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SHAREHOLDER WEALTH MAXIMIZATION AND SECURITIES FRAUD

*James J. Park**

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I. INTRODUCTION

There are two main reasons why public corporations commit wrongful acts. The first is that corporate managers have incentives to selfishly further their own interests. They may steer the corporation towards illegality to preserve their jobs or increase their compensation packages. Corporate misconduct thus reflects a problem of agency costs where a disloyal agent (the manager) betrays a helpless principal (the company). The second is that corporations with publicly traded stock typically act to maximize shareholder wealth.[1] Corporate managers thus decide to sacrifice the interests of stakeholders and society to increase corporate profits because they genuinely view such a course of action as necessary for the corporation to prosper and even survive.

When a legal transgression by a corporation reflects agency costs, it is much easier to justify bringing enforcement cases against individual executives. A personal motivation to enrich oneself can provide the basis for establishing fraudulent or criminal intent. In contrast, when the manager violates the law to further corporate policy, it is often more difficult to bring a viable case against that individual. It may be unfair to single out particular executives who contribute only partly to

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1. *See, e.g.*, In re Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 Del. Ch. LEXIS 197, at *8, *92 (Sep. 7, 2021) (faulting Boeing executives for emphasizing profitability over safety).

a corporation's wrongful acts. The costs of establishing such liability may also be significant relative to the benefits.

The question of whether corporate wrongdoing tends to reflect agency costs is thus critical in assessing recent criticisms that enforcement actors do not bring enough cases against individual executives. Prominent commentators have argued that the relative infrequency of such cases reflects a failure by enforcers.[2] If there are clear examples of individual enrichment that have been left unaddressed, then the failure to hold managers accountable could be explained by factors such as risk aversion by government prosecutors.[3]

The relative infrequency of individual sanctions for corporate wrongdoing is best explained by the reality that managerial decisions reflect a mix of personal and corporate motivations.[4] Individual executives who are responsible for corporate misconduct may be motivated to maximize their personal stock holdings,[5] but because of the strong corporate incentive to maximize shareholder wealth, there will often be an argument that such wrongdoing was also meant to benefit the corporation.[6] When corporate wrongdoing is meant to bolster financial performance, which increases or maintains a company's stock price (at least in the short-term), it is difficult to argue that it was primarily a scheme to benefit just a few particular individuals. Without a distinctive motivation to violate the law, it is more difficult for

2. *See, e.g.*, JOHN C. COFFEE, JR., CORPORATE CRIME AND PUNISHMENT: THE CRISIS OF UNDERENFORCEMENT ix-x (2020) (noting the argument that "prosecutors are too logistically constrained to undertake intensive investigations" of corporate crime); Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. BOOKS (Jan. 9, 2014) (questioning why there were few prosecutions of executives after the financial crisis of 2008).

3. *See, e.g.*, JESSE EISINGER, THE CHICKENSHIT CLUB: WHY THE JUSTICE DEPARTMENT FAILS TO PROSECUTE EXECUTIVES (2017).

4. A corporation can be liable for a legal violation of one of its employees when "(1) the employee acted 'within the scope of her employment,' and (2) she acted with *an* intent to benefit the corporation." Miriam H. Baer, *Corporate Criminal Law Unbounded, in* THE OXFORD HANDBOOK OF PROSECUTORS AND PROSECUTION 479 (Ronald F. Wright, Kay L. Levine & Russell M. Gold eds., 2021). Thus, even when there is an agency costs motivation for corporate misconduct, the corporation can still be responsible so long as one of the motives of the misconduct was to benefit the corporation. There will also be examples where corporate misconduct is intended to benefit the corporation but is also in the personal interest of the employee.

5. *See, e.g.*, COFFEE, *supra* note 2, at x (arguing that "high levels of incentive compensation induce managers to induce high risk—both operationally and legally.").

6. Some commentators have even argued that managers have a duty to break the law when doing so benefits shareholders. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155, 1177 n.57 (1982) (asserting that "managers not only may but also should violate the rules when it is profitable to do so.").

enforcers to establish the individual intent necessary to bring a compelling case against a corporate manager.[7]

It is worth noting that corporate wrongdoing has not been limited to periods where corporate managers owned substantial stakes in their corporations. Even when they were paid in salaries, executives have felt compelled to pollute the environment, pay bribes to win business, and sacrifice investment in safety measures that prevent accidents involving their products. It is thus difficult to conclude that corporate managers steer corporations in ways that harm society solely or even primarily because of their personal interests.

This Essay examines the issue of public company wrongdoing through the specific lens of securities fraud. Corporations can deceive investors by issuing misleading disclosures relating to their financial performance or condition. Hundreds of allegations of such fraud are filed against corporations in the United States each year, typically asserting claims under SEC Rule 10b-5.[8] One view of securities fraud is that it mainly reflects the agency costs view of corporate wrongdoing. Corporate managers inflate the stock price to increase the value of their own holdings so they can sell them before the market realizes the truth.

But the problem of public company securities fraud began to emerge even before managers were mostly paid in stock.[9] While there was a period during the 1990s when allegations that a material misrepresentation permitted managers to benefit through insider trading were prominent, such a theory has not always been dominant and is not prevalent today. Securities fraud is a complex problem that cannot be addressed solely by targeting executive compensation policies. It is a broader structural problem that threatens most public corporations that are pressured to maximize shareholder wealth.

There are some prominent cases of securities fraud that can be tied to the incentive of individual executives to inflate the company's stock price. But there are also many cases where there are no such allegations. Because the process of drafting disclosure documents and financial statements necessarily involves groups of corporate employees, it may be unfair to hold just one or two executives responsible for a material misstatement in such disclosures. Even when a particular

7. Such a case would require establishing a high level of knowledge and intentionality on the part of an individual manager.

8. Rule 10b-5 prohibits material misstatements made with fraudulent intent in connection with the purchase or sale of a security. *See* 17 C.F.R. § 240.10b-5.

9. JAMES J. PARK, THE VALUATION TREADMILL: HOW SECURITIES FRAUD THREATENS THE INTEGRITY OF PUBLIC COMPANIES 3 (2022).

fraudulent misstatement can be linked to a high-level executive, absent evidence of a high level of deceptive intent, it can be difficult to justify imposing strong sanctions on that executive.

Examining securities fraud cases is useful in considering the broader issue of corporate wrongdoing because they are increasingly the place where courts and regulators scrutinize general corporate misconduct. The revelation of corporate transgressions often triggers a significant stock price decline. The failure by the corporation to disclose such wrongdoing and the risks it posed to the company in a timely manner is often framed as deceptive conduct that violates the securities laws. Some recent securities fraud cases highlight how corporate wrongdoing tends to be motivated by a mix of agency costs and shareholder wealth maximization.

In some ways, shareholders want corporate managers to take on risks that may trigger allegations of corporate misconduct. Because a significant percentage of the public qualifies as shareholders, many of us are complicit in a system that tends to sacrifice other corporate stakeholders to generate profits. There is no easy solution to the problem of corporate misconduct because it rests on a system that is desirable in that it encourages efficiency, growth, and innovation. Addressing problems like securities fraud requires relying on a diverse range of measured efforts by enforcers as well as *ex ante* regulation.

II. Agency Costs and Securities Fraud

Corporate managers now have a personal incentive to maximize the company's stock price (at least in the short-term), but that was not always the case. Early applications of agency cost theory predicted that the main problem with corporate managers was that they would sacrifice profits for leisure. Because they did not have enough incentive to increase shareholder value, they would work from nine to five and leave work at the office on the weekend. Agency costs theory did not predict that managers would expend substantial effort to create the perception of exceptional financial performance of companies because such managers had less personal incentive to do so. It was only when compensation packages became more laden with equity and options that the agency costs theory become a widely-accepted explanation for corporate wrongdoing.[10]

10. Corporate wrongdoing should be distinguished from individual wrongdoing. For example, a manager would commit individual wrongdoing by stealing from the corporation. Such actions are clearly outside the scope of the manager's authority and would not be considered corporate acts.

The publication of Jensen and Meckling's seminal article on agency costs was particularly compelling because it coincided with the economic stagnation of the 1970s.[11] Large U.S. corporations were described as bureaucratic and inefficient compared to their nimbler foreign competitors.[12] Corporate managers were seen as too cautious and more concerned with increasing the size of their companies than generating profits for shareholders. Because they were paid like bureaucrats,[13] corporate executives were viewed as taking every opportunity to wring out perquisites from the company—large offices, corporate jets, and ample expense accounts.[14]

Agency costs theory thus predicted that corporate managers would compromise the interests of shareholders through inaction. The indifferent manager might mismanage the company through laziness or ineptitude but would not have the motivation to actively scheme to violate the law to increase profits for the company's shareholders. Some forms of corporate wrongdoing may be the result of passivity, but the worst forms of corporate wrongdoing require active involvement by motivated managers.

In the context of corporate securities fraud, it is telling that the first academic article to systematically apply agency costs theory to securities fraud cases did not view such fraud as maximizing shareholder wealth. Jennifer Arlen and William Carney viewed securities fraud in a 1992 article as a problem of "last period" agency costs.[15] Corporate managers would deceive investors mainly when their firms were failing, and they needed time to save the company. They did so mainly to protect their jobs and salaries rather than to further shareholder interests. Viewed as a "last period" problem, securities fraud would not be as much of an issue for public companies that were not on the brink of collapse.

As stock-related compensation became the norm for corporate managers during the 1990s, it was natural to link the new managerial incentive to increase the stock price with the problem of securities

11. Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

12. *See, e.g.*, Robert H. Hayes & William J. Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV. (1980), https://hbr.org/2007/07/managing-our-way-to-economic-decline.

13. Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 238 (1990).

14. *See, e.g.*, Jensen & Meckling, *supra* note 11, at 313 (defining "agency conflict between the owner-manager and outside shareholders as deriving from the manager's tendency to appropriate perquisites out of the firm's resources for his own consumption.").

15. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 727 (1992).

fraud. The collapse of companies like Enron and WorldCom where executives had large stock holdings, some of which were sold prior to the revelation of a securities fraud, were the main exhibits that supported blaming managers for securities fraud. Enron executives sold tens of millions of dollars in stock before the company collapsed.[16] WorldCom's CEO desperately needed the stock price to stay high because he had taken out massive loans backed by his company stock holdings.[17]

Stock compensation aligned the interests of managers and shareholders, but only partially. Corporate managers arguably only had an incentive to increase the stock price in the short-term by creating the appearance that they were increasing shareholder wealth. They were only concerned about keeping the stock price high for enough time so that they could cash out. Shareholders that preferred to invest for the long-term would prefer that managers not take on the risk of violating securities laws that could trigger government sanctions and reputational harm. Some securities frauds could thus be characterized as reflecting an agency costs problem where managers with short-term incentives compromised the interests of shareholders with a long-term perspective.

In the aftermath of Enron, WorldCom, and numerous other securities frauds, steps were taken to reduce the risk that corporate managers would pump and dump a public company's stock. Sarbanes-Oxley enacted claw-back provisions that would require managers to give back stock gains that could be tied to wrongfully misstated financial statements.[18] Many companies have implemented policies requiring managers to hold stock for significant periods.[19] Such policies were augmented after the 2008 financial crisis with say-on-pay votes and higher expectations for the independence of executive compensation committees.[20]

Corporate managers understood that they could be subject to severe sanctions if their significant stock sales were tied to a fraudulent

16. Second Amended Complaint at ¶¶ 92, 112, S.E.C. v. Lay et al., No. H-04-0284 (S.D. Tex. July 2004).

17. DENNIS R. BERESFORD ET AL., REPORT OF THE INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF WORLDCOM, INC. 323 (2003).

18. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

19. *See, e.g.*, Boris Groysberg et al., *Compensation Packages That Actually Drive Performance*, HARV. BUS. REV. (Jan.–Feb. 2021), https://hbr.org/2021/01/compensation-packages-that-actually-drive-performance.

20. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L. J. 247, 252 (2010).

misstatement. They thus took measures to minimize the risk that they could be accused of insider trading. Executives increasingly used 10b5-1 plans where they would schedule stock sales in advance to avoid the appearance of insider trading.[21] Courts have generally held that executive trades that are properly made pursuant to such a plan do not "raise a strong inference of scienter."[22]

Perhaps because of these responses, in recent years there has been a decline in allegations that fraud was meant to enrich high-level executives. For example, the collapse of major public financial institutions during the 2008 financial crisis was not extensively addressed through enforcement against corporate managers. Unlike with Enron and WorldCom, there was no evidence that bank executives systematically unloaded their shares while assuring markets that all was well. More recently, major securities enforcement cases have generally not uncovered massive insider trading by corporate executives around the time of a scheme to deceive investors.

Corporate managers still have selfish reasons to commit securities fraud. Keeping the stock price high may increase the probability that they can keep their jobs and avoid criticism from shareholders. However, the story that securities frauds were essentially a result of personal financial enrichment was mainly prominent during the late 1990s and early 2000s. Before and after that period, it is more difficult to describe securities fraud as mainly a problem of agency costs.

III. Shareholder Wealth Maximization as the Main Driver of Securities Fraud

Decades before it was seen as a product of agency costs, securities fraud in public companies became a regulatory concern as investors and stock markets became more demanding in seeking information on corporate performance, prompting corporations to focus on increasing shareholder wealth. As stock markets increasingly valued companies based on their future performance, pressure to deliver financial results that provided evidence of continued profitability increased significantly. With such pressure, there was an incentive for public corporations to issue misleading information to create the illusion of success.[23]

21. 17 C.F.R. § 240.10b5-1.

22. In re Lululemon Sec. Litig., 14 F.Supp.3d 553, 586 (S.D.N.Y. 2014). 10b5-1 plans have not been without controversy. The SEC has proposed amendments in response to evidence of opportunistic uses of 10b5-1 plans. *See* Sec. & Exch. Comm'n, Rule 10b5-1 and Insider Trading, Release No. 33-110013; 34-93782 (Jan. 13, 2022).

23. This is the thesis of my book, The Valuation Treadmill, *supra* note 9.

Publicly traded companies were not always incentivized to create the appearance that they were maximizing shareholder wealth. During the 1950s and 1960s, U.S. corporations enjoyed significant deference from shareholders, who were largely passive. Professional corporate managers were seen as uniquely qualified to steer large companies and allocate resources to projects within the boundaries of such firms. The post-war American economy was prosperous and large domestic companies often developed market power that facilitated the delivery of consistent profits.[24] The goal was to maintain such profitability rather than take risks that would grow profits.[25]

This age of managerialism, where deference to managerial decisions was the norm, began eroding during the 1970s.[26] By that time, institutional shareholders had emerged as an influential market force.[27] Because they controlled much larger sums than retail investors, they had a greater ability to affect stock prices. They also were more informed and relied on systematic valuation methods to inform their trading decisions. They mainly utilized the basic discounted cash flow model, which requires prediction of a company's future earnings to generate a fundamental value for an asset like a company's stock.[28] Research analysts emerged to assist market participants in developing predictions of corporate revenue and earnings that could be used to generate reasonable valuations.

Such corporate projections were made possible because public companies themselves had become better at developing internal projections of their performance.[29] A significant part of management requires allocating funds to projections with the highest potential. Making such decisions requires projecting revenue and costs and evaluating how actual performance compares to such projections.

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24. *See, e.g.*, Carl Kaysen, *The Social Significance of the Modern Corporation*, 47 AM. ECON. REV. 311, 314 (1957) (noting use of market power "to insure the security and permanence of the institution, by aggressive creation and occupation of developing markets and technologies, so far as possible. . . .").

25. *See, e.g.*, W. D. KNIGHT & E. H. WEINWURM, MANAGERIAL BUDGETING 14 (1964) ("[M]anagement is in almost universal agreement that the maximization of current profits by means which would jeopardize future operations is not desirable.").

26. For a fuller account of this shift, *see* James J. Park, *From Managers to Markets: Valuation and Shareholder Wealth Maximization*, 47 J. CORP. L. 435, 451 (2022).

27. *See, e.g.*, ROY C. SMITH, THE MONEY WARS: THE RISE AND FALL OF THE GREAT BUYOUT BOOM OF THE 1980s 83 (1990) (describing the increase in institutional investors).

28. For an excellent overview of this model, *see* DAVID WESSELS ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES (7th ed. 2020).

29. *See, e.g.*, ELMER C. BRATT, BUSINESS FORECASTING v (1958) ("New conceptions of the management function in private business have accentuated the importance of forecasting. For example, decisions depend more and more on expected sales, whose figures depend on the use of sales budgets, which are in turn based on sales forecasting.").

Research analysts often sought such internal projections to inform their own projections. Rather than complete guesses about corporate performance, analyst projections were often based in part on the knowledge and expertise of expert corporate managers.[30] As projections became more reliable, they became a means by which markets judged corporate performance. It became important for public companies to deliver short-term results that met projections in order to validate long-term growth trajectories that were the basis of their stock market valuations.

The sudden 1970 collapse of the nation's largest railroad, Penn Central, marked the shift from a managerialist paradigm to one where public companies were compelled to maximize shareholder wealth. While it was one of the largest U.S. companies based on the assets it controlled, Penn Central's core railroad operations were in decline as alternative methods of transportation became more attractive. For some time, it was able to maintain profitability by selling assets, but it struggled to reverse the downward trend in its central business.

According to the Securities and Exchange Commission, which issued a lengthy report on Penn Central, the company committed securities fraud in order to create the impression that it was not in dire straits.[31] In a notable departure from managerialist norms, the company's CEO implemented a maximization policy that emphasized generating results that would persuade investors that the company was overcoming the deterioration of its core railroad business. He made clear to his officers that "despite the vast array of problems facing the company, the earnings picture was to be presented in the best possible light."[32] This led the company to enter into questionable accounting transactions that, in some cases, were made to increase revenue so that the company could meet its financial projections.

The SEC's report noted that some Penn Central executives sold unusual amounts of their stock in the months leading up to the bankruptcy.[33] This would be consistent with an agency costs motivation for securities fraud. Perhaps the main reason they delayed acknowledging the company's core problems was so they had time to exit the stock. But notably, the report acknowledged that the company's CEO, the

30. *See, e.g.*, PREM PRAKASH & ALFRED RAPPAPORT, PUBLIC REPORTING OF CORPORATE FINANCIAL FORECASTS 252, 259 (1974) (noting that analyst projects are based on corporate forecasts).

31. STAFF REPORT OF THE SEC. & EXCH. COMM'N TO THE SPECIAL SUBCOMMITTEE ON INVESTIGATIONS, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY 109, 125, 185 (1972).

32. *Id*. at 33.

33. *Id*. at 9.

driving force behind the company's shareholder wealth maximization policy, did not sell any stock during the same period.[34]

The other major corporate scandal of the 1970s, the discovery that dozens of public companies were paying bribes to win business in foreign countries,[35] can also be viewed through a shareholder wealth maximization lens. While corporate managers arguably deceived markets by not disclosing the payment of such bribes, the practice at its essence was about winning business that would increase corporate profits. The managers were thus not acting mainly to benefit themselves but to expand their company's business, which would benefit stockholders.

By the early 1990s, the pressure to meet corporate projections had become more intense. While analysts only projected revenue and earnings on an annual basis during the 1970s, by the 1990s, quarterly projections had become the norm.[36] As information technology advanced, such projections were disseminated widely among Wall Street analysts.

Allegations of securities fraud against companies that failed to meet projections of financial performance became so common that Congress passed a law in 1995 protecting public companies from securities litigation.[37] The Private Securities Litigation Reform Act provided public companies with a strong safe harbor for forward-looking statements.[38]

The change in executive compensation policies during the 1990s to emphasize stock-related compensation coincided with the increasing pressure to meet quarterly projections. While the Enron and WorldCom cases both involved executives with personal incentives to commit fraud, it is important to recognize that many of the particular misrepresentations issued by the companies in those cases were made so they could meet quarterly and annual projections. Many of the SEC's enforcement efforts advanced the theory that the corporation committed securities fraud to meet market projections. Notably, beginning with its $10 million penalty against Xerox,[39] the agency began

34. *Id*. at 245.

35. *See* SEC. & EXCH. COMM'N, REPORT OF THE SECURITIES & EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES B-4 (1976).

36. *See, e.g.*, Joseph Nocera, *Picking the Winners*, N.Y. TIMES MAG., Sept. 20, 1987, at 26 (observing that the research analyst's "constant task is to predict per-share profits in three-month increments.").

37. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737.

38. *See* 15 U.S.C. §§ 77z-2, 78u-5 (2012).

39. *See* Xerox Corporation Litig. Release No. 17465, SEC. EXCH. COMM'N (Apr. 11, 2002), https://www.sec.gov/litigation/litreleases/lr17465.htm; *see also* James Bandler et al., *Xerox Will*

sanctioning corporate defendants with substantial monetary penalties rather than mainly targeting individual executives. The size of corporate penalties has significantly increased over time, prompting criticism that such penalties are a substitute for careful investigation of individual corporate managers.

There were many contributing causes to the Enron and WorldCom era of securities fraud. Executives had incentives to boost stock prices. Auditors failed to resist pressure to apply accounting rules in questionable ways. But the fundamental driver of the fraud was that corporations faced pressure to create the appearance of continued profit growth in order to maximize their stock prices. If corporations did not have an incentive to meet corporate projections, executives would not have had an incentive to manipulate stock prices to increase their compensation, and auditors would not have been pressured to permit questionable accounting practices.

Shareholder wealth maximization has been a more consistent explanation for securities fraud by public companies over the last few decades than the idea that such fraud is perpetrated by a few rogue actors acting in their personal interest.

IV. General Corporate Wrongdoing and Securities Fraud

Over the last decade or so, securities fraud cases have increasingly highlighted broader forms of corporate wrongdoing than the traditional misstatements relating to a company's financial performance or the development of an important product. After a significant corporate scandal, the SEC and private plaintiffs have often filed securities enforcement cases arguing that the corporate defendant failed to disclose information that would have warned investors about the risk of the scandal.[40] These cases are not only instructive on the question of securities fraud, they also provide a broader window into public company wrongdoing.

The 2010 Deepwater Horizon oil spill involving British Petroleum (BP) prompted both securities class actions and SEC enforcement. The SEC offered a theory that focused on the company's response to the disaster after the spill. It argued that the company issued misleading estimates about the extent of the oil spill after it had occurred.[41] It disseminated low estimates that were at odds with its numerous inter-

Pay $10 Million Penalty to Settle SEC Accounting Charges, Wall St. J. (Apr. 2, 2002), https://www.wsj.com/articles/SB1017682255642049000.

40. *See, e.g.*, Donald C. Langevoort, *Disasters and Disclosures: Securities Fraud Liability in the Shadow of a Corporate Catastrophe*, 107 Geo. L. J. 967, 971 (2019).

41. Complaint, S.E.C. v. BP p.l.c., No. 2:12-cv-02774 (E.D. La. Nov. 15, 2012).

nal estimates of a larger spill. The securities class action focused on the period before the spill, arguing that the company deceived investors about its implementation of safety measures that would have prevented the disaster.[42]

Why would BP's managers deceive investors in these ways? The agency costs theory would contend that they were attempting to save their jobs and their stock compensation by playing down the extent of the spill. Their earlier failure to be candid about the progress of safety measures could have been motivated by a desire to hide the managers' lack of competence in implementing such measures. In contrast, a shareholder wealth maximization theory would contend that the managers were protecting the interests of the company's shareholders by managing public perceptions of the spill. The managers may have been non-transparent about slow progress on safety measures because they believed that rapidly implementing such measures would have been inefficient and reduced corporate value.

Both explanations seem plausible, but there is an argument that the shareholder wealth maximization explanation is more persuasive. Notably, neither the SEC nor the securities class action advanced a theory of insider trading as motivating the alleged fraud. The district court decision permitting the class action to proceed cited a report that "BP's management culture was consumed with cost-cutting and meeting financial targets at the expense of safety and maintenance issues. . . ."[43] Moreover, one would hope that most corporate managers would not be thinking solely about themselves when formulating disclosures relating to a massive crisis and deciding the extent to which they would implement safety measures. Managing public perception and implementing compliance measures raises complicated issues about the best course for the corporation and its shareholders.

The agency costs theory of securities fraud is even less of a fit with respect to a securities fraud case filed against Facebook alleging that the social media giant did not clearly disclose that it was selling data to a political consulting firm. As a result, it was fined $5 billion by the Federal Trade Commission. The SEC filed suit in 2019 alleging securities fraud violations and the case was settled for an additional $100 million penalty.[44]

42. In re BP p.l.c. Sec. Litig., 843 F.Supp.2d 712, 775 (S.D. Tex. 2012); *see also* In re BHP Billiton Ltd. Sec. Litig., 276 F.Supp.3d 65, 80 (S.D.N.Y. 2017) (finding statements relating to the safety of collapsed dam were actionable given company's knowledge of problems with the dam).

43. In re BP p.l.c. Sec. Litig., 843 F.Supp.2d at 726.

44. *See* Complaint at ¶ 53, S.E.C. v. Facebook, Inc., No. 3:19-cv-04241 (N.D. Cal. July 19, 2019).

The CEO of Facebook was and is Mark Zuckerberg, who is also the company's controlling shareholder. It was thus difficult to argue in that case that corporate managers acted to maximize their short-term gains at the expense of other shareholders. Zuckerberg has an incentive to maximize the long-term market value of Facebook because of his status as a significant long-term holder of the company's stock. On the other hand, plaintiffs brought a private securities fraud suit alleging that Zuckerberg and other executives sold stock during the period of the fraud,[45] but these sales were a fraction of Zuckerberg's holdings. The aggressive search for additional revenue streams by selling data is consistent with efforts to increase the stock's value.

The tragic crash of two Boeing jets because of the malfunction of a flight stabilization system also spurred significant litigation, including major SEC enforcement cases.[46] The complaint in a derivative lawsuit against the company's board, which settled for more than $200 million,[47] alleged that Boeing underinvested in safety measures that might have prevented the accidents because of pressure on its profits caused by competition with Airbus. The Delaware court noted that "safety was not a regular topic of Board discussion" and even after the crash, the Board focused on "restoring profitability and efficiency in light of longstanding supply chain issues."[48] Essentially, Boeing prioritized its shareholders over its consumers and society.

Boeing's top management has not faced significant legal consequences for the accidents. While the Delaware Chancery Court permitted fiduciary duty claims to proceed against the company's directors, it dismissed such claims against the company's officers.[49]

45. *See, e.g.*, In re Facebook, Inc. Sec. Litig., 405 F.Supp.3d 809, 822 (N.D. Cal. 2019) (noting the allegation that Zuckerberg sold 30,000 shares of Facebook worth $5.3 billion during the class period). Notably, the district court in dismissing the case did not find the stock sales of Facebook executives significant in discussing whether they acted with scienter. While the lack of discussion may reflect that the Ninth Circuit places less emphasis on the motivation of individual executives in determining whether they acted with fraudulent intent, it also reflects that the argument was unpersuasive.

46. Boeing paid $200 million to settle charges that it violated securities law by misleading investors after the crash. Notably, the SEC also filed a case against the company's CEO, but that case was settled for only $1 million. *See* Press Release, Sec. & Exch. Comm'n, Boeing to Pay $200 Million to Settle SEC Charges that it Misled Investors About the 737 MAX (Sept. 22, 2022), https://www.sec.gov/news/press-release/2022-170.

47. *See* Andrew Tangel, *Boeing Shareholders Reach Settlement in 737 MAX Board Oversight Suit*, WALL ST. J. (Nov. 4, 2021), https://www.wsj.com/articles/boeing-shareholders-reach-settlement-in-737-max-board-oversight-suit-11636076012.

48. In re Boeing Co. Derivative Litig., No. 2019-0907-MTZ, 2021 Del. Ch. LEXIS 197, at *38 (Sept. 7, 2021).

49. *Id*. at *96-97. For a critique of this decision, *see* Roy Shapira, *Max Oversight Duties: How Boeing Signifies a Shift in Corporate Law*, 48 J. CORP. L. 1, 23 (2022).

The Delaware court reasoned that any lawsuit against the officers could be pursued by Boeing's board. Put another way, it was up to the board to determine whether any officers were acting out of selfish interest rather than in the best interests of the corporation. It is unlikely that a board will come to such a conclusion absent the discovery of clear and specific evidence. The criminal investigation also did not result in cases against individuals. The company entered into a deferred prosecution agreement with federal prosecutors, but its executives have not been subject to criminal charges.

Frustration with the failure to hold individual executives is understandable. At the same time, when the conduct of corporate managers is largely driven by broader market pressures rather than their efforts to enrich themselves, it is difficult for prosecutors to justify bringing cases against such managers.

V. The Difficulty of Assigning Individual Blame for Securities Fraud

If securities fraud and other forms of corporate wrongdoing are mainly the results of a general emphasis on shareholder wealth maximization by publicly traded corporations, it is problematic to focus blame for such misconduct solely on corporate executives. Stock markets want public companies to take on risk and maximize profits. If they do not, their stock prices will fall as investors sell the stock. Corporate managers are working within a system that pressures them to compromise societal interests.

Without a clear agency costs story, it is more difficult for enforcers to justify singling out individual executives. They will need strong evidence of direct acts by the individual that can be tied to a fraudulent statement or some other decision that violates the law. Executives can often plead ignorance or hide behind group decision-making. Even when they can be tied to a particular misstatement, without evidence that they were acting for their own interests, it can be difficult to build a compelling case justifying high sanctions against them.

The SEC's case against Citigroup's misrepresentations relating to its holdings of subprime securities towards the start of the 2008 financial crisis illustrates the reluctance of regulators to hold individual executives accountable without evidence of personal enrichment. As concerns about a decline in housing prices emerged, Citigroup incorrectly assured investors that it had reduced its subprime holdings to $13 billion when in fact it had an additional $39 billion in exposure to such

securities.[50] By a later call with investors, some of its managers knew that this was a misstatement but chose not to correct it. It was only a month later when it took losses on the subprime assets that the truth was disclosed.[51]

The SEC chose to bring a case against a high-level Citigroup official, its Chief Financial Officer (CFO), but he only paid a $100,000 penalty to settle the case.[52] It did not bring cases against other executives because they were not directly involved with the company's disclosure on its subprime liability. The CFO clearly knew of a misstatement but there was no evidence that he was personally enriched by the false disclosure. The failure to correct the mistake might have been explained by the misguided view that Citigroup would be better off if attention was not drawn to the earlier mistake through a correction. Without evidence that the CFO received monetary gain from the misstatement, it may have been difficult for the SEC to justify a high sanction against him. Even in a case where an individual executive was held responsible for a material misstatement, without a story of unjust enrichment, there was not a strong basis for condemning the CFO's conduct. The primary penalty was thus a $75 million penalty against Citigroup,[53] which also paid close to a billion dollars to resolve investor lawsuits.

Directing reforms at corporate managers will have a minimal effect so long as shareholders continue to demand wealth maximization. Proposals to moderate stock compensation have generally failed because shareholders want executives to have incentives to increase firm value. The deterrent effect of punishing corporate managers for fraud will be counterbalanced by the reality that public company executives will continue to face pressure to deliver short-term results.

Could the solution be to shift from shareholder wealth maximization to a system that prioritizes a broader range of stakeholders? A wide range of groups are pushing public companies to move away from an approach that privileges shareholder interests. There is now much greater support for corporate governance that considers the needs of corporate stakeholders. Could such efforts affect the incentive of corporations to commit securities fraud as well as other types of wrongdoing?

50. Complaint at ¶ 1, S.E.C. v. Citigroup Inc., No. 1:10-cv-01277 (D.D.C. July 29, 2010).

51. *Id*. ¶ 36.

52. Edward Wyatt, *Judge Accepts Citigroup's Settlement with S.E.C.*, N.Y. TIMES, Sept. 25, 2010, at B2.

53. Notably, the SEC charged Citigroup using provisions that did not require a showing of fraudulent intent. Randall Smith, *Parsing the Citi Settlement: To Bolster Lawsuits, Stockholders and Bondholders Ask: Was Fraud Involved?*, WALL ST. J., Aug. 2, 2010, at C3.

It is notable that many corporate executives have long supported a more expansive stakeholder paradigm.[54] One view is that such a position evidences a sincere desire to pursue broader goals that are consistent with the public good. A more skeptical reaction to such efforts is that managers are seeking to insulate themselves from scrutiny by investors.[55] Moreover, even if managers want to serve the interests of society, the nature of operating as a public company makes it difficult for them to actually do so.

For it to meaningfully affect managerial and corporate incentives, a shift to stakeholderism would have to be accompanied by a greater willingness to value public companies based on their long-term prospects. Moreover, shareholders would need to be more patient and focus less on short-term financial results in judging whether a company's long-term vision is sound. In such a world, if it is possible, there would be less pressure for corporations and their managers to make questionable decisions to increase short-term results.

On the other hand, corporate stakeholderism would not by any means eliminate the problem of fraud. There would still be corporate incentives to manipulate disclosures that are meant to assess the impact of policies on stakeholders. For example, a company could misreport climate emissions to create the impression that it is improving its impact on the environment.

Even companies that have an incentive to consider the interests of stakeholders can still engage in significant wrongdoing. Consider Volkswagen, the car manufacturer headquartered in Germany, where labor has a formal role in corporate governance.[56] The company engineered its cars to falsely pass tests required by U.S. environmental regulation.[57] Such a course of action sacrificed the environment and compliance with the U.S. regulatory regime but were arguably consistent with the interests of German shareholders and workers that would have benefitted from increased production in the U.S. market.

The failure to disclose the scheme was the basis for an SEC enforcement action as well as private litigation.[58] It is possible to argue that

54. *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE (Aug. 19, 2019), https://opportunity.businessroundtable.org/wp-content/uploads/2019/12/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf.

55. *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 122 (2020).

56. *See, e.g.*, GRANT M. HAYDEN & MATTHEW T. BODIE, RECONSTRUCTING THE CORPORATION: FROM SHAREHOLDER PRIMACY TO SHARED GOVERNANCE 254 n.22 (2021).

57. *See* Complaint at ¶ 11, S.E.C. v. Volkswagen et al., No. 3:19-cv-01391 (N.D. Cal. 2019).

58. *See, e.g.*, Ord. Granting in Part and Denying in Part Volkswagen's Motion to Dismiss at 10, In re Volkswagen "Clean Diesel" Mktg., Sales Practices, & Prods. Liab. Litig., No. 2672 CRB

Volkswagen made the decision to hide its violations of environmental law from investors solely to enrich its managers. But given the broader focus on stakeholder values in Germany, it is difficult to contend that the managers were motivated solely by the incentive to increase their own compensation.

The difficulty of holding individual executives accountable for securities fraud reduces the effectiveness of securities fraud enforcement in deterring such fraud. If corporate managers had a significant fear of personal liability or prosecution for securities fraud, they would insist on more conservative disclosure policies. When penalties fall solely on the corporation, they have much less bite and can be seen as simply a cost of doing business. The critics are correct in pointing to the lack of individual sanctions as a deficiency in the system.

At the same time, there are powerful reasons why enforcers should not pursue cases against corporate managers. Due process requires a clear evidentiary trail that links the manager to a securities fraud. To the extent that the motivation for such a fraud can be tied to corporate policy, it is more difficult to single out the executive for substantial blame. Given this reality, it is understandable why enforcers may conclude that the costs of building cases against such executives will often not be justified.

The lack of individual liability for securities fraud does not mean that the system cannot effectively prevent securities fraud. It is important to remember that securities fraud enforcement is only one aspect of securities fraud regulation. *Ex ante* regulation of public companies also plays a significant role. The Sarbanes-Oxley Act of 2002 requires public companies to invest substantial resources in preventing material financial misstatements.[59] The difficulty of effectively deterring securities fraud is a reason for stronger preventative measures to reduce the risk of such fraud. Corporate sanctions for fraud along with the occasional case against individual executives help supplement the regulatory regime that was constructed in the wake of the securities frauds of the late 1990s and early 2000s. A combination of measures can help make it more likely that significant frauds are an aberration rather than the norm.

(JSC) (N.D. Cal. Aug. 20, 2020); United States S.E.C v. Volkswagen AG (In re Volkswagen "Clean Diesel" Mktg., Sales Practices, & Prods. Liab. Litig.), No. 2672 CRB (JSC) (N.D. Cal. Dec. 9, 2020); In re Volkswagen Clean Diesel, Fed. Sec. L. Rep. P 99817 (C.C.H.), 2017 WL 3310179 (N.D. Cal. July 19, 2017) (denying the motion to dismiss securities class action).

59. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

VI. CONCLUSION

Why do public companies commit securities fraud? Some cases can be understood in terms of an agency costs framework, but many instances of such deception are at least partly motivated by managers who are working to increase or maintain the company's stock price on behalf of the shareholders. The same can be said of other forms of public company wrongdoing. Shareholders want corporate managers to generate profits and cannot plead complete innocence when corporations respond to such pressure by acting immorally. When executives are working within the corporate environment, it can be unfair to condemn them individually without compelling evidence that they had a personal motivation to deceive investors.

Because shareholder wealth maximization is a major reason why corporations violate the law, corporate misconduct is a persistent problem that must be addressed through a variety of measures. There is no silver bullet that will eliminate the incentive to deceive investors or take on excessive risk to satisfy stock markets. The benefits of a system that prioritizes efficiency and rigorous valuation requires bearing the cost of the corporate wrongdoing that can result.

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