (Westlaw 2014).

[259] *See generally How we use complaint data*, CONSUMER FINANCIAL PROTECTION BUREAU, www.consumerfinance.gov/complaint/data-use/ (last visited Jun. 14, 2014) (providing a general overview of how the CFPB responds to consumer complaints).

dissuaded from a claim simply because an executive might have funds to draw out proceedings. Hence, class-action suits against executives would provide remedies without the destruction of companies and corporations as a matter of course. Intensified focus on control person liability best serves the interests of both consumers and corporations.

### C. ADOPT THE EXECUTIVE COMPENSATION CLAWBACK FULL ENFORCEMENT ACT IN THE SPECIFIC CONTEXT OF CLASS-ACTION LAWSUIT LIABILITY

It is time for Representative Frank's Clawback Act to be resuscitated and adopted. There is no reason that executives who are found liable in civil cases should be able to mitigate their personal losses and further spread the cost to the public by using insurance. If top executives realize that private individuals can more easily plead their way into court, can work with the CFPB to build cases, and can come together in classes ready to sue for compensation earned and punitive damages, a fully armed Clawback Act would give them pause to look before they leap.

Finally, in order to allow consumers to fully realize the benefits of the above proposals, the judiciary must reinterpret the relationships between corporations, their shareholders, and their clients. Courts should embrace the realist model of corporate structure, which acknowledges that corporate officers control the fate of corporations without accountability to shareholder interests. The judiciary should model its interpretation of modern corporate civil liability on historical analysis of corporate criminal liability, thereby establishing a workable modern doctrine based on the command and control interests espoused in *Hertz*, placing liability where it rightfully belongs.

## CONCLUSION

This Comment recognizes that corporations are essential to the vitality of the U.S. economy. In light of their prominent role, it is now more important than ever that the image of corporations be resuscitated. But a corporate image can only reflect the value of its officers, and when officers can take risks without attendant liability, they can hardly be blamed for doing so. The law must acknowledge the unsustainable paradox of current corporate civil liability doctrine, and in accordance with the above recommendations, re-focus liability more intensely upon C-level executives.