UNFIT FOR DUTY: THE OFFICER AND DIRECTOR BAR AS A REMEDY FOR FRAUD

*Renee M. Jones**

I. INTRODUCTION

Until recently, scholars regarded the Securities and Exchange Commission (SEC) as a model administrative agency.[1] Its haloed reputation began to fade, however, as a series of catastrophes jolted the corporate world at the turn of the 21st century. The Enron and WorldCom scandals, the internet bubble collapse, the subprime mortgage crisis, and Bernie Madoff's brazen and long-running Ponzi scheme all revealed weaknesses within the agency that a high profile enforcement agenda had helped to mask.

The SEC has drawn criticism not only for failing to detect or prevent these catastrophic frauds, but also for its ineffective post-crisis response. Much of this criticism focuses on the efforts of the agency's enforcement division.[2] Although the SEC's website boasts that it has brought actions against 157 financial firms, including charges against 66 senior executives, and extracted more than $2.6 billion in penalties and other forms of monetary relief,[3] closer scrutiny reveals that no senior executive of a failed or bailed out firm has personally paid penalties,[4] and no high-level executive has been charged with a crime.[5]

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1. *See, e.g.*, BREYER ET AL., ADMINISTRATIVE LAW AND REGULATORY POLICY 62 (6th ed. 2006).

2. *See* Ross MacDonald, Note, *Setting Examples, Not Settling: Toward a New SEC Enforcement Paradigm*, 91 TEX. L. REV. 419, 435 (2012) (asserting that the Commission is "failing miserably").

3. *See SEC Enforcement Actions Addressing Misconduct that Led to or Arose from the Financial Crisis*, SEC, http://www.sec.gov/spotlight/enf-actions-fc.shtml (last visited June 12, 2013).

4. Two exceptions to this assertion are discussed *infra* Part III.

5. Mary Kreiner Ramirez, *Criminal Affirmance: Going Beyond the Deterrence Paradigm to Examine the Social Meaning of Declining Prosecution of Elite Crime*, 45 CONN. L. REV. 865, 868 (2013) (noting that the Justice Department has not criminally charged any of the key officers or managers of the financial institutions deemed 'too big to fail'); *see also* James Ridgeway, *How to Put Wall Street CEOs in Prison*, MOTHER JONES (Mar. 8, 2011, 1:59 PM), http:// http://www.motherjones.com/mojo/2011/03/how-put-wall-street-ceos-prison (quoting Charles Ferguson, Oscar winning director of the documentary film "Inside Job": "Forgive me, I must start by pointing out that three years after a horrific financial crisis caused by fraud, not a single financial executive has gone to jail—and that's wrong.").

The response of federal officials to the 2008 financial crisis contrasts starkly with the approach after the 2001–2002 accounting scandals. In that round, a number of top executives faced trial, and prosecutors won convictions against Dennis Kozlowski, Kenneth Lay, Jeffrey Skilling, and Bernard Ebbers, among others.[6] Although the SEC dragnet spared the directors of WorldCom and Enron, private plaintiffs pursuing securities fraud claims extracted unprecedented personal payments from outside directors of these firms.[7]

Much of the recent criticism of the SEC's enforcement efforts has focused on its practice of allowing large financial firms (many of which are repeat offenders) to settle SEC charges without admitting or denying liability.[8] Of equal concern is the agency's failure to identify or punish the individuals responsible for corporate misdeeds. A number of problems stem from these routine SEC settlement practices.[9] First, critics argue that settling cases without identifying culpable individuals deprives the public of information about who is responsible for the collapse of the too-big-to-fail firms.[10] Such opacity prevents institutions and investors from protecting themselves against future financial harm.[11] Others worry that the lack of personal accountability renders the securities laws ineffective in deterring fraud.[12] From a retributive perspective, the absence of personal penalties allows corporate officials to avoid facing any consequence for their transgressions and deprives the public of the opportunity to express disapproval of their conduct.[13] Finally, many fear that the SEC's practice of settling cases without a full accounting of responsibility undermines public confidence in

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6. *See* Ramirez, *supra* note 5, at 884 & n.77.

7. *See* Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105, 155 (2006); Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1129 (2006).

8. SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 332 (S.D.N.Y. 2011) (criticizing the SEC's "long standing policy, hallowed by history but not by reason," of allowing defendants to settle SEC charges without admitting liability); SEC v. Bank of Am. Corp., Nos. 09 CIV. 6829 (JSR), 10 Civ. 0215 (JSR), 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010) (questioning the propriety of the proposed SEC settlement with Bank of America); Samuel W. Buell, *Liability and Admissions of Wrongdoing in Public Enforcement of Law*, 82 U. CIN. L. REV. 504, 508–13 (2013).

9. *See* MacDonald, *supra* note 2, at 435.

10. Buell, *supra* note 8, at 513; *Citigroup*, 827 F. Supp. 2d at 335 ("[T]here is an overriding public interest in knowing the truth. . . . [T]he SEC, of all agencies, has a duty, inherent in its statutory mission, to see that the truth emerges; and if it fails to do so, this Court must not, in the name of deference or convenience, grant judicial enforcement to the agency's contrivances.").

11. Buell, *supra* note 8, at 13.

12. MacDonald, *supra* note 2, at 444; Ramirez, *supra* note 5, at 921.

13. Ramirez, *supra* note 5, at 930; Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 951–52 (1995) (discussing how the social meanings attached to various actions create a framework of understanding within which individuals live).

government.[14]

For these reasons, commentators have called on the SEC and the Justice Department to bring more cases against the individuals who led the failed financial firms to ruin. They worry that only a credible threat of prison time or severe monetary sanctions can deter corporate executives from excessive risk-taking and fraud. Although such concerns are valid, this Article focuses on another enforcement tool that has received less scholarly attention: the power to bar officers and directors of public companies from future service in such roles.

The SEC has long had the power to obtain federal court orders barring individuals who violate the antifraud provisions of the federal securities laws from future service as officers or directors of public companies. Although Congress recently expanded the agency's power in this realm, the SEC seldom pursues bars against directors or senior executives of large firms. This Article argues that if the SEC pursued bars more regularly, it could better motivate executives and directors to heed their obligations under the federal securities laws. Such a strategy should also spur directors to perform more responsibly the enhanced oversight duties imposed by Sarbanes–Oxley and Dodd–Frank.[15]

The proposal for increased use of the officer and director bar should sidestep concerns expressed by some commentators about the fairness of director liability schemes under corporate and securities laws. Some scholars maintain that it is unfair to hold directors liable for accounting frauds spearheaded by the managers they oversee.[16] They claim the mere prospect of such liability would deter capable directors from serving.[17] These concerns have prompted judges and legislators to erect a veritable bulwark against director liability under state and federal

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14. Buell, *supra* note 8, at 513; Luis Aguilar, SEC Commissioner, Taking a No-Nonsense Approach to Enforcing the Federal Securities Laws, Remarks at Securities Enforcement Forum 2012 (Oct. 18, 2012), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171491510#_edn6 (citing statistics showing that "61% of investors have no confidence in government regulators"); *see generally* Matt Taibbi, *Why Isn't Wall Street In Jail?*, ROLLING STONE (Feb. 16, 2011), *available at* http://www.rollingstone.com/politics/news/why-isnt-wall-street-in-jail-20110216 (asserting that "federal regulators and prosecutors have let banks and finance companies that tried to burn the world economy to the ground get off with carefully orchestrated settlements") [hereinafter Taibbi, *Wall Street Jail*]; Matt Taibbi, *Bank of America: Too Crooked to Fail*, ROLLING STONE (Mar. 14, 2012), *available at* http://www.rollingstone.com/politics/news/bank-of-america-too-crooked-to-fail-20120314.

15. This article builds on earlier work that addresses weaknesses in the enforcement system for directors' fiduciary duties. *See* Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model of Directors' Duties of Oversight*, 45 VAND. J. TRANSNAT'L L. 343, 343–44 (2012); Jones, *supra* note 7, at 113–17.

16. *See, e.g.*, Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 976, 982–85 (2009) (arguing for a high bar for director liability for risk management failures).

17. *See, e.g.*, Black et al., *supra* note 7, at 1140–41 (stating "a significantly higher level of risk for outside directors could well deter good candidates from serving and make directors who do serve excessively cautious and process-conscious").

law.[18]

These standard arguments against director liability do not apply with equal force to the proposed policy of removing culpable directors from positions in which they might cause further harm to public investors. Indeed, a common argument against director liability is that the fair and natural consequence for director oversight failures is the loss of future professional opportunities that stems from one's association with corporate mismanagement or fraud.[19] However, anecdotal and empirical data suggest that the purported reputational harm does not keep directors from continuing to occupy fiduciary positions at public companies.[20] Therefore, a policy that bars directors whose oversight failures lead to catastrophic financial harm seems an appropriate means for ensuring the natural consequences that market forces have failed to effect.[21]

This Article therefore argues that the SEC should more regularly seek to bar senior executives and outside directors of corporations impacted by fraud. It shows that astronomical corporate penalties and the remote prospect of criminal prosecution have failed to deter corporate officials from making reckless decisions or abiding fraud. After laying out the case for the increased use of bar orders, the Article recommends changes to the SEC's enforcement strategies that could help the agency improve its success rate when seeking bar orders in court. The Article proceeds as follows. Part II takes on traditional deterrence theory and demonstrates that the threat of jail and ever increasing monetary penalties have failed to deter corporate officials from committing fraud. It then draws on criminal and psychological research to argue that modest penalties commensurate with a defendant's degree of culpability

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18. *See* Jones, *supra* note 7, at 115.

19. Black et al., *supra* note 7, at 1135.

20. For anecdotal accounts, *see Former Enron Directors Then and Now*, WASH. POST (June 6, 2006), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/06/01/AR2006060101852.html (reporting on former Enron directors who continued to serve on other public company boards); Louis Lavelle, *Enron Directors: Unfit to Serve Anywhere?*, BUSINESSWEEK (Feb. 11, 2002), *available at* http://www.businessweek.com/stories/2002-02-11/enron-directors-unfit-to-serve-anywhere (reporting on efforts by shareholder activists to unseat former Enron directors from other corporate boards); Steven M. Davidoff, *Despite Worries, Serving at the Top Carries Little Risk*, N.Y. TIMES (June 7, 2011), *available at* http://dealbook.nytimes.com/2011/06/07/despite-worries-serving-at-the-top-carries-little-risk (noting that directors of failed financial firms continue to serve as directors of other public companies). For an empirical investigation into the same matter, see Steven M. Davidoff et al., *Do Outside Directors Face Labor Market Consequences? A Natural Experiment from the Financial Crisis*, HARV. BUS. L. REV. (forthcoming 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2200552 (concluding "[t]here does not appear to be a viable labor market for outside directors to sufficiently motivate them to act in the way that regulators and perhaps shareholders may wish them to").

21. In a similar vein, Lyman Johnson recently recommended that Congress authorize bankruptcy courts to debar "faithless fiduciaries" from occupying leadership positions in corporate organizations. *See* Lyman Johnson, *Debarring Faithless Corporate and Religious Fiduciaries in Bankruptcy*, 19 AM. BANKR. INST. L. REV. 523 (2011).

would be more effective in encouraging compliance with law. Part III outlines the existing law governing the SEC's power to impose officer and director bars. It shows that, despite the agency's campaign for expanded powers in this realm, it has been reluctant to seek bars against directors and high-level executives of prominent firms. This Part invokes the example of a lesser-known Enron fraud and the facts of the financial crisis to show that director oversight failures have been a contributing factor in many of the last decade's headline-grabbing corporate disasters. Part IV lays out the case for broader utilization of the officer and director bar. It argues that the SEC should investigate director conduct in cases of significant corporate fraud or failure and seek bars in instances of gross dereliction of duty. It also addresses anticipated objections to this proposal.

II. THE FAILURE OF TRADITIONAL PENALTIES TO DETER FRAUD

The stock response from lawmakers to corporate and financial scandals has been greater criminalization of corporate and securities laws. After WorldCom and Enron, Congress created a slew of new corporate crimes and increased criminal and civil penalties for fraud.[22] Congress also expanded the SEC's enforcement powers and significantly increased the agency's budget.[23] The size of monetary settlements in SEC enforcement actions grew significantly after Sarbanes–Oxley, and continued to soar after the 2008 financial collapse.[24]

For example, in a record-setting settlement, Bank of America paid $150 million to settle allegations that it misled investors in disclosures related to its acquisition of Merrill Lynch.[25] Soon thereafter, Goldman Sachs agreed to pay $550 million to settle claims brought over its flawed disclosure in the Abacus CDO transactions.[26] Finally, Citigroup agreed to a $285 million settlement of SEC charges that it fraudulently pawned off worthless mortgage backed securities on investors.[27]

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22. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it Might Just Work)*, 36 CONN. L. REV 915, 969–77 (2003) (cataloging new criminal provisions).

23. *See Cut Proposed for SEC Budget*, L.A. TIMES, Dec. 2, 2003 ("After accounting scandals at Enron Corp. and WorldCom Inc., Congress increased the SECs budget about 70% in fiscal year 2003.").

24. *See* Top Ten SEC Settlements, NERA Economic Consulting, Securities Litigation Trends, *available at* http://www.securitieslitigationtrends.com/top10.asp (reporting post Sarbanes–Oxley SEC settlements ranging from $310 million to $800 million).

25. Louise Story, *Judge Accepts SEC's Deal with Bank of America*, N.Y. TIMES (Feb. 22, 2010), *available at* http://www.nytimes.com/2010/02/23/business/23bank.html.

26. Press Release, SEC, Goldman Sachs to Pay Record $550 million to settle SEC Charges Related to Subprime Mortgage CDO (July 17, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

27. Press Release, SEC, Citigroup to Pay $285 Million to Settle SEC Charges for Misleading

A. The Futility of Corporate Penalties

Despite these ever-escalating settlement amounts, the nation's largest financial firms continued to distinguish themselves as serial re-offenders. Even before 2008, firms such as Citigroup and Merrill Lynch faced multiple fraud charges and paid huge sums to settle shareholder and government suits related to their participation in the Enron and WorldCom frauds, analyst conflicts of interest, and consumer and mortgage abuses.[28]

The apparent futility of corporate level punishment has led many to assert that large corporate fines are both ineffective and ill-conceived.[29] These commentators point out that the costs of large settlements are borne by corporations, their insurers, and ultimately the shareholders, and therefore, do not directly impact the individuals who caused the fraud.[30] Moreover, the sanctioned firms are so wealthy that even a fine running into the hundreds of millions of dollars is often viewed as a mere cost of doing business.[31]

Although some commentators advocate for criminal charges against these firms, the deterrent potential of corporate criminal penalties is equally unavailing. From public comments, it appears that Justice Department officials have determined that criminal charges against large corporations are off the table due to fear of dire collateral consequences and economic harm.[32] Instead of pursuing criminal charges against

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Investors About CDO Company Profited From Proprietary Short Position Former Citigroup Employee Sued for his Role in Transaction (Oct 19, 2011), *available at* http://www.sec.gov/litigation/litreleases/2011/lr22134.htm. The District Court for the Southern District of New York rejected the proposed settlement and ordered the parties to trial. SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (rejecting settlement). Both parties appealed the district court's decision. The U.S. Court of Appeals for the Second Circuit stayed the order requiring trial and heard the appeal on February 8, 2013, but has not rendered a decision on the merits of Judge Rakoff's ruling. Peter Latmann, *Appeals Court Hears Arguments on Judge's Rejection of SEC-Citigroup Deal*, DealBook, Feb. 18, 2013, *available at* http://dealbook.nytimes.com/2013/02/08/appeals-court-hears-arguments-over-judge-rakoffs-rejection-of-citigroup-settlement/?_php=true&_type=blogs&_r=0.

28. *See* Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN L. REV 963, 999–1002 (2009) (cataloging the banks' roles in the Enron and WorldCom fiascos).

29. MacDonald, *supra* note 2, at 423 ("[D]espite the evidence that [] fines have almost no deterrent effect—the Commission's success in extracting even exorbitant fines has failed to prevent or even curb a repeated pattern of financial abuse by a repeated group of abusers—the response from the Commission and Congress has always been the same: more and higher fines.").

30. *See* Ralph Ferrara & Scott Fishwick, *Mary Jo: SEC Enforcement? Go Back to the Future!*, SECURITIES LAW DAILY (BNA) (May 20, 2013).

31. *Id*. ("[C]orporations internalize [penalties] as a cost of doing business, and, in any event, the cost is primarily borne by shareholders.").

32. As then-Assistant Attorney General for the Department of Justice's Criminal Division Lanny Breuer told Frontline:

> [I]n any given case, I think I and prosecutors around the country, being responsible, should

systemically important firms, the Justice Department has turned to Deferred Prosecution Agreements, by which criminal charges are set aside on the condition that the corporation comply with remedial measures prescribed in the agreement.[33] This new approach represents a reaction to the impact of indicting former accounting giant Arthur Andersen—a course commentators have described as a corporate "death penalty."[34]

B. The Deceptive Appeal of Individual Monetary Sanctions

Scholarly disillusionment with the effectiveness and appropriateness of corporate-level penalties has led some to urge officials to focus their enforcement zeal on the individuals responsible for corporate fraud. After all, the theory goes, corporations do not commit fraud: only their human agents do. To this end, some scholars recommend that regulators require responsible individuals to disgorge ill-gotten gains and pay monetary penalties from their own pockets.[35] Still others call for

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> speak to regulators, should speak to experts, because if I bring a case against institution A, and as a result of bringing that case there's some huge economic effect, it affects the economy so that employees who had nothing to do with the wrongdoing of the company— . . . . If it creates a ripple effect so that suddenly counterparties and other financial institutions or other companies that had nothing to do with this are affected badly, it's a factor we need to know and understand. . . . That doesn't mean we won't go forward, but it has to be a factor.

Frontline: The Untouchables (PBS television broadcast Nov. 30, 2012), transcript *available at* http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/lanny-breuer-financial-fraud-has-not-gone-unpunished. Consistent with this sentiment, Attorney General Eric Holder has testified:

> [W]hen we are hit with indications that if you do prosecute, if you do bring a criminal charge it will have a negative impact on the national economy, perhaps world economy . . . that is a function of the fact that some of these institutions have become too large. . . . [I]t has an inhibiting impact on our ability to bring resolutions that I think would be more appropriate. . . . [T]hat is something that we—you all . . . need to consider.

Oversight of the U.S. Department of Justice: Hearing Before the S. Judiciary Comm., 110th Cong. (Mar. 6, 2013) (transcript forthcoming) (statement of Attorney General Eric Holder), *available at* http://www.senate.gov/isvp/?comm=judiciary&type=live&filename=judiciary030613 (webcast).

33. *See* Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1, 18–19 (2014); Ramirez, *supra* note 5, at 905; DONNA NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT 896 (3d ed. 2012) (describing deferred prosecution agreement for KPMG).

34. Gabriel Markoff, *Arthur Andersen and the Myth of the Corporate Death Penalty: Corporate Criminal Convictions in the Twenty-First Century*, 15 U. PA. J. BUS. L. 797, 800 (2013) (stating that after Arthur Andersen's conviction, the Department of Justice has shifted its approach to enforcing criminal law against corporations). Credit Suisse's recent guilty plea to criminal charges for helping its clients evade taxes suggests that the Justice Department may be rethinking its stance against charging large financial institutions with crimes. *See* Aruna Viswanatha, Douwe Miedema & Karen Freifeld, *Credit Suisse Pleads Guilty to U.S. Criminal Charge in Tax Probe*, REUTERS, May 19, 2014.

35. Donald H. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without*

criminal prosecution of executives who led bailed out firms into bankruptcy or insolvency.[36]

Although increased individual accountability for fraud seems necessary to restore public confidence in corporations, shifting the conventional penalty scheme from corporations to individuals is unlikely to yield the desired results. Practically speaking, many of the individuals likely to face charges could not pay a comparable level of penalties, undermining the compensation objective of such penalties.[37] Further, those wealthy enough to pay large fines would be less likely to agree to serve as directors, absent loss-shifting provisions that would vitiate any deterrent effect. From a theoretical perspective, there is also reason to doubt that the threat of astronomical penalties can actually deter fraud.

C. Harsh Penalties Alone Cannot Deter Fraud

Congress's response to mounting corporate scandals conforms to the teachings of traditional deterrence theory, which holds that to deter an activity, its expected cost must exceed its expected benefit.[38] According to this theory, in order to increase the law's deterrent effect, public officials must either increase penalties for fraud or increase the likelihood of detection.[39] With the Sarbanes–Oxley Act, Congress took action along both of these fronts. The 2008 financial crisis shows that such efforts, though well-intentioned, failed to prevent further instances of devastating fraud.

This result is not surprising in light of existing research on why individuals comply with the law. Such research shows that most people comply with the law, not because they fear detection or punishment, but because they believe it is the right thing to do. Most people obey the

Wheels": Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 WAKE FOREST L. REV. 627, 655 (2007); Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L. J. 321, 371 (2007) (arguing for individual asset forfeiture in corporate fraud cases); MacDonald, *supra* note 2, at 445–46.

36. Ramirez, *supra* note 5, at 870 (the failure to prosecute financial crisis frauds sends a message that "crime does pay"); Taibbi, *Wall Street Jail*, *supra* note 14.

37. Congress formally recognized investor compensation as an SEC enforcement objective with Sarbanes–Oxley § 308—the Fair Fund provision. This provision gives the SEC authority to establish an investor compensation fund to distribute any penalties it collects from securities violators to investors harmed by their fraud. *See* Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 318–20 (2008).

38. *See* Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 651–53 (1996) (stating the standard formulation).

39. *See* Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrent Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 675–76 (2002).

law mainly because they have internalized its underlying values instilled from childhood through family and schooling.[40] Society relies on this internalized moral sense to motivate corporate officials to manage corporations responsibly and to refrain from self-enrichment through self-dealing and fraud. Yet the internalization of proper moral values can be undermined if the law is not enforced or if the punishment for breaking the law is perceived to be unfair.[41]

In addition, psychological and criminal law research suggests that threats of harsh punishment do not provide the disciplinary effect that deterrence theory posits.[42] According to psychologists, the best way to encourage the internalization of proper values is through modest rewards and sanctions that promote the desired behavior.[43] As these psychologists explain, when a mild reward or threat induces desired behavior, the reward or threat alone is insufficient to create an independent justification for the conduct. Individuals thus persuade themselves that they followed the conduct rule because they believed it was the right thing to do. In contrast, when authorities rely on severe threats to control behavior, individuals may comply with the authorities' directives when authority figures are present, or if they reasonably fear detection. In the absence of constant monitoring, however, rules backed by severe threats are unlikely to be consistently obeyed.[44]

D. The Bar as a Proportionate Penalty

Increasing public frustration with the ineffectiveness of traditional approaches to fighting fraud suggests the need for a more creative approach to remedies—an approach that holds individuals accountable for their failures without wreaking the devastating personal consequences of astronomical fines or prison terms, which tend to undermine the perceived legitimacy of law. The strategic use of the

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40. *See* TOM R. TYLER, WHY PEOPLE OBEY THE LAW 64–66 (1990). To illustrate, imagine you have just entered a small store to pick up a few grocery items. Save for you, the store is empty, and a sign at the counter reads, "Be right back." You glance around impatiently for any sign of the cashier. You're in a hurry. What do you do? Option (a), walk off with our goods without paying for them; option (b), leave an appropriate amount of cash on the counter and take your goods; or option (c), leave empty-handed and go shop at another store. If you chose to follow option (b) or (c), what explains your choice? The reason could not be fear of punishment or peer disapproval, because your thievery would never be discovered. In such circumstances, the only reason not to steal would be your own internalized sense of right and wrong.

41. *See* Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. L REV. 453, 490–93 (1997).

42. *See* Paul H. Robinson & John M. Darley, *The Role of Deterrence in the Formulation of Criminal Law Rules: At Its Worst When Doing Its Best*, 91 GEO L.J. 949, 985–89 (2003).

43. *See* Jones, *supra* note 7, at 150–51 (reviewing psychology literature).

44. *See id*.

power to bar directors and senior executives from further service in those roles could help the SEC overcome many of the difficulties it has encountered in seeking to deter large financial firms from committing serial fraud.[45]

The officer and director bar has the potential to act as both a corrective and deterrent device.[46] If sought more widely, the bar could operate both to prevent future misconduct by incompetent directors and reinforce societal assessments of director responsibility. For these reasons, the SEC and the courts should look to the bar more frequently as a remedy for fraud.

III. THE OFFICER AND DIRECTOR BAR

A. History

Before explaining why expanded use of the officer and director bar is an appropriate response to the fraud and mismanagement that has characterized the past decade, this Part reviews the law and practice surrounding the SEC's authority in this realm. Congress first granted the SEC's formal authority to seek bar orders when it enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (Remedies Act).[47] The Remedies Act added provisions to the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) permitting the SEC to seek orders in federal court barring an individual who has violated the securities laws' antifraud provisions from serving as an officer or director of a public company "if the person's conduct demonstrates substantial unfitness to serve."[48] Before the Remedies Act, the SEC had obtained bars as part of its traditional injunctive remedies. Although most of these bars were obtained in consent decrees, courts recognized the remedy was available under the courts' general equitable powers.[49]

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45. As Michelle Welsh and I have described in prior work, in Australia, the Australian Securities and Investments Commission (ASIC) has the power to bring actions against directors for breach of their disclosure obligations and for breach of the statutory duty of care. ASIC has successfully pursued claims against directors (including outside directors) and obtained bars in several high profile cases. *See* Jones & Welsh, *supra* note 15, at 381–86.

46. Aguilar, *supra* note 14 ("In terms of general deterrence the officer and director bar is one of the most effective enforcement mechanisms at the SEC's disposal.").

47. PL 101-429, Oct. 15, 1990, 104 Stat 921 (codified at 15 USCA § 77h-1 and 15 USCA § 78(u)).

48. The Remedies Act added Section 21d(2) to the 1934 Act and Section 20(e) to the 1933 Act.

49. SEC v. Posner, 16 F.3d 520, 521 (2d Cir. 1994); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1103 (2d Cir. 1972); *see also* Stephen M. Cutler, Director, Division of Enforcement, U.S. Securities and Exchange Commission, Remarks at the Glasser LegalWorks 20th Annual Federal Securities Institute (Feb. 15, 2002) (stating that before 1990 the SEC had used courts' equitable powers

After Congress passed the Remedies Act, federal courts began to push back against the SEC's efforts to obtain bar orders.[50] Judges began to apply a six-factor test when considering SEC bar petitions.[51] The six-factor test, proposed by Professor Jayne Barnard, asks courts to weigh: (1) the egregiousness of the defendant's violation; (2) the defendant's "repeat offender" status; (3) the defendant's role or position when he engaged in fraud; (4) the defendant's degree of scienter; (5) the defendant's economic stake in the violation; and (6) the likelihood the misconduct will recur.[52]

The District Court of New York first applied the six-factor test in *SEC v. Shah*, an unreported case that declined to impose a lifetime bar against a pharmaceutical executive who had bribed FDA officials and traded stock based on his knowledge of his company's illegal activities.[53] In weighing the six factors, the court found that the defendant: had avoided relatively small losses through his trades, had not been involved in prior violations of the securities laws, and had not engaged in "clandestine trading such as tipping, purchasing stock in the names of other people, or trading in a secret account," factors which "do not suggest a very high degree of scienter."[54] The court concluded that since the defendant had no record of prior violations and had already been "severely punished," the likelihood of future misconduct was "relatively slight."[55] Thus, although the defendant was an officer of the subsidiary of the company whose stock he traded, and had received the entire economic benefit of his trades, the court concluded that the SEC had not shown that the defendant was "substantially unfit" to serve as a director or officer of a public company.[56]

In a related case, *SEC v. Patel*, the defendant appealed a district court order imposing a lifetime bar.[57] Patel was an executive of Par Pharmaceuticals Inc., the parent company of the firm involved in *Shah*.[58] The *Patel* court endorsed the six-factor test, while stating that these were

to obtain bars against "approximately 100 individuals" mostly through consent decrees).

50. Philip F.S. Berg, Note, *Unfit To Serve: Permanently Barring People from Serving as Officers and Directors of Publicly Traded Companies After the Sarbanes-Oxley Act*, 56 VAND. L. REV. 1871, 1877–78 (2003).

51. *See* SEC v. Shah, No. 92 CIV. 1952 (RPP), 1993 WL 288285, at *7 (S.D.N.Y. July 28, 1993).

52. *Id*. (reciting the six factors); *see also* Jayne W. Barnard, *When Is a Corporate Executive "Substantially Unfit to Serve"?*, 70 N.C. L. REV. 1489, 1510–20 (1992).

53. *Shah*, 1993 U.S. Dist. WL 288285 at *1.

54. *Id*. at *7.

55. *Id*.

56. *Id*.

57. SEC v. Patel, 61 F.3d 137 (2d Cir. 1995).

58. *Id*. at 138.

not exclusive factors to be considered.[59] While acknowledging that courts have broad discretion when imposing bars, the Second Circuit took issue with the district court's permanent bar order. It overturned the order, because the district court had not considered whether a bar limited in time or scope might serve as a sufficient remedy.[60] The case was thus remanded for the district court to explicitly consider whether a limited bar was appropriate.[61]

Whether or not one agrees with the end results in *Shah* and *Patel*, the cases show that the six-factor test offers little practical guidance as to when a bar should be imposed.[62] The *Patel* test does not inform courts or the SEC which of the six factors are most important or how many factors must be satisfied to justify a bar. Nor does the test provide much guidance as to what constitutes "egregiousness" or a "high degree of scienter" and what kind of evidence would show a likelihood of future misconduct.[63] The test also fails to delineate those situations in which a time-limited bar may be more appropriate than a permanent bar.[64] For example, courts somewhat formalistically assert that future misconduct is unlikely where there is no record of prior securities offenses. This reasoning conflates two of the factors in the six-factor test, making the sixth factor seem superfluous. In the end, most courts applying *Patel* simply tick through the six factors and reach whatever determination they find appropriate.[65]

After *Patel*, the SEC continued to face obstacles when seeking bar orders in federal court. A particularly needling case was *SEC v. Farrell*.[66] In *Farrell*, an outside director of a community bank was

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59. *Id*. at 141 (finding the six factors "useful in making the unfitness assessment").

60. *Id*. at 142 ("[W]e take note of the fact that the governing statute provides that a bar on service as an officer or director that is based on substantial unfitness may be imposed 'conditionally or unconditionally' and 'permanently or for such period of time as [the court] shall determine.' We take these provisions to suggest that, before imposing a permanent bar, the court should consider whether a conditional bar (e.g., a bar limited to a particular industry) and/or a bar limited in time (e.g., a bar of five years) might be sufficient, especially where there is no prior history of unfitness.").

61. *Id.*

62. The truncated test that courts adopted ignores the wisdom proffered in Professor Barnard's discussion of a discarded seventh factor: the defendant's appreciation of an executive's fiduciary obligations. Professor Barnard recommended that the court "satisfy itself that a defendant is at least as worthy of public trust and confidence as corporate executives of other corporations. The defendant bears the burden of persuasion on this issue." Barnard, *supra* note 52, at 1521.

63. Professor Barnard offers a far more textured analysis of these issues in her writings. *See* Barnard, *supra* note 52, at 1511; Jayne W. Barnard, *Rule 10b-5 and the "Unfitness" Question*, 47 ARIZ. L. REV. 9 (2005).

64. Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 BUS. LAW. 391, 412–13 (2004).

65. *See* Steven J. Crimmins, *Where Are We Going with SEC Officer and Director Bars?*, 38 BLOOMBERG/BNA SEC. REG. & L. R. 717 (2006) (courts "apply [Patel's] six factors in a summary fashion").

66. SEC. v. Farrell, No. 95-CV-6133T, 1996 WL 788367 (W.D.N.Y 1996); Cutler, *supra* note

convicted of insider trading for trading and tipping others to inside information about a pending acquisition of his bank. Although Farrell pled guilty, the district court concluded that a permanent bar order was not appropriate.[67] The court found that "Farrell's securities violations were serious and he did engage in fraudulent conduct in the hopes that his illegal activities would not be discovered. However, upon release from prison, he should not be barred from holding *any* other officer or director positions."[68] Instead, the court reasoned that because Farrell was "a talented executive and a permanent bar would effectively prevent him from using those talents to rebuild his life," he should be permanently barred only "from holding an officer/director position with any banking or financial institutions."[69]

B. Enhanced SEC Authority

The SEC bristled at its occasional failure to obtain bar orders when challenged in federal court.[70] Its leaders began to argue that, as applied, the six-factor test was unreasonably demanding.[71] In particular, SEC officials objected to courts' demand that the agency prove a likelihood of re-offending, a factor courts viewed skeptically in the absence of prior offenses.[72] In a display of frustration with the federal courts' approach, Enforcement Director Stephen Cutler declared, "when it comes to O&D bars, the courts have simply lost their way."[73]

After Enron and WorldCom, the SEC sought enhanced authority to impose officer and director bars. The agency got its wish when Congress enacted the Sarbanes–Oxley Act of 2002. Sarbanes–Oxley strengthened the SEC's hand in two important ways.[74] First, Congress lowered the standard for imposing a bar from "substantial unfitness" to "unfitness."[75] Second, Congress granted the SEC power to impose bars in administrative proceedings as well as in federal court based on the

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67. *Farrell*, 1996 WL 788367 at *8.

68. *Id*.

69. *Id*.

70. According to Barnard, courts had flatly rejected the SEC's bar petitions in only two reported cases. In several other cases, courts imposed a lesser sanction than the SEC sought. Barnard, *supra* note 64, at 396–97.

71. Cutler, *supra* note 49 (asserting that the "substantial unfitness" requirement had "spawned a burdensome and overly restrictive test for imposing officer and director bars").

72. *Id*. (criticizing the courts' holding in SEC v. Patel, 61 F.3d 137 (2d Cir. 1995)).

73. *Id*.

74. Berg, *supra* note 50, at 1899.

75. Sarbanes–Oxley Act of 2002, 107 P. L. 204 § 305, 116 Stat. 745 (codified at Exchange Act § 21(d)(2)(f); Securities Act § 20(e); 15 USC § 7243).

same "unfitness" standard.[76] Curiously, in the time since Sarbanes–Oxley, the agency has not made much use of the new powers it so vigorously pursued.

The SEC lobbied hard for power to impose officer and director bars in administrative proceedings without the need to file charges in federal court. Although Congress balked at this request in 1990, it acceded in 2002 when it adopted Sarbanes–Oxley.[77] It is therefore surprising that since that time, the SEC has rarely used its administrative authority to impose bars.[78] A possible explanation is that the kinds of cases in which the SEC seeks bars are usually serious enough that the agency wants to make use of the full panoply of the federal court's injunctive powers.[79]

The new "unfitness" standard for which the SEC lobbied has also failed to yield significantly different on-the-ground results. Commentators agree that Congress intended to ease the SEC's burden when it changed the standard for imposing bars from "substantial unfitness" to "unfitness."[80] Yet, federal courts continue to apply the onerous six-factor *Patel* test, developed under the "substantially unfit" standard, which Congress has since rejected.[81] Practically speaking, therefore, the SEC remains in the same position with respect to officer and director bars that it occupied prior to 2002.

C. The SEC's Approach to Bars in the Post-Crisis Era

More important from the standpoint of this Article, the SEC remains reluctant to use the bar to address director oversight failures.[82] In fact, the SEC rarely seeks bars against directors, requesting the remedy only in the most egregious cases. In two recent cases in which the SEC sought bars, the directors had ignored multiple employee warnings,

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76. Sarbanes–Oxley Act of 2002, 107 P. L. 204 § 1105, 116 Stat. 745 (codified at Exchange Act § 21(c)(3); Securities Act §§ 8A(f) and 20(e); 15 USC § 78u-3).

77. *See* Barnard, *supra* note 64, at 395–96 (recounting history).

78. *See* Crimmins, *supra* note 65; BRIAN A. OCHS ET AL., *Sanctions and Collateral Consequences*, *in* THE SEC ENFORCEMENT MANUAL 181, 230 (Richard M. Phillips ed., 2d. ed. 2007).

79. *See* Crimmins, *supra* note 65.

80. *Id*.

81. SEC v. Johnson, No. 04-4114, 2006 U.S. App. Lexis 8230, at *11–12 (3d Cir. Apr. 5, 2006) (applying *Patel* factors); *see also* Crimmins, *supra* note 65 (stating that the change from "substantial unfitness" to unfitness has been largely ignored by the courts, which continue to look to the *Patel* six-factor test); Jon Carlson, *Securities Fraud, Officer and Director Bars, and the "Unfitness" Inquiry After Sarbanes-Oxley*, 14 FORDHAM J. CORP. FIN. L. 679, 697 (2009) (courts still erroneously assert the standard for a bar is "substantial unfitness"). Some courts have applied a new nine-factor test that Professor Barnard proposed after Sarbanes–Oxley. *See* Barnard, *supra* note 63, at 46 (outlining proposed new framework); SEC v. Levine, 517 F. Supp. 2d 121, 145–46 (D.D.C. 2007) (applying proposed framework). Still, in *SEC v. Bankosky*, the Second Circuit reaffirmed the validity of the *Patel* factors despite the new statutory language. SEC v. Bankosky, No. 12-2943-cv (2d Cir. May 14, 2013).

82. Jones & Welsh, *supra* note 15, at 396.

auditor and law firm resignations, and allowed executives suspected of misconduct to retain their positions and thus continue their fraud.[83]

Statements from recent SEC Enforcement Directors confirm the view that the officer and director bar is reserved only for the most blatant cases of director malfeasance. Linda Chatman Thomsen, who served as Enforcement Director from 2005 to 2009, observed in a 2008 speech to corporate directors, "the Commission rarely sues directors solely in their capacity as directors."[84] In fact, she reported that during a three-year period, the SEC "brought more than 1,800 enforcement actions involving more than 3,000 defendants," but had "sued less than a dozen outside directors."[85] Her successor, Robert Khuzami, similarly pronounced, "we will not second-guess the good-faith efforts of directors," when explaining the agency's decision to charge directors of a small public company who had "turned a blind eye to warning signs of fraud."[86] True to Khuzami's assurances, only one bar has been imposed against a top executive of a large financial institution whose fraudulent activities contributed to the financial crisis, and not one nonexecutive director of a failed financial firm has faced SEC charges.[87]

83. Press Release, SEC, SEC Charges Military Body Armor Supplier and Former Outside Directors With Accounting Fraud (Feb. 28, 2011), *available at* http://www.sec.gov/litigation/litreleases/2011/lr21867.htm; Press Release, SEC, SEC Charges Former Executives in Illegal Scheme to Enrich CEO With Perks (Mar. 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-39.htm.

84. Linda Chatman Thomsen, Director, Division of Enforcement, Securities and Exchange Commission, Speech, Keeping Up With the Smartest Guys in the Room: Raising the Bar for Corporate Boards (May 12, 2008), *available at* http://www.sec.gov/news/speech/2008/spch051208lct.htm.

85. *Id.*

86. Press Release, SEC, SEC Charges Military Body Armor Supplier and Former Outside Directors With Accounting Fraud (Feb. 28, 2011), *available at* http://www.sec.gov/news/press/2011/2011-52.htm.

87. In 2010, former Countrywide CEO, Angelo Mozilo agreed to pay $67.5 million to settle SEC claims that he misled investors about Countrywide's financial position. Press Release, SEC, Former Countrywide CEO Angelo Mozilo to Pay SEC's Largest-Ever Financial Penalty Against a Public Company's Senior Executive (Oct. 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-197.htm. Mozilo also consented to a permanent officer and director bar. *Id.* The former COO and CFO of Countrywide paid smaller amounts in penalties and consented to time-limited bars. None of the defendants admitted liability in the Countrywide settlement. In February 2011, the Justice Department dropped its criminal investigation of the same Countrywide executives. *See* E. Scott Reckard, *U.S. Drops Criminal Probe of Former Countrywide Chief Angelo Mozilo*, L.A. TIMES, Feb. 18, 2011.

In the only other financial crisis case to end with sanctions against executives of a too-big-to-fail firm, Citigroup CFO Gary Crittenden and Chief Investor Relations Officer Arthur Tidesley agreed to pay $100,000 and $80,000, respectively, to settle SEC charges, brought in an administrative proceeding, that they knowingly misled investors about Citigroup's subprime exposure. *See* Press Release, SEC, SEC Charges Former Mortgage Lending Executives with Securities Fraud (Feb. 11, 2011), *available at* http://www.sec.gov/news/press/2011/2011-43.htm. The two men settled the claims without admitting or denying liability and were not subject to bar orders. *Id*. The SEC also charged the CEO of a less prominent firm, IndyMac, and several other senior executives with securities fraud. IndyMac CEO Michael Perry settled the claim by agreeing to pay $80,000 without admitting or denying

IV. THE DETERRENT CAPACITY OF THE OFFICER AND DIRECTOR BAR

A. Advantages over Monetary Sanctions

Despite the SEC's current hands-off approach to high-level executives and directors, experienced securities lawyers observe that the officer and director bar is the most feared securities law remedy available. Commissioner Luis Aguilar recently stated, "During my four years as a Commissioner, I've noticed how hard defendants fight to avoid officer and director bars. It is one of the sanctions that they fear most, which is what precisely makes it one of the most effective sanctions available."[88] Former SEC Director of Corporate Finance, Alan Beller, made similar comments in 2010 on a panel at the Annual Meeting of the Association of American Law Schools.[89]

Considering the deterrent potential of the officer and director bar, one wonders why the SEC remains reluctant to pursue the remedy against executives and directors of large firms. The enforcement chiefs' apparent "laying down of arms" is especially befuddling. Taking the "most feared" remedy off the table before the SEC even opens a case seems to be a strategic mistake. A better approach would be to ensure that all directors and executives are aware of the possibility of a bar for securities violations while exercising discretion to seek the remedy only in appropriate circumstances.[90]

As a remedy, the bar on future service offers several advantages over monetary penalties, especially as applied to independent directors, who generally have a more tangential connection to the fraud. First, and most importantly, the bar is preventative. It can keep a fraudster or incompetent director from serving in such capacity in the future, thereby protecting investors from future harm.[91] Second, the bar underscores the social message embedded in Sarbanes–Oxley and Dodd–Frank regarding the importance of directors' oversight duties.

In addition, the bar skirts the most common objections to imposing monetary liability on independent directors. As a penalty, the bar is less

liability. Despite the SEC's initial intention to pursue the remedy, Perry did not consent to an officer and director bar.

88. Aguilar, *supra* note 14.

89. *See* Lisa Fairfax, *The Bar on Director and Officer Bars*, THE CONGLOMERATE (Jan. 12, 2010), http://www.theconglomerate.org/2010/01/the-bar-on-director-and-officer-bars.html (reporting on discussion at the AALS Annual Meeting in January 2010).

90. Professor Barnard has offered insightful commentary on when it is appropriate to impose a bar. *See, e.g.*, Barnard, *supra* note 49; Barnard, *supra* note 64. Although courts have adopted many of Professor Barnard's recommendations, they sometimes unreasonably demand concrete evidence, as opposed to reasonable conjecture, that a defendant presents a risk of future harm to investors.

91. Johnson, *supra* note 21, at 523–24.

severe than astronomical monetary awards and settlements that can be extracted in shareholder suits and SEC enforcement actions, which many commentators argue are unfair.[92] The bar can be calibrated to reflect a director's degree of culpability, with time-limited bars imposed for merely reckless conduct, or when directors express contrition or cooperate with authorities.[93] Permanent bars, meanwhile, can be reserved for directors who knowingly participate in, cover up, or benefit from fraud. Finally, corporate officials cannot avoid the consequences of a bar through indemnification or insurance.[94] Thus, unlike the terms of a typical SEC settlement,[95] the bar requires that individuals account for their acts or omissions.

B. Who is "Unfit"?

It is difficult to argue in the abstract that the conduct of the directors of a firm enmeshed in fraud merits the imposition of a bar order. As noted above, under *Patel*, imposing a bar requires consideration of six factors including the egregiousness of the fraud, an individual's role, the degree of scienter, the financial stake in the fraud, the record of prior offenses, and the likelihood of re-offending.[96] Assessing such factors is possible only with the benefit of a full-scale investigation. However, reviewing the facts of a well-reported case helps to demonstrate how director oversight failures can sometimes facilitate corporate fraud and contribute to massive investor losses.

1. Enron 1.0

Most readers are familiar with the reports showing that WorldCom and Enron directors were asleep at the wheel and thus, failed to prevent their corporations' massive frauds.[97] Yet, the details surrounding a less

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92. *Id.* at 532 ("Debarment relief has the advantage of sanctioning misconduct while not depleting the financial resources of the companies themselves, whose investor and creditor constituencies may be unaware of and innocent of wrongdoing.").

93. Barnard, *supra* note 63, at 32–33.

94. Cutler, *supra* note 49 (acknowledging that "monetary penalties—often paid by D&O insurance . . . are not always sufficient to achieve the deterrence we seek").

95. *See, e.g.*, MacDonald, *supra* note 2; Buell, *supra* note 8.

96. *See supra*, text at notes 50–56.

97. *See* WILLIAM C. POWERS, JR., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 22 (Feb. 1, 2002), *available at* news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf (reporting that Enron's Board of Directors failed in its oversight duties); RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HONORABLE JED S. RAKOFF ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, at 22 (Aug. 2003) SK034 ALI-ABA 761, 787, *available at* news.findlaw.com/wp/docs/worldcom/corpgov82603rpt.pdf (finding that "Among other things, the board of directors of the Company consistently ceded power over the direction

familiar Enron fraud show starkly how director complicity and passivity can help set the stage for a devastating corporate collapse. In *The Smartest Guys in the Room*, Bethany McLean and Peter Elkind detail how Enron directors responded to the discovery of accounting manipulation and embezzlement at the small trading unit, Enron Oil.[98] A 1987 report from Enron's auditors revealed glaring problems at Enron Oil, yet Enron's audit committee abided management's decision to sweep the matter under the rug.[99] Later, when rogue trading at the same unit nearly plunged Enron into bankruptcy, CEO Ken Lay and the board of directors feigned shock at the news, and again sought to cover up the full scope of the misconduct.[100]

When Enron finally disclosed the trading shenanigans at Enron Oil, the SEC opened an investigation, creating an opportunity for investigators to follow the fraud to the top of the organization. Instead, the SEC and Justice chose to pursue charges only against the mid-level managers whom Enron's leaders had misleadingly fingered as rogue traders.[101] Years later, a pervasive pattern of accounting manipulation, irreverence toward the law, and abusive self-dealing had taken hold at Enron; conduct that was facilitated by Enron directors who unreasonably took management's implausible explanations of questionable activities at face value. Had the SEC conducted a more thorough investigation of Enron Oil, and probed directors' knowledge of the problems, it could have taken action against Enron's executives and directors for their role in covering up the fraud. Had regulators taken firm action at the time, they may even have prevented the Enron scandal, as we now know it, from occurring.

Under current law, the officer and director bar is available only for securities violations involving scienter, a state of mind encompassing intent or recklessness.[102] The scienter requirement would likely complicate efforts to address instances of director inattention, which

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of the Company to (CEO) Ebbers . . . [who] was allowed nearly imperial reign over the affairs of the Company, without the board of directors exercising any apparent restraint on his actions"); DICK THORNBURGH, SECOND INTERIM REPORT, at 7 (June 9, 2003), *available at* news.findlaw.com/wsj/docs/worldcom/bkexmnr60903rpt2d.pdf (finding that "WorldCom was dominated by Messrs. Ebbers and Sullivan with virtually no checks or restraints placed on their actions by the Board of Directors or other Management. Significantly, although many present or former officers and Directors . . . had misgivings regarding decisions or actions by Mr. Ebbers . . . there is no evidence that these officers and Directors made any attempts to curb, stop or challenge the conduct . . . they deemed questionable or inappropriate.").

98. BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 17–21 (2004).

99. *Id*. at 20.

100. *Id.* at 23.

101. *Id*. at 24.

102. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

sound more in negligence than fraud. However, the Enron Oil debacle shows that in some of the most dramatic instances of corporate fraud, the conduct of senior officers and directors meets the scienter standard. After all, Ken Lay and Enron's directors knew about the problems at Enron Oil, including accounting manipulation, sham transactions, unauthorized trading, and embezzlement. Yet they decided to let the responsible executives keep their positions and continue their fraudulent activities and reckless trading. Enron's managers relied on Enron Oil to deliver paper profits that helped mask the company's true financial position, and worried little about how such "profits" were concocted.[103]

2. The Financial Crisis Cases

As Professor Lyman Johnson observes with respect to the financial crisis, "hindsight . . . shows that stunningly bad and avoidable decisions obviously were made in high places that were bankruptcy inducing for numerous organizations."[104] This observation is supported by findings from special investigators appointed by Congress and the courts to determine what led the failed financial firms to ruin.[105] Anton Valukas, the Bankruptcy Examiner who investigated potential claims against Lehman's directors and officers, concluded that colorable claims existed against CEO Richard Fuld and several former Lehman CFOs.[106] Likewise, the Financial Crisis Inquiry Commission found that Citigroup and other large investment banks "experienced massive losses because of significant failures of corporate governance including risk management."[107] The FCIC further concluded that Merrill Lynch, Citigroup, and Bear Stearns all understated their subprime mortgage exposures in public statements to investors.[108]

Despite ample basis for inquiry revealed by these reports, the SEC did not pursue action against high-level executives and directors of these firms.[109] In all of the SEC settlements with too-big-to-fail firms, directors and senior executives have been spared monetary liability and

103. MCLEAN & ELKIND, *supra* note 98, at 20–21.

104. Johnson, *supra* note 21, at 535.

105. FINANCIAL CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT (2011) [hereinafter *FCIC Report*]; Report of Anton R. Valukas, Examiner, *In re* Lehman Brothers Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. 2010), *available at* http://jenner.com/lehman/.

106. Valukas, *supra* note 105.

107. *FCIC Report*, *supra* note 105, at 279.

108. *Id*. at 258 (Merrill Lynch), 263 (Citigroup), and 281 (Bear Stearns).

109. *See* Joshua Gallu, *SEC Enforcers Said to Weigh Issuing Report on Lehman Abuses*, BLOOMBERG.COM, June 3, 2011 (reporting that the SEC was considering issuing a report in lieu of bringing charges against Lehman Brothers executives for fraudulent financial reporting); Ramirez, *supra* note 5, at 868 (noting that Congressional investigations revealed knowing fraud, and financial firms have agreed to numerous settlements worth billions of dollars).

any other form of personal accountability.[110] For reasons that remain unclear, the SEC has not vigorously pursued claims against executives and directors of failed financial firms, leaving it to private litigants to take on the task.

Although faced with formidable obstacles, in several high profile cases plaintiffs' claims against directors and executives of these same firms survived preliminary motions to dismiss.[111] When these lawsuits settled, the directors' and officers' liability was covered by insurance.[112] Still, the private litigants' ability to successfully plead scienter against the CEOs and senior executives of too-big-to-fail firms suggests the SEC could also have prevailed had it chosen to pursue claims against these same individuals.[113]

C. Toward a New Standard for "Unfitness"

1. The Need for SEC Guidance

For the SEC to fully assert its power to bar officers and directors, federal courts must show more deference to the SEC's assessment as to when a bar is appropriate. To encourage such deference, the SEC should publish guidance on the factors it considers important in seeking bars. The SEC has unwisely left this discussion to academics and the courts and has yet to make clear its rationale for pursuing bars. This ad hoc approach leaves the SEC open to charges of overreaching and using

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110. *See* discussion *supra*, note 85 and accompanying text.

111. *See In Re* Lehman Bros. Sec. & ERISA Litig., 799 F. Supp. 2d 258 (S.D.N.Y. 2011) (denying motion to dismiss and finding strong inference that Dick Fuld and other senior officers acted with scienter with respect to certain material misstatements by Lehman Brothers); *In re* Citigroup Inc. Sec. Litig., 753 F. Supp. 2d 206 (S.D.N.Y. 2010) (denying motion to dismiss and finding strong inference that CEO Prince and other senior officers acted with scienter in concealing the extent Citigroup's CDO exposure).

112. Memorandum and Order, *In re* Lehman Bros. Sec. & ERISA Litig., 08 Civ. 5523 (LAK), 2012 U.S. Dist. LEXIS 74344 (S.D.N.Y. May 24, 2012) (No. 1:09-MD-02017) (approving $90 million settlement of claims against directors and officers with entire payment coming from insurance funds); *In re* Citigroup Inc. Securities Litigation, 965 F. Supp. 2d 369 (S.D.N.Y. Aug. 1, 2013). After initially questioning the fairness of the settlement to which individual defendants failed to contribute, Judge Sidney Stein approved the settlement on August 1, 2013. *See* Nate Raymond & Bernard Vaughn, *Judge Approves Citigroup $590 Million Settlement*, REUTERS, Aug. 1, 2013.

113. For an insider's perspective on the SEC's decision to avoid action against Wall Street executives, see Robert Schmidt, *SEC Goldman Lawyer Says Agency Too Timid on Wall Street Misdeeds*, BLOOMBERG.COM, Apr. 8, 3014, *available at* http://www.bloomberg.com/news/print/2014-04-08/sec-goldman-lawyer-says-agency-too-timid-on-wall-street-misdeeds.html (Quoting James Kidney, a veteran SEC enforcement lawyer, stating that the SEC has become "an agency that polices the broken windows on the street level and rarely goes to the penthouse floors. . . . On the rare occasions when enforcement does go to the penthouse, good manners are paramount. Tough enforcement, risky enforcement, is subject to extensive negotiation and weakening," and that his superiors "were more focused on getting high-paying jobs after their government service than on bringing difficult cases.").

inconsistent criteria to impose bars.

The SEC has addressed the issue of unfitness in inquiries under other provisions of law that permit the agency to bar professionals such as securities brokers and investment advisers.[114] Similar questions arose when the SEC fashioned guidelines on how to exercise authority under Rule 102(e) to bar attorneys and accountants from appearing before it.[115] The SEC should draw on these principles to clearly set forth the circumstances in which it will pursue bar orders and the rationale it will use to distinguish between those cases that merit permanent bars and cases in which time-limited bars are more appropriate.[116]

2. Proposed Considerations

In fashioning such guidance, the SEC must start from the accepted proposition that imposing a bar requires something more than just a Section 17(a) or Rule 10b-5 violation.[117] The SEC should urge courts to focus the unfitness inquiry on the conduct that is the subject of the enforcement action and what that conduct reveals about the defendant's character.[118] After all, it is the defendant's character, not whether he has been caught before, that tells the most about whether he is likely to re-offend.[119] The two factors that seem most relevant for assessing the propriety of the bar are the egregiousness of the fraud and the defendant's contrition (or lack thereof).

In evaluating egregiousness, courts should consider the magnitude of losses attributable to a defendant's conduct, and whether the defendant

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114. Barnard, *supra* note 63, at 24–28.

115. SEC Rules of Practice 102(e), 17 C.F.R. § 201.102(e); *In re* Carter & Johnson, Exchange Act Release No. 17597, 47 SEC Docket 471, 478 (Feb. 28, 1981) (holding that the SEC may bar any attorney who consciously participates in violations of the securities laws from practicing before it).

116. The SEC also could learn from the IRS's experience in addressing attorney involvement in fraudulent tax shelters. In 2010, in response to rampant tax shelter abuse, the IRS released specific guidance for attorneys providing opinions on tax shelters. *See* IRS Circular 230, 31 C.F.R. § 10.50 (2013). After clarifying its position, the IRS began to enforce its rules more aggressively. As a result, tax practitioners now tread carefully before providing legal opinions for tax shelters.

117. *See* Crimmins, *supra* note 65.

118. Barnard, *supra* note 63, at 45–46 (urging a backward-looking inquiry).

119. Criminologists report that it is difficult to predict which securities violators will re-offend. According to Professor Barnard the recidivism rate for securities fraud is about 25%. *Id*. at 27–29. In a recent article, Professor Barnard notes that the personality traits of securities fraud recidivists are similar to the profile for Antisocial Personality Disorder. Jayne W. Barnard, *Securities Fraud, Recidivism, and Deterrence*, 113 PENN. ST. L. REV. 189, 189 (2008). Recent empirical research also suggests a correlation between an executive's antisocial conduct outside of work and his company's accounting fraud. *See* Robert Davidson et al., *Executives' Off the Job Behavior, Corporate Culture and Financial Reporting Risk*, Nat'l Bureau of Econ. Research, Working Paper No. 18001, 2012, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2096226, www.nber.org/papers/w18001.pdf?new_window=1. Such research suggests that a psychological evaluation might assist the SEC and courts in determining when a permanent bar order is warranted.

acted as a ringleader or was a reluctant participant in the fraud. In oversight cases, courts should consider how long the fraud continued without the defendant's intervention and the overtness of any red flags ignored. In considering the defendant's contrition, courts should assess whether the defendant acknowledges her mistakes, accepts responsibility, and indicates a willingness to change. As Professor Barnard wisely counseled in her first article on the subject, the defendant should have the burden of persuading the court that despite her fraud, she can be trusted once again in a fiduciary position at a public company.[120]

An alternative inquiry would borrow from banking law's approach to officer and director bars.[121] Under federal banking laws, regulators have the power to bar officers, directors, or other individuals from working at depository institutions.[122] To impose a bar, regulators must show: (1) a violation of law, safety and soundness standards, or breach of fiduciary duty; (2) the violation or breach has the effect of causing substantial financial harm, prejudicing the interests of depositors, or benefiting the party; and (3) the violation or breach involves personal dishonesty or a willful or continuing disregard for the safety and soundness of the institution.[123] In addition, under current FDIC rules, the FDIC can claw-back compensation from any person "substantially responsible for the failed condition" if they "[f]ailed to conduct [their] responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances," and their failure to exercise care "caused a loss that materially contributed to the failure of the company."[124] Because the banking law approach arguably involves federal regulators in the enforcement of state-based duties, Congress may need to expand the scope of the SEC's enforcement powers for the agency to adopt similar standards.

To earn the deference it seeks from courts, the SEC may also have to ease up on the throttle. Several commentators have expressed the view that permanent bars should be the exception rather than the rule.[125] The

120. *See* Barnard, *supra* note 52, at 1521–22.

121. *See* Barnard, *supra* note 63, at 22–23 (reviewing standards). Lyman Johnson similarly suggested that bankruptcy courts borrow from the FDIC's standards for barring individuals from leadership positions at banks. Johnson, *supra* note 21, at 536.

122. 12 U.S.C. § 1818(e) (2012).

123. *See id.*; Brickner v. FDIC, 747 F.2d 1198, 1203 n.6 (8th Cir. 1984); Magee v. Greenspan, 808 F. Supp. 847, 849–50 (D.C. Cir. 1991); *In re* Seidman, 37 F.3d 911, 929–30 (3rd Cir. 1994). For further discussion see CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 659 (4th ed. 2009).

124. 12 C.F.R. § 380.7(b)(1)(i) (2013).

125. Barnard, *supra* note 63, at 32 (recommending a sanctioning hierarchy in which a permanent bar would be imposed only in the "most egregious cases"); Johnson, *supra* note 21, at 538 ("[O]nly in rare and extraordinary circumstances should the bar be permanent. More typically it would last from

bar is most appropriate when a defendant uses his or her corporate position to defraud investors through accounting manipulation, misleading disclosures, or self-dealing.[126] Yet, a review of the cases in which the SEC seeks bars suggests it focuses its enforcement power on executives at smaller firms, as opposed to large companies.[127]

As Professor Barnard notes, the SEC often seeks to bar individuals who sold unregistered securities, maintained pump-and-dump schemes, or made quick cash trading in their company's stock.[128] Such conduct is reprehensible, but not nearly as threatening to society as the Enron, WorldCom, or Lehman-scale frauds. As noted above, in the few settlements with senior executives charged in financial crisis cases, only Countrywide executives received permanent or temporary bars.[129] More troubling, none of the directors of bailed-out or failed too-big-to-fail firms have faced federal charges for securities fraud or related misconduct.

D. Anticipated Objections

Corporate and securities law commentators have largely overlooked the bar as a potentially ameliorative remedy.[130] Despite the limited commentary, it is not difficult to anticipate the kinds of objections that might arise should the SEC pursue this course. Criticism would likely proceed along the following lines:

1. The Bar is Too Harsh, Unfair, and Would Deter Board Service

Some federal judges who have denied SEC bar petitions have asserted that the remedy is too draconian, because it could potentially deprive the defendant of his or her future livelihood.[131] This concern is overstated. For most directors, a directorship is not a full time job, which means a

one to five years.").

126. Barnard, *supra* note 63, at 47.

127. Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679 (2012) (finding individual defendants from large firms fared better in SEC proceedings than defendants from smaller firms and were less likely to face an industry bar).

128. Barnard, *supra* note 63, at 18 (describing cases and suggesting that such decisions make little sense).

129. *See supra* note 87.

130. In addition to Professor Barnard's excellent articles, Professors Donald Langevoort and Regina Burch have written on the prospective use of the bar. *See* Langevoort, *supra* note 38, at 661–62 (advocating that bar orders be available in private securities litigation); Regina F. Burch, *"Unfit To Serve" Post-Enron*, 45 VAL. U. L. REV. 1081 (2008). Several informative student notes have also been published on this subject. *See* Carlson, *supra* note 81; Berg, *supra* note 50.

131. *See e.g.*, SEC v. Farrell, No. 95-CV-6133T, 1996 WL 788367 (W.D.N.Y 1996); Cutler, *supra* note 49.

bar would not deprive a director defendant of his principal source of income. Furthermore, the bar on serving as an officer applies only to executive level positions, where the person serves in a policy-making role.[132] Thus, although a bar would keep defendants from occupying fiduciary positions, they would still be permitted to work for public corporations in nonexecutive roles. In addition, defendants are free to pursue self-employment or work in high-level positions at privately-held firms.[133]

The Martha Stewart case provides one example of how the bar can protect investors and discipline untrustworthy fiduciaries without depriving a defendant of her future livelihood. In 2002, Stewart, the founder, controlling shareholder and CEO of Martha Stewart Living Omnimedia (MSO), was caught up in controversy related to her trading in another company's stock. During the investigation, Stewart misled federal officials about the true reasons for her trades. Stewart was charged and convicted on four counts of obstructing justice and lying to federal investigators and sentenced to five months in prison.[134]

Despite her legal troubles, Stewart remained employed with MSO. Upon her indictment, she assumed the nonexecutive position, "Founder" of MSO.[135] Stewart later consented to a 5-year bar order to settle the SEC's insider trading charges.[136] After her release from prison in 2010, while still subject to a bar order, Stewart became Chief Editorial, Media and Content Officer of MSO. When the 5-year bar lapsed, Stewart rejoined MSO's board.[137] As the founder and controlling shareholder of MSO, Stewart does not represent the typical barred defendant. Nonetheless, her experience demonstrates that an individual can maintain employment at a public company while subject to a bar order.

2. Rehabilitation/Redemption

Much of the difficulty the SEC has faced when seeking bars involves its efforts to obtain permanent bar orders. One objection to permanent bars is that they do not allow for the possibility of rehabilitation or

132. Crimmins, *supra* note 65; Exchange Act Rule 16a-1(f), 17 C.F.R. § 240.16a-1(f) (2013).

133. Carlson, *supra* note 81, at 687.

134. Constance L. Hays, *Martha Stewart's Sentence: The Overview; 5 months in Jail, and Stewart Vows, 'I'll be Back'*, N.Y. TIMES , July 17, 2004, at A1.

135. MARTHA STEWART LIVING OMNIMEDIA INC., NOTICE OF ANNUAL MEETING AND PROXY STATEMENT (2012) [hereinafter MSO Proxy Statement], *available at* phx.corporate-ir.net/phoenix.zhtml?c=96022&p=irol-sec.

136. Press Release, SEC, Martha Stewart and Peter Bacanovic Settle SEC's Insider Trading Charges (Aug. 7, 2006), *available at* http://www.sec.gov/news/press/2006/2006-134.htm.

137. MSO Proxy Statement, *supra* note 135.

redemption.[138] For that reason, Professor Barnard and others maintain that permanent bar orders should be limited to true recidivists or those whose fraud leads to catastrophic losses. The answer to this concern is not to abandon bars but to pursue them more judiciously. The SEC should seek time-limited bars as a matter of course and reserve requests for permanent bars for the most serious violations. The risk of facing a time-limited bar and the attendant reputational harm should serve as a sufficient deterrent to fraud, and when imposed, such bars send a strong message about society's disapproval of the defendant's conduct.[139]

3. Insisting on Bars Would Make Settlements Impossible

SEC officials would likely argue that insisting on bars as a settlement condition will make it more difficult for the agency to settle cases efficiently. This is, of course, the principal justification the agency offers to defend its policy of allowing defendants to settle without admitting or denying liability.[140] Undoubtedly this is true. Securities lawyers emphasize that most defendants strongly resist the bar order. But this only suggests that the SEC may be driving too soft a bargain in its settlement negotiations.[141] When corporate defendants eagerly accede to settlement terms, an enforcement action becomes akin to a speeding ticket. Most drivers readily pay such fines to preserve their driving privileges.

More importantly, the SEC is capable of settling cases even when it cannot reach agreement regarding the appropriateness of the bar. A recent practice has developed in which the parties submit a consent decree containing all of the settlement terms but litigate the issue of the bar in federal court.[142] In some of these actions, the courts reject the bar petition.[143] Frequently, however, courts grant the relief requested.[144]

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138. Barnard, *supra* note 64, at 414–16 (lifetime bars are punitive in nature).

139. *Id*. at 538.

140. *See* Buell, *supra* note 8, at 517; MacDonald, *supra* note 2. The new SEC Chair, Mary Jo White, has announced that she has reconsidered the "no admit-deny" policy. In the future the SEC will require admissions in certain cases where it deems such admissions to be appropriate. *See* James B. Stewart, *S.E.C. Has a Message for Firms Not Used to Admitting Guilt*, N.Y. TIMES, June 22, 2013, at B1.

141. NAGY ET AL., *supra* note 33, at 705 (stating that defendants want to settle, not litigate, SEC enforcement actions).

142. *See, e.g.*, SEC v. Ishopnomarkup.com, No. 04 CV 4057 (DRH)(ARL), 2012 WL 716928, at *1 (E.D.N.Y. 2012) (reviewing SEC motion for officer and director bar in case where other terms of consent judgment were agreed to by the parties); SEC v. Dunn, No. 2:09-CV-2213 JCM (VCF), 2012 WL 3096646, at *1 (D. Nev. 2012) ("The parties have settled all matters in this case except for the SEC's demand for a permanent officer and director bar against defendant.").

143. *See, e.g.*, SEC v. Schroeder, 2010 WL 4789941 (N.D. Cal, Nov. 17, 2010) (denying SEC motion for a bar order); Competitive Technologies, D. Conn. 3:04-cv-1331 (Oct. 31, 2007) (denying SEC request for a bar order).

4. Federalism Concerns

A final reservation about the increased use of bar orders may be the potential SEC incursion into a traditional state law domain. According to conventional conceptions, federal securities laws are meant to address disclosure issues, while state law governs officer and director conduct standards. Utilizing the bar to discipline corporate officers and directors would, therefore, enmesh the SEC more deeply in corporate governance matters. Such concerns seem grounded in an outdated understanding of the division between state and federal authority in corporate law matters.

Since the Exchange Act was adopted in 1934, the SEC has enjoyed authority to regulate areas of corporate governance such as proxy voting and insider trading.[145] Over the years, Congress has continued to expand the SEC role in regulating corporate governance.[146] With Sarbanes–Oxley and Dodd–Frank, Congress directly charged directors of public companies with responsibility for overseeing financial reporting, executive compensation, and risk management. By encouraging the SEC to use its authority to enforce these enhanced oversight duties, this Article simply seeks to ensure a remedy exists when directors fail to perform the functions Congress has assigned to them. To the extent these recommendations strain the contours of existing SEC authority, Congress should take action to formalize the agency's power in this realm.

V. CONCLUSION

This Article addresses the concerns expressed by many scholars that the federal securities laws have lost their deterrent effect. It focuses on an existing remedy in the SEC's toolkit that thus far has received too little scholarly attention. Broader utilization of officer and director bars should help motivate senior executives and directors to perform their duties faithfully. Although some of the strategies recommended in this Article may require action by Congress, the SEC has the power to pursue most of the recommendations without awaiting further statutory or doctrinal reforms.

144. *See* SEC v. Jasper, 833 F.Supp.2d 915 (July 21, 2010) (ordering a 2-year bar); SEC v. Selden, 632 F. Supp.2d 91 (D. Mass. June 24, 2009) (ordering 2-year bar).

145. Exchange Act, Sections 14(a), 16.

146. *See* Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 887–88 (2006).