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Disgorgement Plans Under the Fair Funds Provision of the Sarbanes-Oxley Act of 2002: Are Creditors and Investors Truly Being Protected?

Don Carrillo*

I. INTRODUCTION

"By the way, you know the six billion dollars in assets that we reported, we were just kidding; they were actually expenses." Imagine the devastating impact these words had on a heavily invested shareholder or any entity with significant equity in the disclosing corporation. In the wake of one of the largest public accounting frauds in history, investors and creditors of WorldCom, Inc. ("WorldCom") were forced to face the harsh reality that they had relied on over nine billion dollars of false or unsupported accounting entries in their investment or loan decisions. Recognizing that the defrauded victims of corporate scandals such as WorldCom and Enron Corp. ("Enron") were left, in many instances, with irreparable harm under the current corporate governance legislation, Congress passed the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley" or "Act"). The Act was intended to protect investors and other parties who reasonably rely on corporate disclosures by improving the accuracy and reliability of those disclosures through the imposition of new and heightened crimi-

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1. DENNIS R. BERESFORD ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. (2003), available at http://nl.findlaw.com/news.findlaw.com/hdocs/docs/worldcom/bdspcomm60903rpt.pdf [hereinafter WORLDCOM INVESTIGATIVE REPORT]. The Special Investigative Committee of the Board of Directors of WorldCom, Inc. submitted a report of its investigation. Id. The Committee reported an excess of nine billion in false or unsupported accounting entries were made in WorldCom's financial systems in order to achieve desired reported financial results. Id. at 1.

nal penalties and other means of depriving corporate actors of their ill-gotten gains.³

Following the corporate scandals of WorldCom, Enron, Adelphia, and other high-profile instances of fraud, investors and creditors alike demanded safeguards to restore their confidence in the investment market. The primary vehicle by which Congress intended to reunite victims of corporate fraud with their assets was the “Fair Funds for Investors” provision of Sarbanes-Oxley.⁴ Under this provision, Congress provided for the addition of civil penalties, at the discretion of the Securities and Exchange Commission (“Commission”), to create disgorgement plans for the “benefit of the victims” of corporate fraud.⁵ Sarbanes-Oxley provided that “in any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors.”⁶ Prior to the enactment of Sarbanes-Oxley, the typical form of relief obtained by the Commission was disgorgement of ill-gotten gains from the culpable parties. Sarbanes-Oxley expanded on this remedy by including the Fair Funds for Investors (“Fair Funds”) provision, which authorized the Commission to add to the disgorgement fund any civil penalties obtained in the same proceeding “for the benefit of the victims” of the securities violation.⁷ This was great news for all defrauded parties, right? Wrong.

In its haste to pass Sarbanes-Oxley, Congress neglected to establish a standard of review a district court must apply to its consideration of disgorgement plans proposed by the Commission pursuant to its authority under the Act. Given the nature of corporate fraud, a diverse range of investors and creditors comprised the defrauded “victims” Sarbanes-Oxley was intended to protect. Naturally, the nature and extent of the disgorgement plan proposed by the Commission would directly affect the ability of each party to realize the losses caused by a corporation’s fraudulent activity. Because Congress failed to provide any guidance with regard to the appropriate standard of review to be given to disgorgement plans ordered by the SEC, the courts were left

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⁵. Id.
⁶. § 78(u).
⁷. § 7246 (providing that the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation).
to speculate and fashion impromptu standards of review to such plans. The lack of congressional guidance and experience in reviewing disgorgement plans after the enactment of the Fair Funds provision of Sarbanes-Oxley laid the foundation for inequitable results precedent to follow.

In October of 2006, the Court of Appeals for the Second Circuit ruled on a case of first impression, which centered on the appropriate standard of review given to proposed disgorgement plans by the Commission.\(^8\) According to the Second Circuit, a disgorgement plan proposed by the Commission can arbitrarily exclude vast numbers of investors or creditors as long as the district court deems the plan to be "fair and reasonable."\(^9\) Citing case law pre-dating the enactment of Sarbanes-Oxley, the Second Circuit held once the district court satisfies itself that the distribution of proceeds in a proposed Commission disgorgement plan is fair and reasonable, its review is at an end.\(^10\) The court reasoned that the primary purpose of disgorgement orders was to deter violations of securities laws by depriving violators of their ill-gotten gains.\(^11\) Therefore, given the fact that disgorgement plans are deterrent in nature, a disgorgement plan's function is achieved the instant the ill-gotten funds leave the hands of a corporate wrongdoer.\(^12\)

While this proposition certainly has appeal at first glance, it disregards any claim investors and creditors have to those funds as a result of their reliance on the corporation's fraudulent activity. Parties injured by corporate fraud certainly have the right to be placed in their "rightful position" in the event an award is obtained from a corporation that had previously engaged in fraudulent activity.\(^13\) Accordingly, courts must recognize that the new Fair Funds legislation shifted the focus of disgorgement plans in the corporate context from that of deterrence to compensating victims of corporate fraud. The crux of this issue lies in an analysis of the purpose of disgorgement penalties in the

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8. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73 (2d Cir. 2006).
9. Id. at 82-84.
10. "The district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent, identifiable private parties have been damaged by [defendant's] fraud." SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991) (citing SEC v. Blavin, 760 F.2d 706 (6th Cir. 1985)).
11. WorldCom, 467 F.3d at 81.
12. See id.
13. Kelly-Rose Garrity, Whose Award Is It Anyway?: Implications of Awarding the Entire Sum of Punitive Damages to the State, 45 Washburn L.J. 395, 397 (2006) (noting the purpose of compensatory damages is "to return the injured party to his 'rightful' position—the position he would have occupied but for the defendant's wrongdoing"). The purpose of compensatory damages is to make the injured party whole.
corporate context; whether that purpose is inherently deterrent or compensatory in nature. If a court adheres to the position that disgorgement penalties are primarily deterrent in nature, as in the case of the Second Circuit, the standard of review to be given a proposed disgorgement plan for disbursement amongst the victims of fraud is merely an afterthought and a lax standard of review is appropriate. However, if a court properly concludes disgorgement plans, in the context of corporate conduct, serve as a means to compensate victims of corporate fraud so that they may be placed in their collective “rightful” positions, a more stringent independent standard of review is required to ensure that those victims are compensated in fact.

In suggesting that reviewing courts should apply a heightened independent review to disgorgement plans proposed by the Commission, this Comment will analyze the abrupt shift in the policy objective disgorgement plans were intended to achieve with the enactment of Sarbanes-Oxley. Part II of this Comment will examine the role of disgorgement plans in the context of corporate activity. In considering the “Rational Actor” principle of deterrence, Part II will demonstrate disgorgement penalties are an ineffective means of deterring executive misconduct, as corporate executives face independent market pressures that break down the Rational Actor Model. Part III of this Comment will explore the Fair Funds for Investors provision of Sarbanes-Oxley and its application to the recent WorldCom scandal. Part III will conduct a brief case study of WorldCom’s fraudulent activity and will investigate the Second Circuit’s treatment of disgorgement penalties against WorldCom. Part IV proposes this Comment’s thesis: disgorgement penalties under the Fair Funds for Investors provision of Sarbanes-Oxley were intended to act as a means for the Securities and Exchange Commission to reunite victims of corporate fraud with their wrongfully deprived assets. In suggesting that disgorgement penalties are compensatory, rather than deterrent, in nature, this Comment will further assert that a heightened and independent standard of review must be given to disgorgement plans proposed by the Commission to ensure that identifiable victims of corporate fraud are in fact placed in their collective “rightful” positions.

II. THE FAIR FUNDS FOR INVESTORS PROVISION OF SARBANES-OXLEY AND ACCOMPANYING LEGISLATIVE HISTORY

Throughout the voluminous legislative history accompanying Sarbanes-Oxley and the Fair Funds for Investors provision in particular, two general themes are introduced: (1) restoration of investor confidence in the nation’s financial markets and protection of their
investments, and (2) more stringent corporate governance to deter future misconduct. This Part introduces the Fair Funds for Investors provision of Sarbanes-Oxley and proposes its primary function of disgorgement of ill-received funds from corporate fraud serves not to deter future misconduct, as discussed above, but is a vehicle through which a court may rightfully compensate victims of such misconduct. The Fair Funds provision provides in relevant part:

(a) Civil penalties added to disgorgement funds for the relief of victims

If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.14

It is a well-grounded principle of statutory construction that "where the language of a statute is plain, unambiguous, and well understood according to its natural and ordinary sense and meaning, the statute itself furnishes a rule of construction beyond which the court cannot go."15 Examination of the Fair Funds provision reveals the following two key aspects: First, the Commission has discretion as to whether civil penalties are to be added to disgorgement funds. Second, in the event a civil penalty is obtained and added to a disgorgement fund, the entire fund is to be "for the benefit of the victims of [the corporate fraud]."16 On July 28, 2006, Congress included the phrase "for the benefit of the victims" to reflect a primary concern that previous legislation had thrown obstacles in the way of securities fraud victims.17 Inclusion of the phrase demonstrated the fact that Congress made an effort to ensure such obstacles were removed.18 The United States Supreme Court ("Court") has instructed that a basic assumption of statutory interpretation is that the ordinary meaning of the statutory language accurately expresses the legislative purpose.19 Applying the

16. § 7246.
18. Id. (indicating current regulations did not do an adequate job of ensuring accountability in our legal system to prevent corporate scandals or to offer constructive remedies and decisive punishment should they occur).
Court’s guidance to interpretation of the Fair Funds provision, the phrase, “for the benefit of the victims,” must be read to evidence Congress’s intention that disgorgement plans compensate those harmed by corporate misconduct. Any other interpretation would subvert the plain meaning of the statute, making its mandatory language merely permissive.\footnote{Miller v. French, 530 U.S. 327, 338 (2000) (indicating inclusion of the term “shall” expresses a congressional mandate that the following be given its plain meaning and carried out accordingly). Following this reasoning, in the event the Commission exercises its discretion to add a civil penalty to a disgorgement plan, it “shall” be for the benefit of the victims of the corporate misconduct.}

Even if one follows the rationale that ascertainment of the meaning apparent on the face of a statute need not end the inquiry, both the context in which Sarbanes-Oxley was enacted and its accompanying legislative history bolster the argument that the Fair Funds provision functions as a means by which victims of corporate misconduct are to be compensated. The context of corporate scandal and near decimation of investor confidence constitutes persuasive evidence that the Fair Funds provision is compensatory in nature.\footnote{Boston Sand & Gravel Co. v. United States, 278 U.S. 41, 48 (1928).} The Enron situation opened Congress’s eyes to the shortcomings of reuniting victims of corporate scandals with the funds wrongfully taken from them, and, as this Comment will show, enactment of the Fair Funds provision was a major step in the direction of providing such compensation. Essentially, Sarbanes-Oxley authorizes the Commission to bring administrative and civil actions against corporations suspected of engaging in activities volatile of its enumerated securities laws.

In the event the Commission obtains an order authorizing a fine against the corporation, any civil penalties, arising out of the same action, may be added to the fine at the discretion of the Commission.\footnote{See 15 U.S.C. § 7246 (2006).} This common fund comprises the “disgorgement fund,” which may either be paid to the United States Treasury or to the victims of the fraudulent activity. Conflict arises when the district court determines the disgorgement fund be returned to the “victims” of the corporate misconduct. In many instances, multiple parties (creditors, investors, consumers, etc.) may have a valid claim to a corporation’s assets and are entitled to a percentage of the disgorgement fund. Sarbanes-Oxley authorizes the Commission to create a distribution plan and ultimately determine which parties will be entitled to their rightful portion of the disgorgement fund.\footnote{§ 7246.} Consider the following...
factual account to understand the breadth of the responsibility and consequences following a reviewing court's decision.

In the aftermath of the WorldCom scandal, the Commission proposed a distribution plan that provided for the disgorgement fund to be distributed to eligible claimants who purchased WorldCom securities from April 29, 1999 through the close of the markets on June 25, 2002 and retained such securities until the close of the markets on June 25, 2002.24 As a result, the definition of an "eligible securityholder" excluded any securityholder who learned of the fraud on June 25, 2002 and sold his security on such date as a result of the fraud announcement prior to the closing of the markets.25 One need only reflect on the situation of investors who learned of the fraud and sold their securities prior to the close of the markets on June 25, 2002 for a moment to understand the injustice they would face if a reviewing court were to approve of the above disgorgement fund. Yet, this is precisely what happened.26

Two schools of thought have emerged as to the standard of review to be given to disgorgement plans authorized under the Fair Funds provision of Sarbanes-Oxley. First, the Second Circuit adheres to its traditional position that disgorgement penalties are deterrent in nature; and, as a result, a review of a proposed disgorgement plan need only ensure it is "fair and reasonable" under the circumstances.27 This position can hardly be reconciled with either the plain language of the Fair Funds provision or the accompanying legislative history. On the other hand, proponents of a heightened standard of review indicate that the phrase "for the benefit of the victims" included within the Fair Funds provision marked a sea of change from the traditional belief that disgorgement funds acted as deterrents to the position that such funds were vehicles by which courts could ensure that victims of fraud were compensated.28

A. Passage of Sarbanes-Oxley Act of 2002

In his statement upon signing Sarbanes-Oxley into law, President George W. Bush stated the "Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and share-

25. Id.
26. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73 (2d Cir. 2006).
27. Id. at 82-84.
28. Id. at 82-83.
Amidst the array of corporate scandals discussed above, Michael G. Oxley, the Chairman of the House Financial Services Committee, sponsored the Corporate and Auditing Accountability, Responsibility and Transparency Act, which passed in the House in April. Also in mid-June, Senator Paul Sarbanes, Chairman of the Committee on Banking, Housing and Urban Affairs, introduced his own bill, The Public Accounting Reform and Investor Protection Act of 2002. On July 10, 2002, an amendment proposed by Senator Daschle on behalf of Senator Joseph Biden, was offered to increase criminal penalties related to conspiracy, mail and wire fraud, as well as some ERISA violations. This amendment passed ninety-six to zero later that day and the "Sarbanes-Oxley" Act, which emerged from conference on July 25, was presented to the President on July 26 and signed into law on July 29, 2002.

B. The Second Circuit's Inappropriate Adoption of the "Fair and Reasonable" Standard of Review of Disgorgement Plans Proposed by the Securities & Exchange Commission

The only circuit to hear the issue of whether a heightened standard of review should be given to proposed disgorgement plans was the Second Circuit in 2006. On July 7, 2003, the district court of New York approved a final settlement between WorldCom and the Commission, under which the company would pay a civil penalty of seven hundred fifty million dollars. The settlement included a nominal disgorgement of one dollar, which triggered the Fair Fund provision, allowing the civil penalty to be added to the disgorgement fund and distributed to defrauded investors. Because there was not enough money to compensate all the victims of WorldCom's fraud, the Plan excluded several groups of investors. In particular, the Plan excluded investors who recovered thirty-six cents or more on the dollar under

29. Press Release, supra note 3 (emphasis added).
31. Id.
32. Id. at 1547.
33. Id.
34. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73 (2d Cir. 2006).
35. Id. at 76.
36. Id.
37. Id.
the Chapter 11 reorganization plan or through the sale of their “eligible securities” and investors who made a net profit on their combined purchases or sales of “eligible securities” during the period in which the fraud occurred.\textsuperscript{38}

An example of the inequities inherent in the proposed disgorgement plan can be found in the fact that the district court approved a definition of “eligible security” to include “any security registered with the Securities and Exchange Commission, whether debt or equity, issued by WorldCom, Inc., or any of its affiliated debtors.”\textsuperscript{39} The fact that an “eligible security” included shares issued by not only WorldCom, but also any of its affiliated debtors, meant a security holder who suffered a loss in his or her WorldCom position as a result of the corporate fraud may have nevertheless been excluded from the disgorgement fund if his or her equity position in an affiliated debtor appreciated to an amount where a total net profit was realized.\textsuperscript{40} As

\textsuperscript{38} Id. at 76. See also SEC v. WorldCom, Inc., No. 02-CV-4963, 2004 WL 1621185 (S.D.N.Y. July 20, 2004).


\textsuperscript{40} A list of “eligible securities” includes:

- **Common Stock**
- WorldCom Group Common Stock
- MCI Group Common Stock

- **Preferred Stock**
- WorldCom Series D Preferred Stock
- WorldCom Series E Preferred Stock
- WorldCom Series F Preferred Stock
- MCI Capital I 8.00% Cumulative Quarterly Income Preferred Securities, Series A
- Intermedia 13.5% Redeemable Exchangeable Preferred Stock due 2009

- **Debt Securities**
- WorldCom 6.25% Senior Notes due 2003
- WorldCom 7.875% Senior Notes due 2003
- WorldCom 7.55% Senior Notes due 2004
- WorldCom 6.5% Senior Notes due 2004
- WorldCom 6.40% Senior Notes due 2005
- WorldCom 8.00% Senior Notes due 2006
- WorldCom 7.75% Senior Notes due 2007
- WorldCom 6.75% EUR Senior Notes due 2008
- WorldCom 7.25% GBP Senior Notes due 2008
- WorldCom 8.25% Senior Notes due 2010
- WorldCom 7.50% Senior Notes due 2011
- WorldCom 7.75% Senior Notes due 2027
- WorldCom 6.95% Senior Notes due 2028
- WorldCom 8.25% Senior Notes due 2031
- MCI 7.5% Senior Notes due 2004
- MCI 6.95% Senior Notes due 2006
- MCI 6.5% Senior Notes due 2010
such, the shareholder’s loss in WorldCom’s stock in reliance on the fraudulent accounting figures became obviated by an unrelated, yet prudent, investment decision grounded in sound accounting disclosures. The prudent investment, in essence, acted as a hindrance to the investor in his or her realization of the losses incurred as a result of WorldCom’s fraud.

The district court remarked the settlement was “not only fair and reasonable, but as good an outcome as anyone could reasonably expect in these difficult circumstances.” On appeal, the Second Circuit upheld the district court’s approval of the proposed disgorgement plan. Citing pre-Sarbanes-Oxley case law, the court reasoned:

Although disgorged profits may be distributed to defrauded investors, “[t]he primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains.” Given that compensation of fraud victims is a “secondary goal,” the size of a disgorgement order “need not be tied to the losses suffered by defrauded investors.”

Reliance on precedent pre-dating Sarbanes-Oxley seems misplaced given the sheer magnitude of the corporate scandals and their devastating effect on creditors, investors, employees, and all other interested parties, leading to Sarbanes-Oxley’s enactment in the first place. Sarbanes-Oxley’s legislative history, including the bankruptcies of Enron Corp. and Global Crossing LLC and the restatements of earnings by several prominent market participants, regulators, investors, and

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41. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003). *See also* SEC v. WorldCom, Inc., No. 02-CV-4963, 2004 WL 1621185, at *2 (S.D.N.Y. 2004) (“When funds are limited, hard choices must be made. Although a plan that included each of these excluded groups might also pass muster, the decision to exclude them was a fair and reasonable exercise of the Commission’s discretion.”).

42. WorldCom, 467 F.3d at 76.

43. Id. at 81 (quoting SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997)). Again, it must be noted that the case law cited by the court pre-dates the passage and enactment of the Fair Funds provision of the 2002 Sarbanes-Oxley Act. Thus, it can hardly be argued that this language was written with any degree of consideration for the “benefit of investors and creditors” as is the focus of the plain language of the Fair Funds provision.
others, expressly demonstrates the need for new and comprehensive securities legislation. While all parties must concede deterrence surely remains a major component of Sarbanes-Oxley, Congress intended to alter the main function of disgorgement orders to vehicles through which funds may be returned to victims of fraud.

The Senate professed Sarbanes-Oxley would play a crucial role in restoring trust in the financial markets by ensuring corporate fraud and greed may be better detected, prevented, and prosecuted. While this exemplifies the first of the dual purposes of Sarbanes-Oxley (deterrence of future fraud), the Senate also indicated that the Act would ensure victims of securities fraud had a fair chance to pursue their claims and recoup their losses. Consistent with the reference to "victims," which is found in the Fair Funds provision of Sarbanes-Oxley, the congressional report emphasized its focus on the victims of corporate fraud and concern for their compensation. This reveals congressional intent to embrace the position that provisions within Sarbanes-Oxley ensure that investors, creditors, and other injured parties are not only protected from corruption, but are also compensated for their losses.

C. Disgorgement Plans Function Primarily as a Means of Compensating Victims of Corporate Fraud Rather Than as a Deterrent to Corporate Actors from Engaging in Fraud

George W. Bush stated:

Today I have signed into law H.R. 3763 [Sarbanes-Oxley], "An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes." The Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption... and protect the interests of workers and shareholders.

44. H.R. REP. No. 107-414 at 18-19 (2002) (stating old securities laws, such as the Securities Exchange Act of 1934, reflect the technology available to public companies and investors at that time, and the securities laws largely reflect the paper-based system of reporting information that was prevalent up until the advent of the electronic age). This development heightened the need for more rapid disclosure of company news and ultimately increased regulation.

45. S. REP. No. 107-146 at 2 (2002) (noting the bill contains a number of provisions intended to increase the criminal penalties for serious fraud, ensure that evidence, both physical and testimonial, is preserved and available in fraud cases, and provide prosecutors with the tools they need to prosecute those who commit securities fraud).

46. Id. at 2.

47. Id.

This statement by President George W. Bush identifies two key concepts: First, Sarbanes-Oxley was intended to accomplish the policy objective of deterring corruption in the corporate arena. Second, the Act's provisions should be read in the context of protecting the interests of workers, shareholders, and presumably any other party affected by corporate scandals. Thus, it had become apparent that Sarbanes-Oxley was to act as both a deterrent to future corporate misconduct, as well as a means of safeguarding the interests, financial or otherwise, of individuals who interact with these corporations.

The assertion that disgorgement orders function solely as a means to deter corporate misconduct demonstrates a basic misunderstanding of the competing market pressures corporate executives face in their daily activities. As this Comment will show, the deterrent effect of the disgorgement of wrongfully obtained profits is subsumed within the independent market pressures high-ranking executives face in the context of multi-billion dollar corporations. It is also important to note that Sarbanes-Oxley includes new and more stringent criminal penalties that directly address the need to deter future misconduct.

The Senate indicated that Sarbanes-Oxley includes three major components that enhances accountability. First, it provides prosecutors with new and better tools to effectively prosecute and punish those who defraud investors, which means ensuring criminal laws are flexible enough to keep pace with the most sophisticated and clever con artists. It also means having criminal penalties tough enough to make con artists think twice before defrauding the public. Specifically, the Act provides two new criminal statutes which would clarify and plug holes in the current criminal laws relating to the destruction or fabrication of evidence and the preservation of financial and audit records. Further, Congress created three new obstruction-related offenses, heightened penalties in the securities fraud context, and

50. Id.
51. Id.
53. Id. at 681 (noting a new provision of the Securities Act of 1933 was intended to make it easier to win a securities fraud prosecution and is modeled on the mail and wire fraud statues, as well as more recent provisions aimed at bank and health care fraud).
more stringent penalties for certain existing crimes.\footnote{Id. at 684 (stating maximum penalties for mail and wire fraud were increased from five to twenty years, maximum criminal penalties under the Exchange Act were increased for individuals from fines of one million dollars and imprisonment of ten years to fines of five million dollars and imprisonment of twenty years, as well as various increases in criminal ERISA violations).} Collectively, these new criminal penalties and heightened maximum penalties act as appropriate deterrence mechanisms in ways disgorgement penalties were unable to achieve. Ultimately, Sarbanes-Oxley protects victims' rights to recover from those who have cheated them.\footnote{S. REP. No. 107-146 at 8 (2002). This section of the report indicated one of the three purposes of the proposed legislation was not only to deter future misconduct, but also to focus on providing means for victims of corporate fraud to recover the losses resulting from that corruption. Id.}

Given that the deterrent effect of disgorgement funds in the corporate context is de minimus at best, such plans are more properly classified as compensatory in nature. A disgorgement fund functions as an equitable remedy for restitution and the Fair Funds provision of Sarbanes-Oxley, which authorizes disgorgement funds to be disbursed for the benefit of the victims of corporate misconduct, is an ideal means to accomplish the goal of compensation. In response to the contention that disgorgement penalties are primarily compensatory, the Second Circuit indicated disgorgement funds may, at the discretion of the SEC, be added to and become part of the disgorgement fund for the benefit of the victims of the violation.\footnote{Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 82 (2d Cir. 2006) (stating the SEC may now, if it chooses, use civil penalties that it sought for the purposes of deterrence to compensate injured investors).} Discretion, the court urged, was significant because potentially no funds at all need be distributed to the victims of fraud, but instead may be paid to the United States Treasury.\footnote{Id.}

However, the Act's legislative history indicates that Congress's intention behind allowing the Commission discretion in obtaining disgorgement from parties convicted or held liable for wrongdoing was not to bolster the position that such penalties were deterrent in nature; rather, the Commission's discretion was intended to allow room to exempt such individuals from disgorgement penalties where such liability would be inappropriate.\footnote{Id.} In fact, one House Report indicated the Commission should conduct an analysis of whether, and under what conditions, any officer or director should be required to disgorge profits gained, or losses avoided, in the sale of the securities immediately preceding the filing of a restated financial statement on the
party’s behalf.\textsuperscript{59} Discretion, then, acts as a means to avoid an inequitable result in the use of disgorgement plans, rather than as an attestation that such plans are instituted to deter misconduct.

The Committee on Financial Services further indicated that if the Commission chose to issue a disgorgement of profits, it should have done so only after providing safeguards and exemptions to ensure such disgorgement is required, that is, only in cases where the Commission can prove extreme misconduct on the part of that officer or director.\textsuperscript{60} The Committee noted safeguards must be in place to ensure no funds were disgorged from corporate actors when such a penalty would be unwarranted or would not further the interest of public policy.\textsuperscript{61} Given that the Commission is required to engage in such a highly particularized investigation of the circumstances surrounding any disgorgement order, it stands to reason the discretion provided in the Fair Funds provision was Congress’s solution to exempt corporate officers from disgorgement penalties rather than an affirmation of the position that such penalties remain deterrent in nature.

The Report authorizes the Commission to exempt any officer or director from an order requiring disgorgement of profits when such an order is inappropriate in the public interest, unnecessary for the protection of investors, unduly impairs the operations of issuers, or inhibits orderly operation of the securities markets.\textsuperscript{62} Here, intent is shown to allow for an independent review of the particular circumstances of any given case to determine whether invocation of the Fair Funds provision is appropriate. Such independent review is distinct and wholly separate from any indication that disgorgement funds function primarily as a deterrent of future misconduct.

Even more indicative of disgorgement plans’ compensatory nature, which the Second Circuit conveniently ignored in its opinion, is the fact that the Commission was required to conduct a study to review and analyze the effectiveness of the Fair Funds provision.\textsuperscript{63} The study required the Commission to review and analyze enforcement actions

\textsuperscript{60} Id. at 21 (stating the Committee intends that the SEC would, in establishing any such rules, ensure fair and impartial procedures, with a right to appeal, for the adjudication of any action to require disgorgement).
\textsuperscript{61} Id.
\textsuperscript{62} Id.
Commission shall review and analyze—(A) enforcement actions by the Commission over the five years preceding July 30, 2002 that have included proceedings to obtain civil penalties or disgorgements to identify areas where such proceedings may be utilized to efficiently, effectively, and fairly provide restitution for injured investors; and (B) other methods to more efficiently, effectively, and fairly provide restitution to in-
by the Commission, obtain civil penalties or disgorgements, and identify areas where such proceedings may efficiently, effectively, and fairly *provide restitution for injured investors*.\(^6\) Again, congressional intent to provide compensation for victims of corporate misconduct was revealed. The fact that Congress required the Commission to conduct an individualized review of disgorgement penalties for the purpose of efficient restitution indicated the focus of the Fair Funds provision was on compensating victims of corporate fraud.

### III. The Economic Theory of Deterrence and Its Role in the Corporate Context

Central to this Comment's thesis is the proposition that disgorgement penalties are incapable of adequately deterring corporate executives from engaging in fraudulent activity. As this Part will illustrate, corporate actors face independent market forces, which neutralize any deterrent effect compelled disgorgement of ill-gotten funds may have on those actors. Initially, this Part introduces the economic theory of deterrence and explores the "Rational Actor" concept. In discussing the economic theory of deterrence, it is important to bear in mind corporate executives' exposure to the criminal penalties found within Sarbanes-Oxley are beyond the scope of this Comment. However, the inclusion of distinct criminal penalties within Sarbanes-Oxley strongly suggests the Act's deterrent goals are accomplished by means wholly separate from compelled disgorgement penalties.

The economic theory of deterrence was pioneered by Gary Becker in his 1968 article on crime and punishment, and has been expanded upon in the corporate arena in numerous law review and journal articles.\(^6\) The fundamental premise behind the economic deterrent model rests on the position that individuals are willing to commit crimes if the expected benefits of the crime exceed the expected benefits of engaging in lawful activity.\(^6\) "Pain and pleasure are the great

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\(^6\) "Injured investors," including methods to improve the collection rates for civil penalties and disgorgements. *Id.* (emphasis added).

\(^6\) *Id.* (emphasis added). The study should also identify other methods to effectively, efficiently, and fairly provide restitution to injured investors including methods to improve collection rates for civil penalties and disgorgements. *Id.*


springs of human action."\textsuperscript{67} If "the apparent magnitude or value of the pleasure or good he expects to be the consequence of the act, he will be absolutely prevented from performing it."\textsuperscript{68} Furthermore:

Economic analyses of deterrence are based on applying a price theory to activities. From an economic perspective people therefore engage in or refrain from injury causing behavior depending on how much they gain or lose from doing so. If the sanctions or "prices" are too high, rational people will refrain from the injury-causing or prohibited conduct.\textsuperscript{69}

There are three main components to an individual's determination of the economic utility of engaging in criminal behavior: (1) the subjective probability of being caught and convicted; (2) the monetary equivalent of the punishment if convicted; and (3) the gain from committing the crime.\textsuperscript{70} Under the Rational Actor Model, "[e]ach individual calculates with more or less correctness, according to the degrees of his information, and the power of the motives which actuate him."\textsuperscript{71}

A person commits a crime because the expected benefits of the crime to him exceed the expected costs.\textsuperscript{72} A key assumption, however, this theory makes is rational actors are faced with only those "prices" imposed by the criminal or civil justice system. A disgorgement penalty is a repayment of ill-gotten gains imposed on wrongdoers by the judicial system. "Funds that were received through illegal or unethical business transactions are disgorged, or paid back, with interest to those affected by the action. Disgorgement is a remedial civil action, rather than a punitive action."\textsuperscript{73} The assumption that disgorgement adequately deters corporate misconduct cannot be made in the context of corporate executive activity where corporate actors are faced with independent business and market pressures, subsuming any threat the deprivation of ill-gotten gains may pose, as explained below.

\begin{itemize}
\item \textsuperscript{67} Jeremy Bentham, Principles of Penal Law 396, 402 (J. Bowring ed., 1843) ("[W]hen a man perceives or supposes pain to be the consequence of an act, he is acted upon in such a manner as tends, with a certain force, to withdraw him . . . from the commission of that act.").
\item \textsuperscript{68} Id.
\item \textsuperscript{69} Yoram Keinan, Playing the Audit Lottery: The Role of Penalties in the U.S. Tax Law in the Aftermath of Long Term Capital Holdings v. United States, 3 Berkeley Bus. L.J. 381, 391 (2006).
\item \textsuperscript{70} Perino, supra note 52, at 675.
\item \textsuperscript{71} Bentham, supra note 67, at 402.
\item \textsuperscript{72} Posner, supra note 66, at 242 (noting studies have shown that criminals respond to changes in opportunity costs, the probability of apprehension, the severity of punishment, and in other relevant variables as if they were the rational calculators of the economic model).
\item \textsuperscript{73} Investopedia, Disgorgement, http://www.investopedia.com/terms/d/disgorgement.asp (last visited Feb. 20, 2008).
\end{itemize}
According to the Second Circuit, the Fair Funds for Investors provision of Sarbanes-Oxley, which authorizes the Commission to deposit in a disgorgement fund any civil penalty obtained under the securities laws in an action against an individual, primarily functions as a deterrent against future corporate malfeasance.\(^7\) Theorists distinguish between the effect of punishment as a general deterrent and its effect as a specific deterrent.\(^7\) Punishment acts as a general deterrent insofar as the threat of punishment deters potential offenders in the general community; it may also act as a specific deterrent insofar as the infliction of punishment on convicted defendants makes them less likely to engage in the crime again.\(^7\) While few will dispute a civil and criminal penalty assessed and ordered to be contributed to a disgorgement fund qualifies as a specific deterrent as against the individual, disgorgement as an equitable remedy bears a more tenuous relationship to the concept of general deterrence in the realm of multi-billion-dollar corporate scandals. As the following studies of the Enron and WorldCom scandals illustrate, the Rational Actor Model breaks down as the economic pressure corporate executives face elevates to a level beyond the contemplation of a reasonable person.

A. Disgorgement Funds and the Myth of General Deterrence in the Corporate Context: Enron Study

The Enron controversy centered on a series of partnerships created by Enron officials for the sole purpose of offsetting or concealing losses incurred by independent merchant investments.\(^7\) On October 16, 2001, Enron announced it was taking a five hundred and forty-four million dollars after-tax charge against earnings and a reduction of shareholders’ equity by one billion, two hundred million dollars related to a transaction with one of its partnerships.\(^7\) Less than one month later, Enron announced it was restating its financial statements

\(^74\). Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 81-82 (2d Cir. 2006).


\(^76\). Id.

\(^77\). WILLIAM C. POWERS, JR. ET. AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 4 (2002), available at http://f1.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf [hereinafter ENRON INVESTIGATIVE REPORT] (noting the partnerships "allowed Enron to conceal from the market very large losses resulting from Enron’s merchant investments by creating the appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that entity was simply an entity in which only Enron had substantial economic stake").

\(^78\). Id. at 2.
for the period from 1997 to 2001 because of accounting errors relating to various other partnerships controlled by Enron.\textsuperscript{79} Essentially, Enron "became a very large hedge fund, which just happened to own a power company. While that in itself does not warrant criticism, it was the extraordinary risk-taking by powerful executives which rarely added value, but simply accelerated the cash burn-off rate," placing millions of dollars in employees' benefits at unnecessary risk.\textsuperscript{80} In conjunction with the loss-concealing transactions involving its alleged special purpose entities, Enron's key executives were being enriched by tens of millions of dollars they should never have received.\textsuperscript{81}

The true victims of the Enron scandal were the employees who were locked into the company's stocks in the form of 401K plans, while the top executives were unloading their positions in the company. Enron stock, which at one point had sold in excess of eighty-two dollars-per-share, plummeted to twenty-six cents-per-share.\textsuperscript{82} "What is clear is that people have been hurt by the collapse of Enron, from the thousands of investors whose retirement and other investment savings have been devastated to the thousands of employees who now find themselves without a job."\textsuperscript{83} Such was the belief of a multitude of public officials throughout the many hearings on the Enron scandal.

Investors, workers, and creditors alike had been wrongfully deprived of their wealth and were left with lawsuits as their only assets. Outside investors, free to sell their Enron stock at any time, advanced the position that they were defrauded by executives and directors because senior management knew the company's stock was overvalued and failed to share information with Enron investors; outside investors also presented evidence suggesting Enron executives bullied analysts who questioned the value of the company's stock.\textsuperscript{84} The roots of Enron's corporate misconduct ran deep and affected a far-reaching

\begin{thebibliography}{99}
\item \textsuperscript{79} Id.
\item \textsuperscript{81} ENRON INVESTIGATIVE REPORT, supra note 81, at 3-4, 8-9 (indicating Andrew Fastow, Enron's Executive Vice President and Chief Financial Officer, received at least thirty million dollars, Kopper received at least ten million dollars, and still two more amounts that the Investigative Committee believed to be in the "hundreds of thousands of dollars").
\item \textsuperscript{82} Hearing, supra note 80, at 82 (statement of Rep. Luis V. Gutierrez).
\item \textsuperscript{83} Id. at 68 (statement of Rep. Sue Kelly).
\item \textsuperscript{84} Recine, supra note 30, at 1540 ("[A]gencies that provided credit ratings for Enron did not downgrade the credit rating even as late as November 2001, when the company was teetering on the edge of bankruptcy . . . [which] raised questions about the agencies' relationships with Enron executives.").
\end{thebibliography}
and diverse group of victims. Many credit the unveiled corruption within Enron as the spark that ignited more stringent corporate governance, which in turn led to the passage of Sarbanes-Oxley. Collectively, the scandals of Enron, Global Crossing,95 Adelphia,96 and WorldCom forced Congress to answer the public outcry for greater corporate accountability by passing Sarbanes-Oxley.

B. Disgorgement Funds and the Myth of General Deterrence in the Corporate Context: WorldCom Study

This Section centers on an in-depth study of WorldCom's Chief Executive Officer, Bernard J. Ebbers, and his role in the largest corporate scandal in recent history. First, a factual background of the WorldCom scandal reveals the extreme financial pressure Ebbers faced at the alleged height of his reign as a WorldCom executive officer. Next, this Section suggests the prospect of financial ruin Ebbers, or any executive in a similar situation, so outweighed the possibility of fine or conviction that any formulaic adherence to the Rational Actor Model of economic deterrence would become skewed to the point of complete speculation. Finally, this Section surmises any deterrent effect a conviction or order to disgorge all ill-received funds from corporate misconduct would be so de minimus as to be non-existent.

"On June 25, 2002, World[Com announced its intention to restate its financial results for all four quarters of 2001 and the first quarter of 2002 because of accounting irregularities."97 These irregularities comprised of more than nine billion dollars in false or unsupported accounting entries made in WorldCom's financial systems in order to achieve desired reported financial results.98 The Special Investigative Committee of the Board of Directors of WorldCom indicated the fraud occurred as a result of knowing misconduct, which was directed

85. Id. at 1541. Recine notes: Global Crossing executives profited from the inflated value of the company by selling more than $1 billion in personal stock during the three-year period before the company filed for Chapter 11. . . . Like Enron, the Global Crossing Board, which was responsible for assuring the accuracy of the company's records, was replete with conflicts of interest. Many of Global Crossing's audit committee members were personal friends of [Global Crossing CEO Gary] Winnick.

86. Id. at 1542 ("In late March 2002, Adelphia, the nation's sixth-largest cable operator, disclosed that it had failed to report $2.3 billion in debt.").

87. Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73 (2d Cir. 2006).

88. WorldCom Investigative Report, supra note 1, at 9 ("In total, from the second quarter of 1999 through the first quarter of 2002, WorldCom improperly reduced its reported line costs (and increased pre-tax income) by over $7 billion.").
by a few senior WorldCom executives and implemented by personnel
in its financial and accounting departments.\(^8^9\) The following factual
recitation centers on the role Bernard Ebbers, WorldCom's Chief Ex-
ecutive Officer, played in the WorldCom scandal as revealed by the
Special Investigative Committee of the Board of Directors of
WorldCom, Inc.:

In the 1990s, the principal business strategy of WorldCom's Chief
Executive Officer, Bernard J. Ebbers, was growth through acquisi-
tions. The currency for much of that strategy was WorldCom stock,
and the success of the strategy depended on a consistently increas-
ing stock price. WorldCom pursued scores of increasingly large ac-
quisitions. The strategy reached its apex with WorldCom's
acquisition in 1998 of MCI Communications Corporation ("MCI"),
a company more than two-and-a-half times WorldCom's size (by
revenues). Ebbers [sic] acquisition strategy largely came to an end
by early 2000 when WorldCom was forced to abandon a proposed
merger with Sprint Corporation because of antitrust objections.

[At the same time,] Ebbers directed significant energy to building
and protecting his own personal financial empire, with little atten-
tion to the risks these distractions and financial obligations placed
on the Company that was making him one of the highest paid exec-
utives in the country. It was when his personal financial empire was
under the greatest pressure—when he had the greatest need to keep
WorldCom's stock price up in order to avoid margin calls he could
not meet—that the largest part of the fraud occurred.\(^9^0\)

A basic margin transaction involves borrowing a portion of the funds
used to purchase stocks or options and is generally utilized to take
advantage of opportunities in the market.\(^9^1\) The borrowing party pays
interest on the funds borrowed until the loan is repaid in full.\(^9^2\) If and
when the account equity falls below a specified point, typically the
Federal Reserve Board's fifty percent margin requirement, the ac-
count enters into a "call" situation, whereupon the lending party may
liquidate the account's stocks or options without notice to meet the

\(^8^9\) *Id.* at 6-7.
\(^9^0\) *WorldCom Investigative Report, supra* note 1, at 5-6.
\(^9^2\) *Id.*
balance owed.\textsuperscript{93} According to one report, Mr. Ebbers chose to finance his acquisition-based business plan by taking out loans from commercial banks, many of which were margin loans secured by Ebbers's WorldCom stock.\textsuperscript{94} In fact, the Wall Street Journal reported that over a period of seven years, Ebbers took out such loans totaling about $929 million from non-WorldCom lenders.\textsuperscript{95} Further, the general terms of these margin loans, although varying in their precise wording, required that the value of Ebbers's stock to remain greater than or equal to some multiple of the amount of the loan.\textsuperscript{96}

The massive amount and terms of the above margin loans are significant because they create an independent market pressure on an executive's, in this case Mr. Ebbers's, personal financial welfare, essentially negating any deterrent effect disgorgement of ill-received gains might create. If we abandon the vision of the corporation as a rational actor and replace it with a vision of the corporation as a conglomeration of individual actors, then the mathematical calculations of corporate deterrence begin to lose their appeal.\textsuperscript{97} Regardless of how well the deterrent sanction is tailored to internalize the total social costs, the decisions that lead to violations still reside in managers and other agents who might bring their own external costs and benefits to the decision-making process.\textsuperscript{98} Executives do not always confine their decisions to the costs and benefits that will accrue to the corporation's shareholders or other stakeholders.\textsuperscript{99} Turning to the three factors of the economic deterrence theory, the subjective probability of being caught and convicted, the monetary equivalent of the punishment of convicted, and the gain from committing the crime, we now may substitute the actual figures of Ebbers's situation to reveal the tenuous effect the threat of disgorgement penalties had in his case.

For the sake of ease and clarity, this Comment will substitute round numbers for the precise figures relevant to Mr. Ebbers's financial situation. As stated above, Mr. Ebbers took out roughly nine hundred and thirty million dollars in commercial margin loans from independent banks. As WorldCom's stock price fell from a high of sixty-two dollars-a-share on June 21, 1999 to $36.52 on April 14, 2000, Bank of

\textsuperscript{93} Id.
\textsuperscript{94} WorldCom Investigative Report, supra note 1.
\textsuperscript{95} Id. at 195 n.106.
\textsuperscript{96} Id.
\textsuperscript{98} Id.
\textsuperscript{99} Id.
America, one of Ebbers’s principal lenders, made a margin call on its outstanding loans.\textsuperscript{100} Unable to satisfy the balance of the margin call, Ebbers began to borrow funds from WorldCom under the authorization of his Board of Directors, an amount that was eventually consolidated into a single promissory note of approximately four hundred and eight million dollars.\textsuperscript{101} All of these transactions were made, at least in part, by Ebbers to secure his personal fortune of nearly forty million dollars.\textsuperscript{102} It is important to note the monetary value assigned to incarceration associated with corporate misconduct is beyond the scope of this Comment.

C. \textit{Independent Market Forces Subsume Any Deterrent Effect Disgorgement Penalties Have on Corporate Executives}

Given the above facts, the next step in the economic theory requires that a monetary value be given to each of the above three factors in Jeremy Bentham’s model. First, in order to identify the value of the “gain” from committing the crime, in this case the fraudulent reporting of earnings to artificially inflate WorldCom’s stock price, the amount Ebbers stood to lose must be determined. The very purpose of Ebbers’s fraudulent activity was motivated primarily to secure his personal financial wealth by avoiding the various margin calls that were secured by his stock in WorldCom.\textsuperscript{103} Therefore, the amount he stood to gain from engaging in the fraudulent conduct was the amount equal to retention of the personal wealth he had accumulated at the time the misconduct took place. This value was calculated to nearly forty million dollars;\textsuperscript{104} this Comment will use this amount for the purposes of engaging in the risk calculus of the economic theory.

Second, a value must be given to the monetary equivalent of the punishment if convicted. Again, this Comment’s focus is solely on the alleged deterrent effect disgorgement penalties have on an executive’s conduct. Disgorgement, by definition, is “[t]he act of giving up something (such as profits illegally obtained) on demand or by legal compulsion.”\textsuperscript{105} Here, a distinction must be made between the misconduct of the principal agents of WorldCom collectively and the misconduct of Bernard Ebbers individually. While WorldCom as a corporation

\begin{itemize}
\item \textsuperscript{100} WorldCom Investigative Report, \textit{supra} note 1, at 303.
\item \textsuperscript{101} Id. at 304.
\item \textsuperscript{102} See Gretchen Morgenson, \textit{Ebbers to Shed Assets}, N.Y. Times, July 1, 2005, at C1.
\item \textsuperscript{103} WorldCom Investigative Report, \textit{supra} note 1, at 6 (“Ebbers directed significant energy to building and protecting his own personal financial empire, with little or no attention to the risks these distractions and financial obligations placed on [WorldCom].”).
\item \textsuperscript{104} Morgenson, \textit{supra} note 106, at C1.
\item \textsuperscript{105} Black's Law Dictionary 501 (8th ed. 2004).
\end{itemize}
was held liable in a Commission enforcement action for two and one
quarter billion dollars in civil penalties, as well as a disgorgement pen-
alty of one dollar through the payment of (a) five hundred million
dollars cash, and (b) common stock of reorganized WorldCom valued
at two hundred fifty million dollars, Ebbers was held accountable only
for a fraction of that amount. Ebbers was held accountable only
for a fraction of that amount.106 Ebbers was ordered to disgorge forty
million dollars of his personal assets. Therefore, the forty million
dollar figure serves as the monetary equivalent of Ebbers's
punishment.

Finally, the third component of the deterrence theory requires that
a value be given to the subjective probability of being caught and con-
victed. Violators have strong incentives to conceal their illegal conduct
and, thereby, avoid the imposition of a fine.108 "Hence, many violators
will not be fined, and the harms resulting from their violations will go
uncompensated."109 Given the speculative nature of this figure, it is
sufficient for the purposes of this Comment to note it weighs against
the possibility that the penalty for engaging in illegal conduct will ac-
tually be realized. Thus, under the Rational Actor Model of deter-
rence, the risk-calculus weighs in favor of engaging the illegal activity
for the situation Mr. Ebbers was in. This calculus can be demonstrated
as follows:

List of Variables

- Gain from engaging in fraudulent reporting of earnings: forty
  million dollars, that is retention of forty million dollars (Eb-
  bers's personal fortune) from liquidation sales of margin calls on
  his commercial loans.
- Monetary equivalent of punishment if convicted: forty million
dollars, that is amount of actual disgorgement order.
- Subjective probability of being caught and convicted: (acts of
  concealment + costs of detection) - (X); this figure must be sub-
 tracted from the probability that the forty million dollar convic-
tion amount will actually be realized.

106. Brief of SEC at 2, Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC,
No. 04-4710 (2d Cir. Jan. 25, 2005).
108. Michael K. Block, Optimal Penalties, Criminal Law and the Control of Corporate Behav-
ior, 71 B.U. L. Rev. 395, 397 (1991) (stating "there are also costs involved in detecting violations
and in imposing fines," which must also factor in to the value given to the probability that a
violation will be detected).
109. Id.
Risk Calculus

- Forty million dollars (that is, retention of personal fortune) is greater than forty million dollars (that is, disgorgement of ill-gotten funds) minus X (that is, acts of concealment and costs of detection).

As the above calculus demonstrates, disgorgement of ill-gotten funds from fraudulent corporate conduct does not carry with it a strong enough penalty or disincentive to persuade a rational actor to avoid misconduct when the “cost” of doing so equals the threatened punishment. In the context of WorldCom, Mr. Ebbers exposed his personal fortune to the threat of liquidation by the means of past due margin calls. Here, the margin calls acted as an independent threat to his fortune, having the same force and effect that the prospect of disgorgement of his wealth posed. The potential realization of the margin call skews the extra-rational calculus of an actor in a similar situation to Mr. Ebbers by exacerbating his behavioral bias toward concealment of fraudulent activity, which further undermines deterrence of malfeasance and warps perceptions of materiality.\(^{110}\)

The optimal penalty theory of economic deterrence:

Requires that fines be set at a level which fully reflects the costs to society of a prohibited activity engaged in by an economic agent. Society must impose penalties on these agents because, otherwise, these agents would force society to bear the cost of the harms which result from their engaging in a prohibited activity.\(^{111}\)

Optimal fines force economic agents to internalize the total cost of their activities.\(^{112}\) Here, the threat of margin calls, which would liquidate all of Mr. Ebbers's personal holdings, acted as the “optimal penalty” in this instance. Significantly, these margin calls would have reached even those personal assets that were completely personal to Ebbers and unrelated to the corporate misconduct. It stands to reason then, that any deterrent effect potential disgorgement of the profits Mr. Ebbers illegally gained became secondary and insignificant.

A disgorgement penalty functions primarily as a vehicle to redistribute funds wrongfully taken from victims of corporate misconduct rather than as a deterrent to such misconduct. As the above section illustrated, independent market forces pose a more extreme threat to a corporate executive’s personal wealth than does the prospect of being deprived of gains associated with misconduct. The reach of margin

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\(^{111}\) Block, *supra* note 108, at 397.

\(^{112}\) *Id.*
calls extend to the entirety of an executive’s fortune, whereas a disgorgement penalty is limited to those funds an executive realized as a result of his involvement in fraudulent activity. Given the very nature of a disgorgement penalty is to force a wrongdoer to part from the fruits of his or her misconduct, it follows that the funds should be returned to their rightful owners as compensation for the victims of a violation. Further, the United States Supreme Court has expressly stated disgorgement of profits “is a remedy only for restitution.”\textsuperscript{113} In that case, the Supreme Court distinguished disgorgement penalties from traditional civil penalties or fines by indicating disgorgement of funds served an additional purpose of providing restitution by returning to the proper owner property or the monetary value of a loss sustained.

Traditionally, restitution is defined as a deprivation of profit or wrongfully received money or property in favor of the aggrieved parties for actual damages or loss caused by an offense.\textsuperscript{114} As the following section will demonstrate, Congress undoubtedly recognized the shortcomings of disgorgement penalties as a deterrent. Although it would be presumptuous to identify a single purpose behind any particular piece of legislation, this Comment suggests that the tenuous relationship between disgorgement penalties and a deterrent effect of corporate misconduct provided Congress with an opportunity to shift the policy objective of disgorgement plans to that of compensation of the victims of fraudulent activity.

IV. Independent Judicial Review of Disgorgement Plans Are Required to Ensure That Disgorgement Plans Realize Their Intended Goal of Compensating Victims of Corporate Fraud

Having disposed of the contention that disgorgement plans are primarily deterrent in nature, this Part proposes that an independent standard of review must be given to potential disgorgement plans to ensure that identified parties are placed in their rightful position. As the scandals of WorldCom, Enron, and other corporations have demonstrated, large groups of investors and creditors were devastated by the loss of their investments or business transactions with those corporations. Once the fraud was exposed, these parties not only lost the entirety of their investments, but would also have been left with-

\textsuperscript{113} Tull v. United States, 481 U.S. 412, 424 (1987) (indicating an action for disgorgement of profits is a remedy only for restitution, a more limited form of relief than a civil penalty).

\textsuperscript{114} See generally 3 FEDERAL PRACTICE AND PROCEDURE—FEDERAL RULES OF CRIMINAL PROCEDURE § 528.2 (2007).
out remedy if the Commission decided not to establish disgorgement funds after obtaining civil judgments against these corporations.

In electing to create a disgorgement fund "for the benefit of the victims" of corporate fraud pursuant to its authority under the Fair Funds for Investors provision of Sarbanes-Oxley, the Commission implicitly acknowledges the victims' reliance interest in transacting with the violating entities and undertakes an obligation to satisfy that interest. This Comment demonstrates the Second Circuit was misguided in embracing a "fair and reasonable" standard of review for proposed disgorgement plans and suggests that heightened independent reviews of such plans are required to restore victims to their rightful positions.

The Second Circuit expressed in its opinion that once a district court determines the distribution of disgorgement fund proceeds are "fair and reasonable," its review is at an end. The court, however, deviated from that standard by acknowledging a district court need not make an inquiry into the effect that a disgorgement plan has on individual investors. This position disregards the fact that investors and creditors have, at times, very significant reliance interests in conducting business and maintaining financial relationships with various corporate entities. Creditors and investors alike conduct extensive value analyses prior to transacting with corporations in an effort to safeguard their investments.

One principle method by which investors and creditors make such valuation analyses is the asset-based method. Asset based methods start with the book value of a company's equity, which is simply the value of all the company's assets, less its debt. As will be presently demonstrated, a corporation that publishes balance sheets or other financial reports indicating its asset holdings invites outside creditors and investors to rely on the figures contained in those reports as a basis for their investment or other business decisions. Parties relying on these figures generate a reliance interest in their authenticity, an interest that must be protected should the Commission decide to exercise its disgorgement authority under the Fair Funds Provision of Sarbanes-Oxley.

115. SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) ("[T]he district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent, identifiable parties have been damaged by the [defendant's] fraud.").

116. Ian H. Giddy, *Methods of Corporate Valuation, New York University* (2006), http://pages.stern.nyu.edu/~igiddy/valuationmethods.htm (stating equity includes tangible things like cash, current assets, working capital and shareholder's equity, or intangible qualities like management or brand name, or essentially everything that a company would have if it were to suddenly stop selling products and stop making money tomorrow, and pay off all its creditors).
The Second Restatement of Contracts ("Restatement") provides a judicial remedy for the reliance interest of a promise, which is defined as "an interest in being reimbursed for loss caused in reliance on a contract by being put in as good a position as he or she would have been in if the contract would not have been made."[117] Further, because, in the case of creditors and investors, value is conferred to the corporation, whether in the form of a monetary loan or funds given for a percentage of control in the company, a restitution interest is created if the value is given as a result of fraudulent conduct. Again, the Restatement provides for restitution interest, which is defined as an "interest in having restored to him any benefit that he or she has conferred on the other party."[118] Interestingly enough, no mention is made of a "disgorgement interest" in either the Restatement or case law.

Perhaps the most comprehensive definition of a disgorgement interest was explained by Robert Cooter and Thomas Ulen in their collective article on law and economics.[119] "'Perfect disgorgement' [is] a sanction that restores the wrongdoer to the same position that she would have been in but for the wrong [and thus] strips the agent of her gain from misappropriation and leaves her no better or worse off than if she had done no wrong."[120] Thus, in the context of corporate fraud or other misconduct, an individual's disgorgement interest is the sum of her reliance interest, which created the injury, and her restitution interest, which requires compensation for injury based on reliance upon the misconduct. Significant here is the fact that the United States Supreme Court expressly adopted this position when it stated that an equitable action for disgorgement of profits "[wa]s a remedy only for restitution, a more limited form of relief than a civil penalty."[121] It stands to reason then, that when the Commission invokes the Fair Funds provision to order disgorgement of profits ill-received from corporate misconduct, it assumes the responsibility to protect both the reliance and restitution interests, together constituting the disgorgement interest, of all identifiable victims of the misconduct.

While the Second Circuit placed great emphasis on the fact that the Commission has the discretion to authorize such disgorgement plans in its holding that disgorgement penalties were primarily deterrent in

118. Id.
120. Id. at 1051.
nature, it failed to properly dissect the ability to order disgorgement of profits from the disgorgement interest protected once such a plan is ordered. Although the Fair Funds Provision certainly does provide the Commission with discretion to invoke disgorgement of profits, the provision more probably intended to allow for exemptions from liability when necessary; once disgorgement is ordered, both the victims' reliance and restitution interests are invoked as a matter of course. Thus, it is incomprehensible to hold to the belief that merely a "fair and reasonable" cursory review of a proposed disgorgement plan is sufficient to protect these interests.

For victims of corporate fraud to fully realize the protection of their reliance and compensatory interests, an independent review of the particular circumstances surrounding both the nature of the fraud and the provisions of the disgorgement plan is necessary. While few will dispute that multi-billion dollar corporate scandals create situations making it difficult to identify all victims of the fraud, this is hardly justification for the Commission to deny remedy to parties that bring suit in the form of excluding them from proposed disgorgement plans or denying them opportunities to introduce modifications that would protect their reliance and restitution interests.

For example, the WorldCom bankruptcy left identifiable unsecured creditors without recourse after the Second Circuit affirmed the district court decision to approve a disgorgement plan that excluded large groups of creditors from the receipt of proceeds.\textsuperscript{122} Because the Second Circuit adopted a standard of review that gave no consideration as to whether, or to what extent, individual parties were harmed by WorldCom's fraud, these unsecured parties were left out of the ultimate disgorgement plan.\textsuperscript{123} Unless an independent review of proposed disgorgement plans is given in each instance of corporate misconduct, the decision to approve of such distribution under a "fair and reasonable" standard will, in many instances, lead to inequitable and

\textsuperscript{122} The proposed distribution plan excluded from participation in the fund:
(a) \textit{Any} person who made a net profit on that person's combined purchases and sales of all eligible securities; (b) with respect to any particular eligible security, any securityholder (i) who received a higher payout under the plan with respect to such security than that received by WorldCom's general unsecured creditors under the plan, or (ii) who sold an eligible security after the conclusion of the fraud period at a price which allowed the seller to recoup a percentage of the seller's purchase price that is higher than the percentage recovery general unsecured creditors will receive under the plan; and (c) any securityholder that purchased an eligible security prior to the commencement of the fraud period and held such eligible security throughout such period in reliance of WorldCom's fraud.


\textsuperscript{123} See id.
potentially arbitrary exclusions of victims. As an example, the Official Committee of Unsecured Creditors generated the following hypothetical:

Investor A bought WorldCom stock during the Fraud Period and suffered a loss of $10,000 by selling on June 26, 2002, then reinvested the proceeds in MCI bonds and made a $15,000 profit for a net gain of $5,000. Investor B also bought WorldCom stock during the fraud period and also sold for a $10,000 loss, but reinvested the proceeds of the sale in IBM stock, and made a $15,000 profit for a net gain of $5,000. Each of these parties suffered a loss, followed by a net gain in investment capital, yet investor B can still participate [in the disgorgement plan while investor A is excluded]. This regime is inherently unfair . . . 124

As is apparent from the above hypothetical, inclusion in the proposed disgorgement fund turned on the particular security an investor subsequently added to his portfolio. Under the “fair and reasonable” standard of review, such arbitrary exclusion was approved not only in the initial reviewing court, but also on review when that standard of review was challenged. No inquiry was made as to the extent of the victims’ reliance upon WorldCom’s fraud, nor were the amounts of the individual losses examined when this plan was approved. While all parties potentially could have placed equal reliance upon the fraudulent figures WorldCom released and would have equally viable claim to disgorgement funds, the Second Circuit’s refusal to authorize independent review of the plan facilitated inequity in WorldCom’s bankruptcy distribution.

V. Conclusion

Corporate scandals such as Enron and WorldCom highlighted the various inadequacies of corporate governance legislation in place prior to passage of Sarbanes-Oxley. In response to these tragedies, Congress enacted Sarbanes-Oxley to answer the public outcry in favor of more stringent executive accountability and protection of investor and creditor relationships with these corporations. Accompanying passage of this legislation were the policy objectives of restoring investor confidence, protecting investments, and deterring future corporate misconduct. Sarbanes-Oxley addressed these policy objectives by not only creating and strengthening criminal penalties for corporate misconduct, but also by providing means for reimbursing creditors and

investors for the wrongful deprivation of their assets by corporate corruption.

One such vehicle for providing victims of corporate scandals a means of realizing their losses associated with the wrongdoing were disgorgement penalties; which are authorized under the Fair Funds for Investors provision of Sarbanes-Oxley.\textsuperscript{125} In a case of first impression, the Second Circuit held that disgorgement penalties were primarily deterrent in nature and any compensatory affect that was to be attributed to such funds was secondary.\textsuperscript{126} As a result, the panel approved of the "fair and reasonable" standard of review a review, but in reality adopted a standard that gave no consideration as to whether, or what extent, any identifiable victims were harmed by the misconduct. This position directly contradicts the fact that Sarbanes-Oxley's legislative history indicates the a primary focus of the Act to be providing for compensation of the victims of corporate misconduct. Disgorgement funds are equitable remedies for restitution and have little deterrent effect in the corporate arena, because corporate executives face independent market forces and bring their own biases into a rational actor analysis, subsuming the deterrent effect disgorgement penalties would otherwise entail.

Because the primary objective of disgorgement penalties is properly classified as compensatory in nature, if such a penalty is assessed, the reliance and restitution interests of identifiable victims must be protected. To ensure that victims' reliance and restitution interests are properly protected, as mandated by the Fair Funds provision, a reviewing court must conduct an independent review of the proposed disgorgement plan obtained by the Commission to satisfy itself that identifiable parties are properly reimbursed for the inequities brought to them. A standard of review that merely ensures that the disgorgement plan, as a whole, is "fair and reasonable" facilitates inequity by allowing a reviewing court discretion to approve a plan that may arbitrarily exclude large groups of creditors or investors from the plan.

This injustice became reality when the Second Circuit affirmed a New York district court decision to authorize a disgorgement plan that excluded investors on the basis of whether they sold their positions in WorldCom either the day of its announcement to restate its earnings, or the next day thereafter.\textsuperscript{127} Such a fortuitous event must not serve as the basis for excluding a significant group of creditors and investors

\textsuperscript{126} Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 81 (2d Cir. 2006).
\textsuperscript{127} Id. at 84.
from participation in an effort to provide compensation for funds wrongfully taken from those parties. Should a reviewing court conduct an independent review of the identifiable parties victimized by corporate fraud and their inclusion or exclusion from proposed disgorgement funds, such injustice could be avoided.