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**BEYOND PROTECTION: INVIGORATING INCENTIVES  
FOR SARBANES-OXLEY CORPORATE AND  
SECURITIES FRAUD WHISTLEBLOWERS**

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*Section 806 of the Sarbanes-Oxley Act of 2002 (“SOX”) recognized the importance of private actors in bringing to light information about corporate financial and accounting fraud. That section provides some protection against retaliation for whistleblowers who object to, and report, violations of the federal securities laws. While this limited protection is a step in the right direction, current law does not go far enough to encourage whistleblowers to risk incurring the adverse social, psychological, and economic consequences of exposing serious corporate and securities fraud. This Article develops the “bounty” model for rewarding SOX whistleblowers, and argues that sound public policy counsels its adoption and implementation. By giving whistleblowers a share of the recovery of those damaged by corporate and financial fraud (a “bounty”), the law could increase incentives for whistleblowing. The Federal False Claims Act provides a sensible precedent.*

#### INTRODUCTION

The last decade has been marred by some of the most serious corporate scandals in American history. Yet today, Congress seems poised to roll back some provisions of the Sarbanes Oxley Act of 2002 (“SOX”),<sup>1</sup> a law enacted in response to those events. While there is much fault to find in SOX, the statute did offer at least one important reform. For the first time, Congress enacted a uniform, national, anti-retaliation provision to protect whistleblowers who exposed their employers’ financial and accounting fraud. At a time when SOX may be headed for the legislative graveyard, it is vital to analyze this provision and explore how to better leverage the inside information possessed by potential whistleblowers as a means of deterring serious corporate fraud. This Article argues that a bounty model should be adopted to strengthen incentives for whistleblowing in the securities context.

In the debate over SOX and the role of whistleblowers in fighting securities and corporate fraud, a historical perspective is important. A decade ago, Congress recognized that something was broken in the private securities litigation arena.<sup>2</sup> Class action lawyers, rather than genuinely aggrieved

<sup>1</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18, and 28 U.S.C.).

<sup>2</sup> See Keith Johnson, *Deployment of Institutions in the Securities Class Action Wars*, 38 ARIZ. L. REV. 627, 628 (1996) (referring to “a strong belief on the part of Congress that our private securities litigation system is in need of repair”).

investors, initiated and managed securities fraud actions.<sup>3</sup> Semi-professional class representatives were paid bounties by the plaintiffs' bar.<sup>4</sup> Strike suits – filed after nearly every public corporation earnings restatement or major stock price fall regardless of the strength of the requisite fraud allegations – were common.<sup>5</sup> Plaintiffs' law firms extracted settlements from corporate defendants wary of costly, time-consuming discovery and risky securities fraud trials. The result, the Private Securities Litigation Reform Act of 1995 (PSLRA),<sup>6</sup> was designed to curb these perceived abuses of the securities

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<sup>3</sup> See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3-5 (1991) (criticizing the current class action framework for allowing "entrepreneurial attorneys," who are "subject to only minimal monitoring," to control litigation in which "the identified plaintiff operates almost always as a mere figurehead"); see also Michael C. Dorf, *The Indictment of the Milberg Weiss Law Firm and America's Love/Hate Relationship with Class Action Litigation*, FINDLAW'S WRIT, May 22, 2006, <http://writ.news.findlaw.com/dorf/20060522.html>.

<sup>4</sup> See James D. Cox et al., *An Empirical Analysis of Institutional Investors' Impact as Lead Plaintiffs in Securities Fraud Class Actions* 8-9 (Vanderbilt Univ. Law Sch. Pub. Law & Legal Theory Research Paper Series, Paper No. 06-09, Duke Univ. Law Sch. Legal Studies Research Paper Series, Paper No. 107, 2006), available at <http://ssrn.com/abstract=898640> ("The class representative was frequently recruited by plaintiffs' lawyers in the securities bar, who maintained 'a list of potential plaintiffs and their stockholdings.'" (quoting Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2061 (1995))); Macey & Miller, *supra* note 3, at 5-6 ("[A]ttorneys are routinely forced to circumvent ethical restrictions on solicitation and maintenance in order to obtain named plaintiffs as their ticket into profitable litigation."). Many of the worst pre-PSLRA abuses of the private securities litigation system have come to light only recently with the federal indictments of a leading plaintiffs' class action firm, Milberg Weiss Hynes & Bershad. See Brooke A. Masters, *A Law Firm Under Pressure: Case Reopens Debate on Whether To Indict a Company*, WASH. POST, May 25, 2006, at D1 ("The indictment alleges that two of the firm's top partners . . . secretly paid more than \$11.3 million in kickbacks to individuals to serve as plaintiffs in class-action securities cases . . .").

<sup>5</sup> See Marilyn F. Johnson et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. (forthcoming) (manuscript at 3), available at <http://www.law.umich.edu/centersandprograms/olin/abstracts/discussionpapers/2002/JohnsonNelsonPritchard02011.pdf> ("Congress eventually concluded that the potentially enormous damages in securities fraud class actions were encouraging frivolous 'strike' suits."). But see John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation* 3 n.5 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 293, 2006) [hereinafter Coffee, *Reforming the Securities Class Action*], available at [http://ssrn.com/abstract\\_id=893833](http://ssrn.com/abstract_id=893833) (arguing that "[t]he true 'strike suit' nuisance action, which is filed only because it was too expensive to defend, is . . . a beast like the unicorn, more discussed than directly observed").

<sup>6</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77i, 77k, 77z-1, 77z-2, 78j-1, 78u-4, 78u-5 (2000)).

laws.<sup>7</sup> In enacting the PSLRA, Congress evinced its belief that the existing securities litigation regime was ineffective at exposing new information about ongoing corporate fraud. After the PSLRA, many leading plaintiffs' securities lawyers chose to forgo federal actions in favor of suits filed under state Blue Sky laws.

Little more than five years later, Enron collapsed after its creative accounting practices were revealed.<sup>8</sup> Similar creativity was revealed at Global Crossing.<sup>9</sup> And Adelphia.<sup>10</sup> And Tyco.<sup>11</sup> And WorldCom.<sup>12</sup> And Qwest.<sup>13</sup> Again, Congress came to the rescue.<sup>14</sup> SOX, a hodgepodge of recycled corporate governance proposals,<sup>15</sup> was the result. Amid all of the garbage

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<sup>7</sup> See James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 760 (2003) [hereinafter Cox et al., *SEC Enforcement*] ("Concerns that too many suits were 'strike suits' led to the enactment of the PSLRA.").

<sup>8</sup> The resulting Enron bankruptcy, in December 2001, has been called "a perfect storm" for corporate governance. Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post-WorldCom Era*, 58 S.C. L. REV. 65, 66 (2006).

<sup>9</sup> See John W. Cioffi, *Irresistible Forces and Political Obstacles: Securities Litigation Reform and the Structural Regulation of Corporate Governance* 28 (Comparative Research in Law & Political Econ., Research Paper No. 7/2006), available at <http://ssrn.com/abstractid=902648>.

<sup>10</sup> See André Douglas Pond Cummings, "Ain't No Glory in Pain": *How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets*, 83 NEB. L. REV. 979, 999-1000 (2005).

<sup>11</sup> See Cioffi, *supra* note 9, at 28. The Adelphia and Tyco scandals differed from Enron, WorldCom, and Global Crossing in that they were "stories of individual greed, rather than direct accounting corruption." Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 924-25 (2003).

<sup>12</sup> See Branson, *supra* note 8, at 66 ("WorldCom's bankruptcy resulted in losses for millions of investors and caused the pendulum's swing to gather speed.").

<sup>13</sup> See Cunningham, *supra* note 11, at 932.

<sup>14</sup> Most Americans forget that scandals similar to those at Enron and WorldCom were mirrored across the globe: for example, Elan in Ireland, Royal Ahold in the Netherlands, and One.Tel in Australia. See Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT'L L.J. 367, 369 (2005). Both the United Kingdom and Australia adopted regulatory responses to their own corporate scandals. See *id.* at 375. While these countries have some whistleblower protections, they have yet to explore the use of financial incentives to stimulate whistleblowing. See Elletta Sangrey Callahan et al., *Whistleblowing: Australian, U.K., and U.S. Approaches to Disclosure in the Public Interest*, 44 VA. J. INT'L L. 879, 899 (2004) [hereinafter Callahan et al., *Australian, U.K., and U.S. Approaches*] ("Protection from retaliation is the keystone of whistleblower legislation in all three countries.").

<sup>15</sup> See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005) ("[M]any of the substantive corporate governance provisions in SOX are not in fact regulatory innovations devised by Congress to

provisions,<sup>16</sup> many of which are likely to be repealed at the next opportunity,<sup>17</sup> there is a gem: SOX's whistleblower protection provision, section 806(a) of the Act.<sup>18</sup> In this provision, SOX recognizes the importance of insiders in exposing corporate fraud. SOX's whistleblower protections, however, are largely defensive. They are designed to deter fraudsters from retaliating against whistleblowers (or potential whistleblowers) by creating criminal liability for retaliatory actions. But SOX fails to radically increase the incentive for insiders with knowledge of ongoing corporate fraud to share that knowledge.

Potential whistleblowers face tremendous obstacles beyond direct employer retaliation. They know, for example, that bringing massive, Enron-style fraud to light could potentially lead to their current employer's implosion. Moreover, whistleblowers may fear blacklisting from future employers who suspect disloyalty, as well as social ostracism from their coworkers. Additionally, the psychological burdens associated with whistleblowing, including the effects of public criticism and a lengthy stay in litigation's

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cope with deficiencies in the business environment in which Enron and WorldCom failed. Rather, they may more accurately be characterized as recycled ideas advocated for quite some time by corporate governance entrepreneurs."); *see also* Cunningham, *supra* note 11, at 941-42 ("Sweeping as these [SOX provisions] sound in breadth, all changes made by the Act had been discussed among corporate governance and accounting devotees for years."); Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure 2* (UCLA Law & Econ. Research Paper Series, Paper No. 06-14, 2006), available at <http://ssrn.com/abstract=899593> ("[Congress] threw a bunch of ideas into a single basket and rushed it into law so that angry investors would blame somebody – anybody – other than Congress for the stock market bubble's bursting and the corporate governance scandals.").

<sup>16</sup> The Act

includes six main initiatives: creating the Public Company Accounting Oversight Board, a private, nonprofit corporation that is overseen by the SEC to "oversee the audit of public companies that are subject to the securities laws"; enhancing the independence of public company auditors; regulating corporate governance and responsibility; enhancing financial disclosure; regulating securities analyst conflicts of interest; and adding several new substantive crimes under the securities laws and enhancing penalties for violations of the securities and other laws.

Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149, 1154 (2004) (footnotes omitted). As Lawrence Cunningham writes, "[i]ncremental provisions of the Act are best seen as patchwork responses to precise transgressions present in the popularized scandals – legislative action akin to the frequently maligned military strategist fighting the last war rather than planning for the next." Cunningham, *supra* note 11, at 918-19. Roberta Romano opines that "the quality of decisionmaking that went into the SOX legislative process was, to put it mildly, less than optimal." Romano, *supra* note 15, at 1527.

<sup>17</sup> *See* Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 721 (2005) ("Since its adoption in the wake of corporate scandals . . . [SOX] has been the subject of heated criticism. If anything, the intensity of such attacks has grown over time.").

<sup>18</sup> *See* Sarbanes-Oxley Act of 2002 § 806(a), 18 U.S.C. § 1514A (Supp. IV 2004).

limelight, cannot be ignored. Finally, employees may be contractually or otherwise bound in a way that deters them from blowing the whistle.

SOX's whistleblower provision lacks a strong financial incentive for whistleblowers to expose corporate fraud. The SEC has limited power to share fines with those who bring fraud to light, but it rarely invokes this power. Whatever bounties are offered are likely too small to offset the psychological, economic, and social costs of being a whistleblower. Fortunately, there is an apt model for motivating insiders to bring fraud to light: the *qui tam*<sup>19</sup> provisions of the False Claims Act (FCA).<sup>20</sup> Also known as the "Informer's Act" and "Lincoln's Law,"<sup>21</sup> this statute provides a means for insiders who bring fraud against the government to the attention of regulators or the media to reap a substantial financial reward in the form of a "bounty."<sup>22</sup> FCA whistleblowers, known in the practice as "relators,"<sup>23</sup> can earn a percentage of the government's total recovery – up to 30% – in any FCA litigation.<sup>24</sup> From an information-generation perspective, the FCA works. Thousands of FCA

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<sup>19</sup> *Qui tam* is short for "*qui tam pro domino rege quam pro se ipso in hac parte sequitur*," which means "he who pursues this action on our Lord the King's behalf as well as his own." 1 JOHN T. BOESE, CIVIL FALSE CLAIMS AND QUI TAM ACTIONS 1-7 (3d ed. 2007) [hereinafter BOESE, FALSE CLAIMS]; ROBIN PAGE WEST, ADVISING THE QUI TAM WHISTLEBLOWER: FROM IDENTIFYING A CASE TO FILING UNDER THE FALSE CLAIMS ACT 1 (2001); Pamela H. Bucy, *Private Justice*, 76 S. CAL. L. REV. 1, 44 (2002) [hereinafter Bucy, *Private Justice*]. With roots as far back as Ancient Rome, see Richard A. Bales, *A Constitutional Defense of Qui Tam*, 2001 WIS. L. REV. 381, 385, *qui tam* actions "gained popularity in thirteenth century England as a means of enabling private parties to gain access to the royal courts, since only by alleging the king's interest was such access granted." 1 BOESE, FALSE CLAIMS, *supra*, at 1-7. Although common law *qui tam* actions fell into disfavor in England, the first statutory *qui tam* action was authorized in the admiralty context in the year 1400. See *id.* at 1-8. In fact, "[*qui tam*] actions have been 'frequently permitted by legislative action' under English and American law for hundreds of years prior to the formation of the United States." STEPHEN M. KOHN, CONCEPTS AND PROCEDURES IN WHISTLEBLOWER LAW 204 (2001) (quoting *United States ex rel. Marcus v. Hess*, 317 U.S. 537, 541 (1943)). For a detailed history of English and American *qui tam* law, see generally J. Randy Beck, *The False Claims Act and the English Eradication of Qui Tam Legislation*, 78 N.C. L. REV. 539 (2000).

<sup>20</sup> 31 U.S.C. §§ 3729-3731 (2000).

<sup>21</sup> 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-3; WEST, *supra* note 19, at 1. The moniker "Lincoln's Law" no doubt has to do with the fact that the law was enacted "[a]t the urging of President Lincoln." Elletta Sangrey Callahan & Terry Morehead Dworkin, *Do Good and Get Rich: Financial Incentives for Whistleblowing and the False Claims Act*, 37 VILL. L. REV. 273, 302 (1992) [hereinafter Callahan & Dworkin, *Get Rich*]. President Lincoln said, "[w]orst than traitors in arms are the men who pretend loyalty to the flag, feast and fatten on the misfortunes of the Nation while patriotic blood is crimsoning the plains." See ROBERTA ANN JOHNSON, WHISTLEBLOWING: WHEN IT WORKS – AND WHY 94 (2003).

<sup>22</sup> See KOHN, *supra* note 19, at 203.

<sup>23</sup> WEST, *supra* note 19, at 1.

<sup>24</sup> See Bucy, *Private Justice*, *supra* note 19, at 50.

cases have been filed over the last twenty years, generating billions of dollars in recoveries. More importantly, some very serious fraudulent schemes have been uncovered, often at an earlier stage than otherwise might have occurred.

The FCA and its *qui tam* provisions are best known in those industries where firms regularly contract with the government and are thus exposed to FCA claims.<sup>25</sup> Corporations and securities law scholars rarely explore the FCA's potential application to securities fraud claims. This Article argues that FCA-style incentives could work in the securities and corporate fraud context. Whistleblowers would be far more likely to face the social, psychological, and other obstacles in their paths if they could recover some share of investors' losses from fraud litigation. More information would be brought to light, and private securities litigation plaintiffs would more effectively play the role of "private attorneys general." Instead of "junk lawsuits"<sup>26</sup> filed after earnings restatements, securities fraud actions would more likely be based on *new* information, thereby enhancing market efficiency.

Some earlier works have proposed a *qui tam*-style "bounty" system to reward SOX whistleblowers.<sup>27</sup> This Article draws on, and is indebted to, such

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<sup>25</sup> See WEST, *supra* note 19, at 4 ("The most common scenarios involve government contractor fraud, defense industry fraud, Medicare and Medicaid fraud, construction fraud, and grant fraud (such as misuse of grant funds and making false statements in grant applications)."). Historically, a majority of *qui tam* cases involved the defense industry, although the share accounted for by healthcare cases is rapidly rising. See *id.* at 5; see also Elletta Sangrey Callahan & Terry Morehead Dworkin, *The State of State Whistleblower Protection*, 38 AM. BUS. L.J. 99, 101 [hereinafter Callahan & Dworkin, *State Protection*]. This is probably the result of declining military expenditures during the 1990s, see JOHN T. BOESE, QUI TAM: BEYOND GOVERNMENT CONTRACTS 13 (1993) [hereinafter BOESE, QUI TAM], and rising healthcare costs, see Patricia Meador & Elizabeth S. Warren, *The False Claims Act: A Civil War Relic Evolves into a Modern Weapon*, 65 TENN. L. REV. 455, 455 (1998).

<sup>26</sup> "President Bush contended that '[t]he unpredictability of our liability system means that even frivolous cases – people call them junk lawsuits – carry the risk of enormous burdens.'" Joshua D. Kelner, *The Anatomy of an Image: Unpacking the Case for Tort Reform*, 31 U. DAYTON L. REV. 243, 266 (2006) (alteration in original) (citing Joseph Curl, *Bush Says "Junk" Lawsuits Hurting Health Industry*, WASH. TIMES, July 26, 2002, at A4).

<sup>27</sup> See, e.g., Bucy, *Private Justice*, *supra* note 19, at 76 ("The *qui tam* FCA private justice model should be expanded to cover protection of the environment and national financial markets."); Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, LAW & CONTEMP. PROBS., Autumn 1997, at 167, 170 [hereinafter Fisch, *Role of the Plaintiff*] ("*Qui tam* illustrates the prospect of greater flexibility in regulatory form, demonstrating that current proposals to eliminate the class representative are not as radical as they appear. An analysis of *qui tam* suggests advantages and implications of viewing the barrier between private litigation and public enforcement of the law as permeable."). Professor Fisch's article, published a decade ago, viewed the proposal to "[r]emodel[] class actions along the lines of *qui tam*" as a "radical suggestion." *Id.* at 202. Accordingly, she did not so much propose use of bounties in corporate fraud class actions as utilize the bounty model to develop a method of theorizing the class action. See *id.* ("By breaking down the conceptual

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work, but takes the bounty proposal further,<sup>28</sup> in that it offers a more practical path for bringing bounties to the securities whistleblower context as well as a mechanism less vulnerable to constitutional challenge and administrative complexity. First, this Article makes the novel suggestion to use the “Fair Fund” provision of the Sarbanes-Oxley Act to compensate whistleblowers. Second, this Article explores for the first time whether existing *state* false claims acts modeled on the Federal FCA, coupled with current investment by state entities, already permit *qui tam*-style suits by corporate and securities fraud whistleblowers. Third, this Article more fully examines the constitutional and policy issues raised by any new statute permitting *qui tam* claims in the corporate and securities fraud context. Earlier works developed proposals to reward SOX whistleblowers with bounties, but serious standing and Takings Clause concerns need to be addressed for such proposals to have any reasonable chance of being adopted and surviving constitutional scrutiny. This Article also explores some more imaginative ways to reward whistleblowers with bounties, such as through the use of the FCA in a post-Social Security Trust Fund diversification context, or through asymmetric liberalization of insider trading prohibitions.

Developing the bounty model for the SOX whistleblower at this time is particularly important given the chorus of voices calling on Congress to roll back various provisions of SOX.<sup>29</sup> It would not surprise anyone if Congress revoked SOX<sup>30</sup> in response to businesses’ vociferous complaints about the Act’s onerous disclosure requirements.<sup>31</sup> Dramatic descriptions of SOX’s

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barrier between private litigation and public enforcement . . . *qui tam* provides important insights about enforcement litigation as well as possibilities for more incremental reforms.”).

<sup>28</sup> In general, the concept of private enforcement, including FCA *qui tam* action, “has received inadequate academic and policy analysis.” Bucy, *Private Justice*, *supra* note 19, at 5. According to one recent commentator, the bounty model is “an intriguing idea that deserves further study.” Richard E. Moberly, *Sarbanes-Oxley’s Structural Model To Encourage Corporate Whistleblowers*, 2006 BYU L. REV. 1108 n.5.

<sup>29</sup> See, e.g., Branson, *supra* note 8, at 112 (“The time has come for a retrenchment from Sarbanes-Oxley.”); Romano, *supra* note 15, at 1529 (“The central policy recommendation of this Article is that the corporate governance provisions of SOX should be stripped of their mandatory force and rendered optional for registrants.”). *But see* Ahdieh, *supra* note 17, at 722 (characterizing the “jurisdictional redundancy” of SOX’s national regulation of corporate governance as “valuable”).

<sup>30</sup> See Bainbridge, *supra* note 15, at 2 (“Talk of regulatory relief is in the air . . . .”); A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1081 (2005) (“Congress, however, shows certain signs of restlessness. As the echoes of those accounting shenanigans begin to fade, various members of Congress have been making threatening noises . . . .”).

<sup>31</sup> One commentator said that SOX is “breaking real-world backs.” Branson, *supra* note 8, at 66. Mid-cap companies report an average cost of over \$4 million in complying with just one provision of SOX, a figure more than twice the SEC’s estimate of what the new



costly effects abound,<sup>32</sup> and Congress may soon heed those concerns. While one hopes Congress will act deliberately and only revoke those SOX provisions that impose unexpected burdens,<sup>33</sup> Congress does not always act with such deliberation.<sup>34</sup> Scholars must be aggressive in offering alternatives to SOX, such as the one developed in this Article, to ensure that the country does not return to the pre-Enron, scandal-prone environment. There is a nugget of gold in the morass which is SOX, that being the emphasis on the role of internal whistleblowers in combating corporate fraud. This Article proposes a way to preserve that nugget, and possibly polish it up a bit.<sup>35</sup>

A bounty model for private securities litigation also represents a way to radically rethink the nature and justification for non-governmental securities enforcement. The various rationales typically provided for such suits – compensation and deterrence being the two primary ones – strike many commentators as unconvincing.<sup>36</sup> A whistleblower-bounty model for SOX private actions would prove better suited to the nature and purpose of financial markets: information generation. Given that markets with more *information* function better, in that they more *efficiently* allocate resources to the most productive economic activities, any policy that brings more information to the market should be explored. The bounty model proposed in this Article offers just such an approach.

Moreover, the bounty model offers a novel way to resolve a longstanding tension in our securities enforcement regime. On the one hand, Congress and

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requirements would cost. *See id.* at 71; *see also* Bainbridge, *supra* note 15, at 2 (“[C]orporate compliance costs have gone up far more than anyone anticipated . . .”).

<sup>32</sup> *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141, 141 (2006) (“The enactment of the Sarbanes-Oxley Act (SOX) in 2002 may represent the final act in regulation of corporate disclosure. By that I mean that the costs of regulation clearly exceed its benefits for many corporations.” (footnote omitted)).

<sup>33</sup> The burdens of SOX have been particularly severe for small companies. *See* James S. Linck et al., *Effects and Unintended Consequences of the Sarbanes-Oxley Act on Corporate Boards 1* (May 16, 2006) (unpublished manuscript), available at <http://ssrn.com/abstract=902665>; *see also* Larry E. Ribstein, *Sarbanes-Oxley After Three Years*, 2005 N.Z. L. REV. 365, 380.

<sup>34</sup> *See* Geoffrey Christopher Rapp, Case Note, *Low Riding*, 110 YALE L.J. 1089, 1095 & n.35 (2001).

<sup>35</sup> John W. Cioffi has suggested that the very reason SOX imposed such onerous structural regulations is because political constraints inhibited the use of traditional private litigation remedies. Cioffi, *supra* note 9, at 5. Ironically, had Congress chosen a private actor remedy like the one proposed in this Article, SOX might not have ended up being as burdensome as anti-SOX scholars have argued. *See id.*

<sup>36</sup> *See, e.g.,* Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 4; Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009, 1029-31 (1996).

the courts turned to private actors to help enforce the laws in the face of government resource limitations and the emergence of extreme examples of corporate fraud. On the other hand, Congress and scholarly critics fault the securities litigation regime for the excesses of class action attorneys. This tension manifests itself in SOX, a legislative effort to fight fraud. Although it adopted sweeping and costly reform, Congress resisted any effort to expand the role of private litigation. Relying on bounties to stimulate whistleblowers might achieve the anti-fraud aspirations of SOX without triggering the abuses targeted by the PSLRA.

In Part I of this Article, I describe the evolution of the role private actors play in securities litigation. While this history may be familiar to some readers, it will help explain why SOX limited its embrace of private actors, and how *qui tam*-style lawsuits could avoid the previously recognized pitfalls of private securities litigation. In Part II, I discuss the current structure of the SOX whistleblower provisions, demonstrating the insufficiency of SOX's incentives for whistleblowers with the most valuable information about ongoing corporate financial shenanigans. Part III outlines the FCA's bounty model and describes its advantages in terms of generating information and creating incentives. Part IV explores the policy and legal issues that arise in adopting a bounty model for the corporate and financial fraud context. Finally, after some brief concluding remarks, I provide sample language for implementing the proposals offered in Part IV in a short statutory appendix.

#### I. THE EVOLVING ROLE OF PRIVATE ACTORS IN SECURITIES LITIGATION

In this section, I describe the awkward evolution of the private actor's role in American securities litigation. Originally, the Securities Act of 1933 and the Securities Exchange Act of 1934 were not viewed as matters of private concern, but rather as laws to be enforced by the criminal and administrative apparatus of the state.<sup>37</sup> Only after World War II did private actors come to play a major role in enforcing our securities laws.<sup>38</sup>

For the sake of clarity, I divide the post-World War II environment into three "eras." The first period, which I dub the "Milberg-*Basic* Era," represented a rather steady expansion of the role of private actors in enforcing the securities laws. Primarily, this expansion took the form of increased class action litigation. The second period, which I dub the "PSLRA-Enron Era," represented legislative efforts culminating in a major restriction of the capacity of private actors to enforce the securities laws. This period also coincided with some of the most severe corporate and accounting scandals in our nation's

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<sup>37</sup> There were limited exceptions in Congress' initial securities regulations efforts. For example, the 1934 Securities Exchange Act created a few express private causes of action. See Cox et al., *SEC Enforcement*, *supra* note 7, at 739.

<sup>38</sup> The first case to recognize an implied private right of action in the securities context was *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 802-03 (E.D. Pa. 1947). See Cox et al., *SEC Enforcement*, *supra* note 7, at 739.

history (although the causal links between the PSLRA and the subsequent scandals have not been adequately studied).<sup>39</sup> Finally, I describe the legislative beginnings of our current era, which I dub the “SOX Era,” embodied in the Sarbanes-Oxley Act of 2002.

A. *The Milberg-Basic Era*

The first post-war trend in the role of private actors in securities litigation was a gradual expansion of that role.<sup>40</sup> I dub this era the “Milberg-Basic Era.” The first part of the term comes from Milberg Weiss, the “phenomenally successful”<sup>41</sup> plaintiffs’ securities litigation firm that pioneered the use of the class action lawsuit to enforce federal securities laws.<sup>42</sup> The law firm had a glorious rise<sup>43</sup> and, more recently, a tremendous fall when a federal grand jury indicted the firm for paying kickbacks to class representatives.<sup>44</sup> The second part of the moniker comes from the Supreme Court’s 1988 decision in *Basic Inc. v. Levinson*.<sup>45</sup> The *Basic* decision was the high water mark for private actors in securities litigation; the Court, largely on policy grounds, adopted the so-called fraud-on-the-market presumption of reliance based on a dubious reading of contemporary financial economics literature.<sup>46</sup> The decision introduced a practical method of resolving a potential barrier to class action litigation in the securities context:<sup>47</sup> in effect, the Court read out of securities fraud claims the common law element of reliance.<sup>48</sup>

During this period of expansion, private litigation became “a central enforcement mechanism in the American securities law and corporate governance machinery.”<sup>49</sup> The most obvious explanation for the growth of the

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<sup>39</sup> See *infra* notes 83-84 and accompanying text.

<sup>40</sup> See Cioffi, *supra* note 9, at 16-17.

<sup>41</sup> Masters, *supra* note 4.

<sup>42</sup> See MILBERG WEISS BERSHAD & SCHULMAN LLP, FIRM BROCHURE, available at [http://milberg.admin.hubbardone.com/files/tbl\\_s5087FileUploads/File5684/271/MWFirmBrochure.pdf](http://milberg.admin.hubbardone.com/files/tbl_s5087FileUploads/File5684/271/MWFirmBrochure.pdf).

<sup>43</sup> It was glorious, at least, from the standpoint of the firm’s partners’ profits and political influence. See Cioffi, *supra* note 9, at 17 (“In part, the rise in litigation rates was due to the development of a sophisticated plaintiff-side securities litigation bar that produced a veritable litigation industry and provided substantial financial backing to the Democratic Party.”).

<sup>44</sup> See Masters, *supra* note 4.

<sup>45</sup> 485 U.S. 224 (1988).

<sup>46</sup> See *id.* at 247; Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in Cammer v. Bloom and Its Progeny*, 10 U. MIAMI BUS. L. REV. 303, 327 (2002).

<sup>47</sup> See *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267, 291 (S.D.N.Y. 2003).

<sup>48</sup> See Douglas M. Branson, *Securities Litigation in State Courts – Something Old, Something New, Something Borrowed . . .*, 76 WASH. U. L.Q. 509, 522 (1998).

<sup>49</sup> Cioffi, *supra* note 9, at 19.

private class action suit as a mechanism of securities fraud enforcement is the “much studied and well understood problem” of SEC resource limitations.<sup>50</sup> Private suits can provide “more enforcement resources and facilitate more efficient allocation of public resources.”<sup>51</sup> Class action lawsuits were championed for their deterrent effect, not for their compensation of victims, because individual class members typically received very small financial windfalls from successful (or successfully settled) suits.<sup>52</sup>

The Supreme Court first recognized an implied private right of action under the securities laws (in connection with section 14(a) of the Securities Exchange Act of 1934) in the 1964 case *J.I. Case Co. v. Borak*.<sup>53</sup> *Borak* cleared the way for major private class actions in the 1970s, such as *Blackie v. Barrack*.<sup>54</sup> The general trend over the twenty-odd years of the Milberg-*Basic* Era was toward the production of “detailed prescriptive rules and enforcement through private litigation.”<sup>55</sup> This evolution was not without its critics, such as leading securities scholar John C. Coffee, Jr.,<sup>56</sup> who came to “question[] the incentives that surrounded the initiation and conduct of securities class actions.”<sup>57</sup> Jonathan Macey and Geoffrey Miller argued persuasively that the principal-agent relationship between investor plaintiffs and class action attorneys created significant agency costs and divergent incentives.<sup>58</sup>

Emboldened by these scholarly critiques, lower courts began to turn away from the expansionist SEC rulemaking and Supreme Court decisions during this era. Courts began to accept defendants’ arguments that *Basic*’s presumption of reliance did not apply because of apparent inefficiencies in the trading markets for a corporation’s securities.<sup>59</sup> The contraction of the role of private actors in securities litigation was underway.

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<sup>50</sup> Cox et al., *SEC Enforcement*, *supra* note 7, at 757; *see also* Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission’s Authority*, 107 HARV. L. REV. 961, 969 & nn.15-18 (1994).

<sup>51</sup> Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93, 107 (2005).

<sup>52</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 175.

<sup>53</sup> 377 U.S. 426 (1964).

<sup>54</sup> 524 F.2d 891 (9th Cir. 1975).

<sup>55</sup> Cioffi, *supra* note 9, at 3.

<sup>56</sup> *See* John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 229 (1983); John C. Coffee, Jr., *Understanding the Plaintiff’s Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 726 (1986).

<sup>57</sup> Cox et al., *SEC Enforcement*, *supra* note 7, at 740.

<sup>58</sup> *See* Macey & Miller, *supra* note 3, at 20-24.

<sup>59</sup> *See* Rapp, *supra* note 46, at 308-09.

B. *The PSLRA-Enron Era*

The second era in the role of private actors began with the election of the Republican Congress in November 1994. The GOP's "Contract with America" campaign platform included securities litigation reform.<sup>60</sup> After the GOP victory, the changed political landscape in Washington paved the way for the adoption of a statute greatly restricting the use of "private litigation to curb managerial financial misconduct."<sup>61</sup> The resulting statute, the Private Securities Litigation Reform Act of 1995,<sup>62</sup> was enacted over President Clinton's veto.<sup>63</sup>

In its findings, Congress described what it viewed as "abusive practices" in private securities litigation.<sup>64</sup> These included

- (1) the routine filing of lawsuits . . . whenever there is a significant change in an issuer's stock price . . . with only faint hope that the discovery process might lead eventually to some plausible cause of action;
- (2) the targeting of deep pocket defendants . . . ;
- (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and
- (4) the manipulation by class action lawyers of the clients whom they purportedly represent.<sup>65</sup>

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<sup>60</sup> Republican Contract with America, <http://www.house.gov/house/Contract/CONTRACT.html> (last visited Feb. 1, 2007); see also Phillips & Miller, *supra* note 36, at 1019; Cioffi, *supra* note 9, at 18. One of the most "damaging accusations" made against securities litigation is that it is "lawyer-driven." Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 533 (1997) [hereinafter Fisch, *Lessons from Securities Litigation*]. The drafters of the Republican Contract with America viewed such litigation as inherently abusive. *Id.*

<sup>61</sup> Cioffi, *supra* note 9, at 5.

<sup>62</sup> Pub. L. No. 104-67, 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77l, 77k, 77z-1, 77z-2, 78j-1, 78u-4, 78u-5 (2000)).

<sup>63</sup> Cioffi, *supra* note 9, at 18. This was the only time that the Republican Congress successfully overrode one of President Clinton's vetoes during his two terms in office. *Id.* at 19.

<sup>64</sup> H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 730.

<sup>65</sup> *Id.* According to Jill Fisch, the PSLRA "reflected congressional efforts to address a frequently repeated description of abusive litigation. The abuse scenario portrayed plaintiffs' lawyers as responding to corporate announcements of bad news or a drop in stock price with hastily drafted complaints containing poorly supported allegations of fraud." Fisch, *Lessons from Securities Litigation*, *supra* note 60, at 535 (footnotes omitted). Prior to the PSLRA, firms were "sued with greater frequency – often in response to inevitable fluctuations in the price of securities." Cioffi, *supra* note 9, at 17.

Congress considered evidence that raised a suspicion that many settlements were driven by the expense of litigation rather than the merits of the particular case.<sup>66</sup>

The PSLRA introduced a number of reforms. It “placed limits on abusive discovery, adopted a heightened pleading standard, abolished joint and several liability in favor of a ‘fair share’ rule of proportionate liability, made the awarding of attorneys fees to prevailing [defendants] in ‘abusive’ cases more likely, and imposed various restrictions on the selection of class representative and counsel in class actions.”<sup>67</sup> The so-called “lead plaintiff” provision of the Act attempted to wrest control of securities litigation away from class action attorneys and put it in the hands of a class plaintiff presumed to have the greatest vested interest in the case.<sup>68</sup> Congress apparently hoped that institutional investors would begin to participate actively in securities litigation.<sup>69</sup> In addition, Congress created safe harbors for forward-looking statements.<sup>70</sup>

Congress’ predominant concern seems to have been abusive discovery. Fearful of the potentially high costs of discovery – amounting to 80% of litigation expenses – many defendants were settling cases viewed as non-meritorious.<sup>71</sup> Congress therefore reformed the law such that discovery could only begin after the court had addressed all defense motions to dismiss.<sup>72</sup>

The most immediate perceived impact of the PSLRA was that it drove many securities cases “underground” – that is, out of the federal system and into state

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<sup>66</sup> See Bucy, *Private Justice*, *supra* note 19, at 30 (reporting that while the majority of cases (92%) claimed damages of over \$10 million, median settlements prior to the PSLRA were just \$3.5 million).

<sup>67</sup> *Id.* at 26. The heightened pleading standard in the PSLRA has been called a “super heightened pleading standard,” in that it requires pleading of facts that create a “strong inference” that defendants had a specific intent to defraud. Cummings, *supra* note 10, at 1009-10.

<sup>68</sup> The PSLRA’s “lead plaintiff provision” provided that the shareholder with the largest stake in the case would be presumed lead plaintiff; the goal was to elevate institutional investors over other private actors to curb abuses of the securities litigation system. Cioffi, *supra* note 9, at 20. The lead plaintiff selects counsel to represent the class, subject to court approval. Johnson, *supra* note 2, at 629.

<sup>69</sup> See Fisch, *Lessons from Securities Litigation*, *supra* note 60, at 533.

<sup>70</sup> See Johnson et al., *supra* note 5 (manuscript at 4) (“In enacting the PSLRA, Congress expressed concern that companies failing to meet earnings expectations were vulnerable to securities fraud class action. . . . Congress addressed this concern with a forward-looking safe harbor, which makes it more difficult to bring fraud claims based on projections.”). The safe harbor provision is the “most daunting” of the PSLRA’s procedural hurdles, *id.* (manuscript at 8), allowing issuers to avoid liability by including “meaningful cautionary statements” with what would otherwise amount to a misleading statement or omission of material fact. 15 U.S.C. § 78u-5(c) (2000); see also Cummings, *supra* note 10, at 1018.

<sup>71</sup> Bucy, *Private Justice*, *supra* note 19, at 26 & n.136.

<sup>72</sup> *Id.*

courts.<sup>73</sup> Those cases that remained in the federal system appear to have been the more meritorious ones. Dismissal rates declined and the disparity between claimed damages and settlement figures narrowed.<sup>74</sup> Still, in 1998, Congress sought to curb state securities litigation suits by passing the Securities Litigation Uniform Standards Act (SLUSA).<sup>75</sup> Despite the title, “the main goal of the law was to reduce litigation, not to create clearer or more coherent legal doctrine.”<sup>76</sup>

Congress could have simply eliminated private rights of action with the PSLRA, but chose not to. Congress found that private securities litigation amounted to an “indispensable tool” that “promote[s] public and global confidence in our capital markets and help[s] to deter wrongdoing.”<sup>77</sup> Nevertheless, the PSLRA clearly represents a retrenchment from the previous era’s commitment to the use of private actors to enforce the securities laws.<sup>78</sup> The law “fasten[s] the doors tight against many federal class-action securities fraud plaintiffs, . . . dispirit[s] victims of securities fraud from finding an attorney and bringing a lawsuit, . . . and . . . impose[s] a variety of roadblocks against securities fraud class-action plaintiffs.”<sup>79</sup> As a result, the law may serve to “discourage some entrepreneurial attorneys from monitoring areas ripe for fraud and initiating and organizing class actions.”<sup>80</sup>

A few years after the adoption of the PSLRA, the Enron bubble burst.<sup>81</sup> The

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<sup>73</sup> See *id.* at 30-31; Cummings, *supra* note 10, at 1028. While there were numerous studies indicating an increase in litigation in the state courts following the enactment of the PSLRA, in retrospect, the evidence is “at best ambiguous.” Cioffi, *supra* note 9, at 23.

<sup>74</sup> Bucy, *Private Justice*, *supra* note 19, at 31.

<sup>75</sup> Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered subsections of 15 U.S.C. §§ 77-78); see also Cioffi, *supra* note 9, at 23.

<sup>76</sup> Cioffi, *supra* note 9, at 24.

<sup>77</sup> H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), as reprinted in 1995 U.S.C.C.A.N. 730, 730; see also Bucy, *Private Justice*, *supra* note 19, at 77.

<sup>78</sup> Indeed, some have characterized the PSLRA as specifically targeting the plaintiffs’ firm Milberg Weiss. See Richard A. Booth, *Windfall Awards Under PSLRA*, 59 BUS. LAW. 1043, 1043 n.1 (2004); Julie Triedman, *What’s Next for Milberg Weiss?*, LAW.COM, May 22, 2006, <http://www.law.com/jsp/law/LawArticleFriendly.jsp?id=1148029540762>. Ironically, the PSLRA may have initially increased the dominance of Milberg Weiss, since the firm was uniquely positioned to attract institutional investor lead plaintiffs and to bear the costs of more lengthy pre-settlement litigation proceedings. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 162 (2004). However, it may have also prompted some of the kickbacks that led to the firm’s eventual federal indictment. Newer firms, like Bernstein Litowitz, now garner the most lead- or co-counsel dollars. See Triedman, *supra*.

<sup>79</sup> Cummings, *supra* note 10, at 1027 (footnotes omitted).

<sup>80</sup> Bucy, *Private Justice*, *supra* note 19, at 56.

<sup>81</sup> See Cummings, *supra* note 10, at 1029.

facts underlying Enron's collapse have been recounted elsewhere,<sup>82</sup> and will be familiar to most readers. Some commentators have made the case that the PSLRA played a causal role in bringing about the collapse of Enron.<sup>83</sup> The argument for that proposition strikes me as rather weak,<sup>84</sup> given that Enron's

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<sup>82</sup> See, e.g., MIMI SWARTZ WITH SHERRON WATKINS, *POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON* (2003); SPECIAL INVESTIGATIVE COMM. OF THE BD. OF DIRS. OF ENRON CORP., *REPORT OF INVESTIGATION* (2002), available at <http://f11.findlaw.com/news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf>; AFTER ENRON: LESSONS FOR PUBLIC POLICY (William A. Niskanen ed., 2005); Cummings, *supra* note 10, at 1044-46; Cunningham, *supra* note 11, at 928-29; Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 CORNELL L. REV. 394, 397-417 (2004); Ribstein, *supra* note 33, at 366-67. Ironically, while Enron is now a household name, a 1996 name-recognition survey by the company indicated that ordinary people thought "Enron" was either a politician or a science fiction weapon. LOREN FOX, *ENRON: THE RISE AND FALL*, at v (2003).

<sup>83</sup> See generally Cummings, *supra* note 10. Professor Cummings' title (*Ain't No Glory in Pain: How the 1994 Republican Revolution and the Private Securities Litigation Reform Act Contributed to the Collapse of the United States Capital Markets*) may unnecessarily politicize the corporate scandals of the Enron era. After all, as Cummings admits, the PSLRA had some bipartisan support on Capitol Hill. *Id.* at 1005; see also Phillips & Miller, *supra* note 36, at 1009 ("The [PSLRA] came into being because sizeable bipartisan majorities of both houses of Congress became persuaded that the private securities litigation system was seriously out of balance."). Further, Cummings' suggestion that capital markets collapsed after Enron may be a bit of a stretch. While *the corporations* Enron and WorldCom collapsed, and in so doing revealed a number of flaws in the pricing of stocks during the relevant period, the capital markets themselves *did not* collapse. Perhaps the most striking feature of the Enron scandal is that American capital markets proved remarkably resilient, able to withstand even the collapse of one of the country's largest (in terms of market value) and most touted corporations. See Alan Reynolds, *Political Responses to the Enron Scandal*, in AFTER ENRON: LESSONS FOR PUBLIC POLICY, *supra* note 82, at 18, 19 (pointing out that of 16,200 companies required to file SEC reports, only twenty were involved in the corporate scandals of the Enron era). To the extent that the stock market declined, it did so mostly *before* the collapse of Enron, not after. *Id.* at 22.

<sup>84</sup> Timing alone does not prove that the PSLRA caused the Enron collapse. See Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, in AFTER ENRON: LESSONS FOR PUBLIC POLICY, *supra* note 82, at 125, 138 ("Some use . . . chronology to imply a causal relation between the PSLRA and corporate fraud. That logic is based on publicity rather than sound statistical inference."). Indeed, alleging a causal relationship based on sequence of events is error of a classic kind, the so-called *post hoc ergo propter hoc* fallacy long ago exposed as faulty logic.

Professor Cummings' reliance upon popular media accounts of the Enron collapse as evidence of a causal link is also unpersuasive. See Cummings, *supra* note 10, at 1044-45. Cummings argues that Enron's management would have had to feel "a particular sense of protection from substantial personal risk and personal liability" to orchestrate a fraudulent scheme of the magnitude of the company's off-the-books partnerships. *Id.* at 1047. That is of course a debatable psychological proposition; regardless, nothing proves that the PSLRA is *that which* created such a whiff of prophylaxis for Kenneth Lay, Jeff Skilling, and others.



collapse is primarily attributable to its shaky business model<sup>85</sup> in times of investor exuberance<sup>86</sup> – a model that preceded the effective date of the PSLRA. However, the corporate scandals and the passage of the PSLRA belong to the same “era” in the role of private actors in American securities litigation, if for no other reason than that the PSLRA governed the claims of the plaintiffs in investor class actions relating to the corporate scandals.

### C. *The SOX Era*

Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002, commonly known as the Sarbanes-Oxley Act, on July 30, 2002.<sup>87</sup> Some American leaders feared that the emerging corporate scandals<sup>88</sup> and the recent collapse of the “dot-com” bubble might cause the complete collapse of the American financial system.<sup>89</sup> At a minimum, Congress was likely concerned about the egg on its own face after passing private securities litigation reform just a few years before the revelations of massive corporate and accounting fraud.<sup>90</sup> Congress enacted SOX as a sort of “emergency” measure,<sup>91</sup> prompting much criticism of the legislative process behind its adoption.<sup>92</sup>

Despite the pressure for congressional action after the collapse of Enron, WorldCom, and the like, the political legacy of the PSLRA era constrained Congress during the debate on SOX. “The conservative political realignment during [the] 1990s precluded the development or expansion of litigious enforcement mechanisms (i.e., private causes of action) to curb corporate and managerial financial misconduct.”<sup>93</sup> SOX’s most distinctive feature is

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Ultimately, the more cautious position recognizes that the question of whether Enron, WorldCom, and Global Crossing “were caused, enabled, or promoted” by the PSLRA is an “[u]nanswerable” one. Cunningham, *supra* note 11, at 940.

<sup>85</sup> See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1125 (2003).

<sup>86</sup> See Pritchard, *supra* note 30, at 1078 (“Corporate mismanagement and corruption can be obscured by rising stock prices in a bull market, but the dirty laundry has a way of surfacing in bear markets.”).

<sup>87</sup> Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18, and 28 U.S.C.); see also Branson, *supra* note 8, at 66.

<sup>88</sup> Most scholars view the WorldCom collapse as the “tipping point” at which congressional action became inevitable. See, e.g., Cunningham, *supra* note 11, at 925.

<sup>89</sup> Cioffi, *supra* note 9, at 29.

<sup>90</sup> See FOX, *supra* note 82, at 293 (“Enron became a real political football. . . . If there was any mudslinging, perhaps it was inevitable given that Washington was equally awash in mud.”); Cioffi, *supra* note 9, at 28-29 (“Congress was . . . vulnerable to charges that it had passed litigation reform legislation that intensified the pressures on the SEC while failing to provide the funding necessary for it to function.”).

<sup>91</sup> Romano, *supra* note 15, at 1557.

<sup>92</sup> See Ahdieh, *supra* note 17, at 728-29 & nn.34-39 (citing critics).

<sup>93</sup> Cioffi, *supra* note 9, at 1.

probably that it “did *not* loosen legislative restrictions on securities litigation, let alone create new causes of action,”<sup>94</sup> instead only modestly extending statutes of limitation and easing barriers to the collection of restitution awards from corrupt executives’ personal assets.<sup>95</sup> Simply put,

[p]reservation of securities litigation reform was a non-negotiable item for congressional Republicans. It was a “line in the sand” over which they would have killed any reform legislation. Whereas the Democrats were at best ambivalent about securities litigation, the Republicans were almost universally intensely hostile to it. As a result, Sarbanes did not even raise the issue of private causes of action when drafting legislation. Sarbanes’ draft legislation never contained new private rights of action.<sup>96</sup>

Thus, the bulk of the SOX reforms focused on structural devices designed to elevate the position of corporate “gatekeepers.”<sup>97</sup> Institutional and organizational restructuring was intended to “effect policy goals of improved corporate governance, managerial accountability, and financial market legitimacy.”<sup>98</sup> For example, the Act requires that:

- each listed company’s CEO attest to the integrity of financial reporting procedures;<sup>99</sup>
- “firms file periodic reports with the SEC on an ‘accelerated’ basis”;<sup>100</sup> and
- public corporations establish independent audit committees of the boards of directors.<sup>101</sup>

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<sup>94</sup> *Id.* at 25; see also Johnson & Sides, *supra* note 16, at 1195 (stating that SOX “provides no built-in interpretative, adjudicative, or enforcement mechanisms accessible to shareholders”).

<sup>95</sup> See Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASH. L. REV. 1029, 1063 (2004).

<sup>96</sup> Cioffi, *supra* note 9, at 41 (footnote omitted).

<sup>97</sup> See Branson, *supra* note 8, at 67-68. The “core provisions” of the Act “took the form of structural regulation intended to function as non-litigious, self-executing mechanisms of regulation.” Cioffi, *supra* note 9, at 1. For a thorough summary of what applicable finance literature has to say about the efficacy of SOX’s chosen reforms, see Romano, *supra* note 15, at 1529-43.

<sup>98</sup> Cioffi, *supra* note 9, at 4.

<sup>99</sup> Sarbanes-Oxley Act of 2002 § 404(a), 15 U.S.C. § 7262(a) (Supp. IV 2004). Section 404 has been called the “principal factor in increased costs” associated with SOX. Carney, *supra* note 32, at 142.

<sup>100</sup> Branson, *supra* note 8, at 69.

<sup>101</sup> Tamar Frankel, *Using Sarbanes-Oxley Act To Reward Honest Corporations* 14 (Boston Univ. Sch. of Law Pub. Law & Legal Theory Working Paper Series, Paper No. 06-08, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=897783](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=897783).

Primarily, SOX aims to transform corporate board members into active managers rather than part-time monitors.<sup>102</sup>

The problem with SOX's focus on internal controls and governance regulations is that it may do little to *actually* reduce corporate and financial fraud. As William Carney notes, financial fraud was *already* illegal prior to SOX.<sup>103</sup> Even internal controls can universally be defeated by a determined and inventive conspiracy of employees.<sup>104</sup>

Overcoming an internal conspiracy can only succeed if insiders bring information about ongoing corporate and securities fraud to the attention of regulators, something the drafters of SOX grudgingly recognized.<sup>105</sup> The corporate scandals of the Enron era demonstrated that employees had valuable information about ongoing financial and accounting fraud, and also that very few incentives existed to encourage employees to blow the whistle on their employers.<sup>106</sup> Many accounting scandals come to light because of a whistleblower tip.<sup>107</sup> Some of the more famous scandals of the era featured whistleblowers in prominent roles:

Sherron Watkins, who exposed Enron's enormous fraud, might be the most famous contemporary corporate whistleblower. Also notable is Cynthia Cooper, the head of internal accounting for WorldCom, who, aided by her team of internal auditors, first identified the accounting fraud in the company and revealed it to government investigators, even though Scott Sullivan, the CFO and her boss, initially encouraged her not to report, or at least to delay reporting, her findings. Other whistleblowers include James Bingham, a relatively senior executive in the Xerox finance department, who years ago identified Xerox's false accounting and was rewarded with constant stonewalling by the company and eventual dismissal.<sup>108</sup>

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<sup>102</sup> See Branson, *supra* note 8, at 110-11.

<sup>103</sup> Carney, *supra* note 32, at 142.

<sup>104</sup> *Id.*

<sup>105</sup> See Pamela H. Bucy, "Carrots and Sticks": Post-Enron Regulatory Initiatives, 8 BUFF. CRIM. L. REV. 277, 313 (2004) [hereinafter Bucy, *Carrots and Sticks*] (arguing that SOX recognizes "the benefit of insiders' information and make[s] efforts to enlist such information").

<sup>106</sup> See Moberly, *supra* note 28, at 1107-08.

<sup>107</sup> See Branson, *supra* note 8, at 78-79 ("Fraud and accounting imbroglios come to light because of a tip (42.6%), internal auditing (24.6%), accident (18%), outside auditors' discovery (16.4%), and last of all, by virtue of an earlier-installed internal control (8.2%).").

<sup>108</sup> James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 438-39 (2004) (footnotes omitted).

Yet prior to SOX, there was no general, nationwide statute to protect whistleblowers from retaliation for bringing fraud to light.<sup>109</sup>

SOX took a limited approach to empowering private actors in the securities litigation arena, focusing solely on protecting whistleblowers and providing institutional channels for internal complaints about financial and accounting irregularities. The Act makes retaliatory interference with employment a crime,<sup>110</sup> and creates a civil cause of action against employers who “discharge, demote, suspend, threaten, harass, or in any other manner discriminate against” a whistleblower who reveals corporate or financial fraud.<sup>111</sup> After an employee exhausts her administrative remedies by filing a complaint with the Occupational Safety and Health Administration (OSHA), she may bring a claim in federal district court.<sup>112</sup> If she proves that (1) she was engaged in protected activity, (2) she was the victim of an adverse employment action, and (3) her lawful act was a contributing factor in the adverse action, then she is entitled to relief making her “whole.”<sup>113</sup> This relief includes reinstatement, back pay with interest, and compensation for litigation costs, expert witness fees, and reasonable attorney fees.<sup>114</sup> However, punitive damages are not authorized.<sup>115</sup>

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<sup>109</sup> See Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875, 888 (2002).

<sup>110</sup> Sarbanes-Oxley Act of 2002 § 1107(a), 18 U.S.C. § 1513(e) (Supp. IV 2004). The extent to which judges will be willing to impose stiff criminal sanctions is open to doubt. See Moberly, *supra* note 28, at 1145.

<sup>111</sup> Sarbanes-Oxley Act of 2002 § 806(a), 18 U.S.C. § 1514A(a). Some commentators suggested that the Act would be interpreted broadly to protect whistleblowers who reported other types of corporate wrongdoing, such as environmental or safety violations. See Robert G. Vaughn, *America's First Comprehensive Statute Protecting Corporate Whistleblowers*, 57 ADMIN. L. REV. 1, 34-38 (2005). Those predictions have proven wrong, as administrative law judges (ALJs) have repeatedly held that SOX “whistleblower protections are strictly for those employees who assert allegations of securities violations and fraud against shareholders.” Terry F. Moritz et al., *Recent Developments in the Interpretation of the Sarbanes-Oxley Act Whistleblower Provisions*, in 2 PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2005, at 447, 452 (PLI Corporate Law & Practice, Course Handbook Series No. B-1464, 2005); see also Richard E. Moberly, *Sarbanes-Oxley's Anti-Retaliation Protections: An Empirical Perspective* 29 (Nov. 1 2006) (unpublished manuscript, on file with author).

<sup>112</sup> 18 U.S.C. § 1514A(b).

<sup>113</sup> Marc I. Steinberg & Seth A. Kaufman, *Minimizing Corporate Liability Exposure When the Whistle Blows in the Post Sarbanes-Oxley Era*, 30 J. CORP. L. 445, 447-48 (2005).

<sup>114</sup> 18 U.S.C. § 1514A(c)(2).

<sup>115</sup> Cherry, *supra* note 95, at 1066; see also Frank J. Cavico, *Private Sector Whistleblowing and the Employment-at-Will Doctrine: A Comparative Legal, Ethical, and Pragmatic Analysis*, 45 S. TEX. L. REV. 543, 580 (2004) (“There is, it must be underscored, no language in the federal statute pertaining to emotional distress or punitive damages, and since the category of ‘special damages’ comes under the general heading of ‘Compensatory

SOX also requires the audit committees of public company boards to establish channels for processing complaints and anonymous submissions of concerns by employees regarding “questionable accounting or auditing matters.”<sup>116</sup> The Act does not specify the exact channels for corporate complaints, although the SEC has urged companies to appoint ombudsmen or private inspector generals to respond to complaints.<sup>117</sup>

Criticism of the SOX anti-retaliation provisions has been relatively limited, probably because the scope of those provisions is so narrow. The most serious criticism lodged against the law, other than that it inadequately protects whistleblowers, is that SOX may “give[] shirking employees a potent way to fend off scrutiny of their performance.”<sup>118</sup> Read in connection with its failure to repeal the key provisions of the PSLRA, SOX reflects the current bipolar attitude toward the role of private actors in enforcing American securities laws: “one perspective enlists plaintiffs as private attorneys general, and the other perspective paints the same plaintiffs as vexatious litigants.”<sup>119</sup>

## II. THE INADEQUACY OF SOX’S PROTECTIONS AND CURRENT SEC BOUNTIES IN CREATING INCENTIVES FOR WHISTLEBLOWERS TO REVEAL MAJOR FRAUDS

Whistleblowing is an individual decision. A corporate employee who discovers ongoing fraudulent conduct (either by accident or through deliberate search) must make an affirmative choice to blow the whistle. The variables guiding that decision are complex,<sup>120</sup> but ultimately whistleblowing can be viewed from a cost-benefit perspective.

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Damages,’ one can safely assume that the federal courts will not be interpreting the statutory remedies beyond those explicitly stated.”).

<sup>116</sup> Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(4) (Supp. IV 2004).

<sup>117</sup> Steinberg & Kaufman, *supra* note 113, at 456.

<sup>118</sup> Ribstein, *supra* note 33, at 371; *see also* Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 43 (2002) (“[T]he new law obviously can give significant leverage to employees, including in cases in which the firm has good reason to take action against the employee. It is an open question whether the benefits of exposing fraud will outweigh the disruptive effects of this new form of job protection.”); Steinberg & Kaufman, *supra* note 113, at 457 (“One of the more difficult challenges in devising an effective law compliance program is creating mechanisms to adequately handle incompetent employees who happen to be whistleblowers.”).

<sup>119</sup> Cox et al., *SEC Enforcement*, *supra* note 7, at 741; *see also* Pritchard, *supra* note 30, at 1085. The Supreme Court has also recognized the potential for “vexatiousness” in private securities litigation. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975)); *see also* Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 3-4.

<sup>120</sup> *See* Randi L. Sims & John P. Keenan, *Predictors of External Whistleblowing: Organizational and Intrapersonal Variables*, 17 J. BUS. ETHICS 411, 411 (1998). For example, some researchers have described whistleblowing as a four-stage process:

Assuming rational decision making, an employee will blow the whistle when the marginal private benefits exceed the marginal private costs.<sup>121</sup> For a potential whistleblower, both benefits and costs include pecuniary and non-pecuniary elements. For example, a whistleblower might hope for a book deal, like Enron whistleblower Sherron Watkins,<sup>122</sup> or a movie deal, like Big Tobacco whistleblower Jeff Wigand (“The Insider”).<sup>123</sup> Either would be a positive “benefit” on the “blow-the-whistle” side of the column. A whistleblower might also feel better about herself for “doing the right thing”<sup>124</sup> – again, a factor that would encourage blowing the whistle.<sup>125</sup> Weighing against blowing the whistle would be countervailing forces, like the potential of job loss.

While it is of course impossible to compare precisely the non-pecuniary and pecuniary components of the whistleblowing decision,<sup>126</sup> it is safe to assume

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A triggering event occurs, involving questionable, unethical, or illegal activities, and this leads an employee to consider blowing the whistle. Second, the employee engages in decision making, assessing the activity and whether it involves wrongdoing, gathering additional information, and discussing the situation with others. Third, the employee exercises *voice* by blowing the whistle; alternatively, the employee could *exit* the organization, or remain silent out of *loyalty* or *neglect*. Fourth, organization members react to, and possibility retaliate against the whistleblower.

Terry Morehead Dworkin & Melissa S. Baucus, *Internal vs. External Whistleblowers: A Comparison of Whistleblowing Processes*, 17 J. BUS. ETHICS 1281, 1282 (1998) (citation omitted).

<sup>121</sup> See Ben Depoorter & Jef De Mot, *Whistle Blowing: An Economic Analysis of the False Claims Act*, 14 SUP. CT. ECON. REV. 135, 159 (2006); Marsha J. Ferziger & Daniel G. Currell, *Snitching for Dollars: The Economics and Public Policy of Federal Civil Bounty Programs*, 1999 U. ILL. L. REV. 1141, 1171-72.

<sup>122</sup> See generally SWARTZ & WATKINS, *supra* note 82.

<sup>123</sup> See generally Marie Brenner, *The Man Who Knew Too Much*, VANITY FAIR, May 1996, at 170, available at <http://www.mariebrenner.com/articles/insider/man1.html>.

<sup>124</sup> Research suggests that many whistleblowers are motivated by institutional or organizational loyalty, acting with the primary objective of helping their employer. Callahan & Dworkin, *Get Rich*, *supra* note 21, at 293; Elletta Sangrey Callahan & Terry Morehead Dworkin, *Who Blows the Whistle to the Media, and Why: Organizational Characteristics of Media Whistleblowers*, 32 AM. BUS. L.J. 151, 166 (1994) [hereinafter Callahan & Dworkin, *Who Blows the Whistle*]. Whistleblowing may be “partially a matter of individual conscience,” Cherry, *supra* note 95, at 1085, though Fred Alford refers to the principal motivation for whistleblowing as “narcissism moralized,” a term whistleblowers have found upsetting. C. FRED ALFORD, WHISTLEBLOWERS: BROKEN LIVES AND ORGANIZATIONAL POWER 63 (2001).

<sup>125</sup> Some scholars, however, caution against over-reliance on this factor. See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 335-36 (“It is clear that the call to conscience has had limited appeal for potential whistleblowers. Virtue may be its own reward, but for many, money is more gratifying.”).

<sup>126</sup> Of course, any discussion of a whistleblower’s likely “cost-benefit” analysis is “stylized for the purpose of simplification.” Ferziger & Currell, *supra* note 121, at 1179

that each whistleblower, at some point, decides that some combination of factors favors blowing the whistle over silence.<sup>127</sup> Presumably, a large enough financial benefit in favor of blowing the whistle could outweigh any social or psychological factors favoring silence. However, because potential whistleblowers will discount their expected recovery from whistleblowing by the chance that they will not receive such a recovery,<sup>128</sup> and to account for the time value of money, a potential financial benefit may need to be quite large in order to stimulate a risk-averse employee to blow the whistle.

SOX's whistleblower regulation consists primarily of an anti-retaliation rule (enforceable both by criminal sanction and civil action). While several scholars have focused on the defects in SOX's whistleblower protection provisions,<sup>129</sup> this Article concentrates on the Act's failure to generate *sufficient incentives* for whistleblowers. At best, SOX's whistleblower provisions "seal cracks in the doctrine";<sup>130</sup> they do not offer radical reform. The inadequacy of SOX in incentivizing whistleblowers would be irrelevant if the other elements of SOX optimally deterred corporate leaders from engaging in questionable management and financial practices. Unfortunately, the regulatory solutions embedded in the other sections of SOX offer, at best, a piecemeal solution to the problem of financial and corporate fraud. The administrative approach taken by other provisions of SOX is flawed, because

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("Most informants will not actually engage in algebra as they contemplate whether to inform . . .").

<sup>127</sup> The degree to which various factors will motivate an employee to blow the whistle will of course depend on the employee's "individual characteristics," including the degree to which the employee values money. See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 291. That is simply to say that different individuals have different ways of processing the various perceived costs and benefits of whistleblowing. See MARCIA P. MICELI & JANET P. NEAR, *BLOWING THE WHISTLE: THE ORGANIZATIONAL AND LEGAL IMPLICATIONS FOR COMPANIES AND EMPLOYEES* 49 (1992).

<sup>128</sup> See Ferziger & Currell, *supra* note 121, at 1171-72.

<sup>129</sup> For example, the statute of limitations for filing a retaliatory discharge complaint with OSHA is an "unreasonably short" ninety days. Moberly, *supra* note 28, at 1127. The OSHA administrative complaint requirement also imposes a cumbersome and inefficient burden. *Id.* at 1128. OSHA may know how to process whistleblower complaints from its experience with workplace safety whistleblowers, but its staff is unlikely to know about the securities laws, accounting, or high-end corporate finance. See Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21, 67 (2006); Moritz et al., *supra* note 111, at 449; Ribstein, *supra* note 33, at 371. Other flaws attributed to SOX's whistleblower provisions include a failure to specify procedures that employers must follow when receiving complaints (although one might conclude that state law fiduciary duties of care would adequately guide those receiving complaints), and a failure to overturn existing legal regimes respecting the enforceability of clauses in employment contracts providing for mandatory arbitration of employment disputes (although that is less a feature with the statute than with the current landscape of employment law). See Cherry, *supra* note 95, at 1070-83.

<sup>130</sup> Cunningham, *supra* note 11, at 966.

“a public regulatory system will always lack the one resource that is indispensable to effective detection and deterrence of complex economic wrongdoing: inside information.”<sup>131</sup> Only a strong whistleblower law aimed at generating incentives for corporate insiders to expose fraud can optimize the quantity of insider information brought into the public domain.

A. *Existing Incentives To Blow the Whistle*

1. Incentives for Whistleblowing Under SOX

SOX takes two approaches to encouraging whistleblowing. First, it includes an “anti-retaliation” provision through which employees may recover damages, including attorney fees, to compensate them for their wrongful discharge.<sup>132</sup> Meaningful damage awards hopefully serve to “deter reprisals and compensate whistleblowers for the severe negative consequences that usually accompany retaliation.”<sup>133</sup> To the extent that the fear of retaliation prevents potential whistleblowers from exposing fraud,<sup>134</sup> the SOX anti-retaliation provision might marginally increase the rate or effectiveness of whistleblowing.<sup>135</sup>

However, experience with previous anti-retaliation whistleblower protection laws suggests that this approach is inadequate.<sup>136</sup> Standing alone, anti-

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<sup>131</sup> Bucy, *Private Justice*, *supra* note 19, at 5.

<sup>132</sup> Sarbanes-Oxley Act of 2002 § 806(a), 18 U.S.C. § 1514A (Supp. IV 2004); *see also* Baynes, *supra* note 109, at 889. A companion provision makes retaliation against whistleblowers a criminal offense. Sarbanes-Oxley Act of 2002 § 1107(a), 18 U.S.C. § 1513(e); *see also* Bucy, *Carrots and Sticks*, *supra* note 105, at 283-86.

<sup>133</sup> Callahan et al., *Australian, U.K., and U.S. Approaches*, *supra* note 14, at 901; *see also* Larry Catá Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327, 372 (commenting that although the “utility of whistleblower protections remains to be seen . . . SOX does appear to protect employees from time to time”).

<sup>134</sup> To some degree, the anti-retaliation provision was tailored to the experience of Enron whistleblower Sherron Watkins, who claimed in subsequent congressional testimony that she “was troubled by [Enron’s] accounting practices but was uncomfortable reporting them . . . fearing termination.” Baynes, *supra* note 109, at 877-78. Watkins’ status as a true “whistleblower” continues to be the subject of much debate; she has been criticized for failing to do more after her initial efforts to raise the issue of Enron’s questionable and aggressive accounting practices had been rebuffed. *See, e.g.*, Dan Ackman, *Sherron Watkins Had Whistle, but Blew It*, FORBES, Feb. 14, 2002, <http://www.forbes.com/business/2002/02/14/0214watkins.html>; Posting of Peter Lattman to Wall Street Journal Law Blog, *Sherron Watkins: The Polarizing Person of the Year*, <http://blogs.wsj.com/law/2006/06/01/sherron-watkins-the-polarizing-person-of-the-year> (June 1, 2006, 3:56 pm).

<sup>135</sup> *See* Callahan & Dworkin, *Get Rich*, *supra* note 21, at 276.

<sup>136</sup> Where states adopted whistleblower protection laws, the number of wrongful discharge whistleblower retaliation claims was *no higher* than it was where no such statutes existed and employees filed similar claims under common law principles. *Id.* at 277; *see also* MICELI & NEAR, *supra* note 127, at 243-44.



retaliation provisions simply “do not provide realistic encouragement for employees to become corporate monitors.”<sup>137</sup> Few employees are even aware of the protections they may have, or the extent of those protections.<sup>138</sup> In addition, employees have historically achieved little success under federal whistleblower laws in demonstrating the necessary connection between their whistleblowing and adverse employment action.<sup>139</sup> Potential whistleblowers might discount the protection that SOX affords based on the low probability of success on an anti-retaliation claim. Moreover, many employers will choose retaliatory techniques subtler than outright termination. As Fred Alford writes, “The usual practice is to demoralize and humiliate the whistleblower, putting him or her under so much psychological stress that it becomes difficult to do a good job.”<sup>140</sup> Although potential whistleblowers may know that protection exists under SOX, they may also doubt their ability to prove more subtle forms of workplace retaliation. This is not to say that anti-retaliation provisions are useless;<sup>141</sup> indeed, they “provide important protections to whistleblowers by ensuring that they are not punished for engaging in socially beneficial conduct.”<sup>142</sup> While shielding whistleblowers from retaliation is necessary, standing alone, it is insufficient as a legal model of whistleblowing regulation.<sup>143</sup>

SOX’s second approach to encouraging whistleblowing involves a “Structural Model,” which “requires that corporations provide employees with a standardized channel to report organizational misconduct internally within the corporation.”<sup>144</sup> Specifically, the structural model declares that boards of public companies must establish disclosure channels for employees to report financial or accounting irregularities.<sup>145</sup> The structural element of SOX’s whistleblower reforms may be more important than its anti-retaliation provision. Richard Moberly argues that the whistleblower provision’s structural characteristics “provide[] incentives to increase employee participation as corporate monitors and reduce[] various disincentives to

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<sup>137</sup> Moberly, *supra* note 28, at 1129.

<sup>138</sup> *See id.*

<sup>139</sup> *See* Baynes, *supra* note 109, at 891 (reporting success rates “between 25 and 33 percent” (quoting TOM DEVINE, GOV’T ACCOUNTABILITY PROJECT, THE WHISTLEBLOWER’S SURVIVAL GUIDE: COURAGE WITHOUT MARTYRDOM 116 (1997))).

<sup>140</sup> ALFORD, *supra* note 124, at 31-32.

<sup>141</sup> Half to two-thirds of all whistleblowers, after all, lose their jobs. *Id.* at 18.

<sup>142</sup> Moberly, *supra* note 28, at 1130.

<sup>143</sup> Sarah Wood Borak, Comment, *The Legacy of “Deep Throat”: The Disclosure Process of the Whistleblower Protection Act Amendments of 1994 and the No FEAR Act of 2002*, 59 U. MIAMI L. REV. 617, 658 (2005).

<sup>144</sup> Moberly, *supra* note 28, at 1109.

<sup>145</sup> Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m)(4) (Supp. IV 2004); *see also* Moberly, *supra* note 28, at 1110.

employee whistleblowing.”<sup>146</sup> Some social science supports the idea that the rate of whistleblowing rises “when there is an identifiable, specific means for whistleblowing to occur.”<sup>147</sup> SOX will perhaps “improve[] the legitimacy of the disclosure channel”<sup>148</sup> by mandating that “disclosures go directly to the board of directors – a structure that signals the importance of employee monitoring and reporting.”<sup>149</sup> Employees may be more confident in disclosing wrongful activity, because they will have greater faith that a corporation will act upon their complaints.<sup>150</sup> Moreover, the anonymous reporting options mandated by SOX may serve to reduce the expected losses facing potential whistleblowers.<sup>151</sup>

Still, there are limitations to the SOX structural model. For example, a company may “cheat” and implement a disclosure system that looks good but is non-operational.<sup>152</sup> Moreover, most employees know that while anonymity may be a goal of a reporting system, it is never a guarantee.<sup>153</sup> Should a whistleblower need to testify, her identity may be made public despite the exhortations of SOX. Thus, while the structural characteristics of SOX may help, they are not enough.

SOX’s anti-retaliation and structural reforms are not useless, but they are inadequate. Part of the problem may have been the policy aspiration underlying SOX’s whistleblower provision. Merely protecting whistleblowers should not be the only goal. Rather, the goal should be to optimize the quantity and quality of information that whistleblowers bring to light about ongoing corporate malfeasance,<sup>154</sup> and to do so in a way that makes early intervention by public and private enforcement authorities feasible and effective.

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<sup>146</sup> Moberly, *supra* note 28, at 1111.

<sup>147</sup> *Id.* at 1132 n.112; *see also* Callahan & Dworkin, *Who Blows the Whistle*, *supra* note 124, at 164.

<sup>148</sup> Moberly, *supra* note 28, at 1138.

<sup>149</sup> *Id.* at 1146.

<sup>150</sup> To the extent that “an even larger concern than retaliation is the fear that nothing will be done in response to a whistleblowing complaint,” a more effective complaint process may increase internal whistleblowing. *Id.* at 1144.

<sup>151</sup> *See* Ferziger & Currell, *supra* note 121, at 1175.

<sup>152</sup> Moberly, *supra* note 28, at 1111.

<sup>153</sup> Ferziger & Currell, *supra* note 121, at 1180.

<sup>154</sup> *See id.* at 1172 (“[A] bounty program should adjust the relative levels of potential informants’ discounted gains and losses to maximize the inflow of valuable information.”). Of course, this assumes that there are no downsides to whistleblower bounty schemes. If, for example, bounty programs alter incentives to engage in a particular type of business by exposing firms to too great a risk of liability, then a bounty program might not be socially optimal even if it does generate the most information (or putative information) about ongoing corporate and financial fraud.

## 2. SEC Bounties

Another possible incentive for whistleblowing exists in the form of bounties currently offered by the SEC. Congress has experimented with the use of bounties to motivate securities fraud whistleblowing. For example, the Insider Trading and Securities Fraud Enforcement Act of 1988 authorized the SEC to offer whistleblowers rewards of up to 10% of the penalty imposed against a person found to have violated the insider trading laws.<sup>155</sup> Potentially, an insider aware of ongoing corporate or financial fraud might profit by blowing the whistle under this program. Many of the major corporate scandals, of course, were accompanied by insider trading allegations. For example, the son of Enron's Ken Lay was short-selling Enron (that is, making a financial bet that Enron's stock price would go down) prior to the revelation that Enron was cooking the books.<sup>156</sup> A whistleblower with information about both corporate fraud and insider profiteering could recover a bounty for blowing the whistle on the latter, which might indirectly reveal information about the former.

These rewards, however, are limited to a share of the penalty assessed, not to the illegal profits of the guilty insider.<sup>157</sup> Therefore, existing SEC bounties amount to a much smaller "carrot" than other bounty programs. Moreover, unlike the *qui tam* model discussed below, SEC bounties are paid at the discretion of the administering agency; there is "no guarantee of any recovery" and "no track record of payments."<sup>158</sup> Additionally, there is no judicial review of the SEC's bounty decisions and no minimum bounty award.<sup>159</sup>

In fact, the SEC rarely has paid bounties under this statutory authority. The discretionary nature of a bounty might not impede those with inside information from exposing corporate fraud,<sup>160</sup> if the governing agency made frequent and substantial payments. However, in some ten years of administering the program, the SEC is widely believed to have paid only a

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<sup>155</sup> 15 U.S.C. § 78u-1(e) (2000); see also Callahan & Dworkin, *Get Rich*, *supra* note 21, at 280.

<sup>156</sup> See Alexei Barrionuevo & Simon Romero, *Enron Prosecutor Attacks Theory of 2001 Collapse*, N.Y. TIMES, Apr. 28, 2006, at C3. Although Mark Lay did sell short on Enron, he may not have had "material non-public information," and presumably for that reason, was never charged with violating the law's insider trading prohibitions.

<sup>157</sup> 15 U.S.C. § 78u-1(e); see also 17 C.F.R. § 201.61 (2006); Callahan & Dworkin, *Get Rich*, *supra* note 21, at 280 & n.27. The bounty is limited to just 10% of the money penalties, a far smaller proportion than any other federal bounty program. See Ferziger & Currell, *supra* note 121, at 1146 tbl.1.

<sup>158</sup> Callahan & Dworkin, *Get Rich*, *supra* note 21, at 306.

<sup>159</sup> See Ferziger & Currell, *supra* note 121, at 1155.

<sup>160</sup> "Discretion is not, in and of itself, a pure evil in a bounty scheme." *Id.* But see *Lewis v. United States*, 32 Fed. Cl. 59, 64 (1994) ("An informer would have little incentive to give original information upon occasions at considerable personal risk to officers of the United States if his compensation rested in the absolute discretion, almost, one might say, in the whim, of an executive officer." (quoting *Wilson v. United States*, 135 F.2d 1005, 1009 (3d Cir. 1943))).

single bounty to a tipster.<sup>161</sup> Although the SEC may have recently begun to use this provision more often,<sup>162</sup> it has not, to date, offered sufficient incentives to prompt effective whistleblowing.<sup>163</sup>

### B. *Disincentives*

Against these incentives to blow the whistle are severe counterincentives that can convince insiders not to bring information about ongoing corporate and financial fraud to light. “It is difficult emotionally, personally, intellectually and professionally to come forward and blow the whistle on one’s employer, colleagues and friends.”<sup>164</sup> Whistleblowers describe their experience as a “nightmare,”<sup>165</sup> and a venture “fraught with dangers and risks.”<sup>166</sup> Whistleblowers may even be the victims of physical retaliation or threats to their safety or lives,<sup>167</sup> although one suspects that such incidents are rare in the United States.<sup>168</sup>

Perhaps the best evidence of the severe disincentives to whistleblowing comes from surveys of employees who *have* blown the whistle. In one survey, 22% of whistleblowers said they would have done exactly what they did, 44% said they would do it again (but differently), and a full 33% reported that they would not have blown the whistle because it “wasn’t worth it.”<sup>169</sup> Another

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<sup>161</sup> See Ferziger & Currell, *supra* note 121, at 1144 & n.14.

<sup>162</sup> See “Carrots and Sticks” of SEC Enforcement, in ADVANCED SECURITIES LAW WORKSHOP 2002, at 791, 794 (PLI Corporate Law & Practice, Course Handbook Series No. B-1324, 2002) (stating that the SEC’s payment of a \$29,000 bounty to an insider trading tipster “may indicate that the SEC is reviving its rarely-exercised statutory authority to pay bounties to reward whistleblowers who provide the agency with roadmaps to wrongdoing”).

<sup>163</sup> One scholar has suggested expanding SEC bounty programs to include fraud-on-the-market informers:

The monitoring effect of SEC enforcement could be enhanced by increasing the civil penalties available to the SEC and by offering bounties to fraud on the market informers. Such bounties are currently provided for information leading to insider trading prosecutions. Bounties would make it more difficult for company managers (or exchanges) to suppress information about fraud. Such bounties also would substitute for investigative efforts performed by plaintiffs’ attorneys under the class action regime.

A.C. Pritchard, *Markets as Monitors: A Proposal To Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 980-81 (1999) (footnote omitted).

<sup>164</sup> Bucy, *Private Justice*, *supra* note 19, at 61.

<sup>165</sup> *Id.*

<sup>166</sup> Baynes, *supra* note 109, at 882.

<sup>167</sup> See Sonja L. Faulkner, *After the Whistle Is Blown: The Aversive Impact of Ostracism* 6 (Aug. 1998) (unpublished Ph.D. dissertation, University of Toledo) (on file with author). Faulkner describes one instance in which a wrongdoer hired a “hit man” who followed the whistleblower “down dark streets and otherwise harassed him.” *Id.* Another whistleblower reported being “physically abused.” See *id.* at 57.

<sup>168</sup> See JOHNSON, *supra* note 21, at 91.

<sup>169</sup> Faulkner, *supra* note 167, at 57.

researcher reports that nearly “all [whistleblowers] say they wouldn’t do it again – if they had a choice, that is.”<sup>170</sup> Given that these survey groups are self-selected to be inclined toward whistleblowing (in that they have already done so), it is striking that such a large proportion would not have blown the whistle given the chance to reconsider their decision.

Moreover, as will be discussed below, the disincentives to whistleblowing are most potent when the fraud involved is a *major* one. In particular, the more serious the fraud, the more likely a whistleblower is to find herself out of a job *and* socially ostracized. Yet it is in connection with these major frauds that public policy has the greatest interest in encouraging effective whistleblowing. A bounty model like the one developed in this Article<sup>171</sup> has the advantage of increasing profits for whistleblowers reporting more serious fraud. As a result, the bounty scheme I propose can help outweigh disincentives to whistleblowing in precisely those cases where whistleblowing is most essential and disincentives are most profound.

Without reform, the incentives in favor of whistleblowing provided by SOX and existing SEC bounty schemes simply do not outweigh the disincentives. This may explain the “low success rates of employees who bring claims under Sarbanes-Oxley.”<sup>172</sup> Preliminary data indicates that SOX complaints are less frequently resolved in complainants’ favor than are the complaints of other types of whistleblowers subject to OSHA administrative review.<sup>173</sup> In part, this may result from the fact that SOX, unlike the FCA model I develop below, does not provide sufficient incentives for those with knowledge of the *most serious* corporate and financial fraud to blow the whistle.

#### 1. Loss of Employment Even with SOX Anti-Retaliation Provisions

One disincentive to whistleblowing is that even with the anti-retaliation provisions of SOX in place, a whistleblower who exposes a major fraud may find herself out of a job. This is because the revelation of a serious fraud scheme can destroy a corporation. For example, though Sherron Watkins was one of the last employees to leave Enron, she remained out of work for five years after the Enron scandal.

Certainly, one of the lessons of the Enron debacle is that effective whistleblowing can lead to an employer’s demise.<sup>174</sup> A striking aspect of the Enron and WorldCom affairs was that the news of massive fraud utterly destroyed their market value even though they possessed underlying assets

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<sup>170</sup> ALFORD, *supra* note 124, at 1.

<sup>171</sup> *See infra* Part IV.

<sup>172</sup> Moberly, *supra* note 28, at 1128.

<sup>173</sup> *Id.*; *see also* Moberly, *supra* note 111, at 19-21.

<sup>174</sup> *See* Bucy, *Private Justice*, *supra* note 19, at 61.

with positive value.<sup>175</sup> A corporation's stock price crash may be completely out of proportion to the "fundamental news" that a disclosure conveys.<sup>176</sup> The Enron collapse led many to conclude that markets do not price efficiently,<sup>177</sup> and certainly overreact to news of emerging corporate scandals. Investors seem too eager to infer trends from sudden increases and decreases in stock price, even though such dips or spikes may be little more than regression to the mean.<sup>178</sup> Where a price change follows the revelation of corporate or securities fraud, investors may be even more likely to "pile on" a distressed company and drive its stock price into the tank.

Moreover, to the extent that a potential whistleblower is an undiversified investor in her employer's securities (in the form of a 401(k), pension plan, or stock option compensation package), her employer's stock market collapse will have an even stronger negative financial impact on her than the mere loss of her job.<sup>179</sup> The average Enron employee held Enron stock as 60% of her 401(k) assets; when the stock's price fell from \$84 a share to practically zero, Enron employees lost virtually everything.<sup>180</sup>

## 2. Fear of Social Ostracism

Another strong disincentive facing a potential whistleblower is the fear that blowing the whistle may lead to ostracism, isolation, and loneliness. A century ago, William James wrote that "[n]o more fiendish punishment could be devised" than social ostracism.<sup>181</sup> Ostracism threatens a basic human motivation to avoid exclusion from important social groups.<sup>182</sup> Ostracism may be as simple as giving the "cold shoulder" or the "silent treatment" to a whistleblower,<sup>183</sup> or it may evolve into full blown social rejection.<sup>184</sup> It may also take more modern forms such as "cyber ostracism," in which an employee

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<sup>175</sup> See Bradford Cornell & James C. Rutton, *Market Efficiency, Crashes and Securities Litigation*, 81 TUL. L. REV. (forthcoming) (manuscript at 25-27), available at <http://ssrn.com/abstract=871106>.

<sup>176</sup> *Id.* (manuscript at 27).

<sup>177</sup> See, e.g., Macey, *supra* note 82, at 418-20.

<sup>178</sup> See William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 906-07 (2005).

<sup>179</sup> See Lisa Meulbroek, *Company Stock in Pension Plans: How Costly Is It?*, 48 J.L. & ECON. 443, 443 (2005) ("The collapse of Enron dramatically illustrated the risk to employees of investing in their employer's stock. . . . Employees holding company stock do not have fully diversified portfolios and are therefore exposed to firm-specific risk that could otherwise be 'diversified away.'").

<sup>180</sup> John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 58 n.6 (2005) (citing James K. Glassman, *Diversify, Diversify, Diversify*, WALL ST. J., Jan. 18, 2002, at A10).

<sup>181</sup> 1 WILLIAM JAMES, PRINCIPLES OF PSYCHOLOGY 293 (Dover Publ'ns 1950) (1890).

<sup>182</sup> Faulkner, *supra* note 167, at 22.

<sup>183</sup> *Id.* at 10-11.

<sup>184</sup> See MICELI & NEAR, *supra* note 127, at 83.

no longer receives as many e-mails or office memos (or receives e-mails that are of a less personal nature).<sup>185</sup> Regardless of its form, ostracism can have a tremendous impact on its targets on both a psychological and physical level.<sup>186</sup> Although the precise incidence of ostracism of whistleblowers is difficult to determine, researchers universally mention it as a leading consequence of blowing the whistle.<sup>187</sup>

Fear of ostracism may explain low rates of whistleblowing. Even though many lower-level employees at corporations like Enron must have known about and participated in the company's financial and accounting irregularities, very few raised objections, and none took their concerns outside the company.<sup>188</sup> Employees seemed to have an "inherent hesitation to speak out."<sup>189</sup> This may be due to the "tremendous . . . social risks associated with whistleblowing."<sup>190</sup> Whistleblowers "are often ostracized by fellow employees and peers."<sup>191</sup> Social pressure may "discourage[] individuals from becoming 'squealers' and betraying loyalties."<sup>192</sup> In fact, researchers have found that the social ostracism of whistleblowers is a more common retaliatory technique than adverse employment action.<sup>193</sup>

Both supervisors and co-workers are responsible for this ostracism. Co-workers may disapprove of whistleblowing, fearing that the revelation and termination of wrongful activity could cost them their jobs.<sup>194</sup> Unlike adverse employment actions such as demotion, termination, or reassignment,<sup>195</sup> ostracism is a form of retaliation that any co-worker may implement.<sup>196</sup> One need not have any particular power or position to engage in socially retaliatory behavior. Ostracism may also be a "cheaper" form of retaliation because it is

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<sup>185</sup> Faulkner, *supra* note 167, at 13.

<sup>186</sup> *Id.* at 11.

<sup>187</sup> *See id.* at 7. In Faulkner's survey, "all respondents were ostracized after reporting wrongdoing in their company." *Id.* at 59. However, respondents may have self-selected in part *because* they were ostracized. *Id.* at 141.

<sup>188</sup> *See* Moberly, *supra* note 28, at 1119-20.

<sup>189</sup> *Id.* at 1120.

<sup>190</sup> *Id.* at 1144.

<sup>191</sup> Sean Hamer, *Lincoln's Law: Constitutional and Policy Issues Posed by the Qui Tam Provisions of the False Claims Act*, KAN. J.L. & PUB. POL'Y, Winter 1997, at 89, 99.

<sup>192</sup> Moberly, *supra* note 28, at 1145.

<sup>193</sup> Faulkner, *supra* note 167, at 8-9.

<sup>194</sup> *Id.* at 4-5. In Faulkner's survey, respondents gave examples of co-workers' defensive ostracism: "'People were afraid to be associated with me,' 'They thought they'd lose their jobs,' 'guilt by association.'" *Id.* at 50.

<sup>195</sup> The line between social ostracism and adverse employment action, however, is not always clear. For example, an employee may be given the "silent treatment" by a superior, and therefore fail to receive feedback on her job performance or instructions as to what she is expected to do. *See id.* at 61. Even though that type of retaliation might look like ostracism, it likely rises to the level of an adverse employment action.

<sup>196</sup> *Id.* at 8.

unlikely to violate applicable laws,<sup>197</sup> and is almost impossible to prove even if it does.<sup>198</sup>

The social pressures of a workplace can be profound. Pamela Bucy refers to the social pressure not to blow the whistle as the “carpool factor.”<sup>199</sup> A potential whistleblower is likely to be social friends with corporate wrongdoers: “They will belong to the same community and social organizations, their children may attend school and extracurricular activities together, and their families probably carpool together.”<sup>200</sup> An accountant, for example, who turns in his employer for fraud will likely be “less welcome at the after-hours cocktail parties he formerly attended.”<sup>201</sup> Personal relationships are an important part of the work experience.<sup>202</sup> For some potential whistleblowers, fear of social retaliation may be a stronger deterrent than the possibility of termination or demotion.

Fear of ostracism is likely to be particularly acute in cases of major fraud. An employee about to blow the whistle on fraud that could undermine the entire corporation may fear that co-workers will view him as the cause of the corporation’s likely demise or contraction. Since society’s interest in exposing major frauds is particularly acute, it is troubling that ostracism is likely to be most severe in major fraud cases.

SOX protects employees from adverse employment actions. But law can do nothing, directly, to reduce the social pressures that impede whistleblowing. While the SOX channeling mechanisms could decrease social pressures to stay silent in the face of wrongdoing,<sup>203</sup> such pressures will likely remain strong. Offering a lucrative financial reward may be the best way to help potential whistleblowers overcome their fear of ostracism.

### 3. Psychological Strain

The psychological impediments to whistleblowing are related to the fear of social ostracism, but nevertheless constitute a discrete obstacle facing potential SOX whistleblowers. In this context, a potential whistleblower is not dissuaded out of fear of social retaliation, but rather out of fear of the internal psychological costs that whistleblowing is likely to impose.

Whistleblowing can be psychologically challenging.<sup>204</sup> Even though employees of a company engaged in financial or accounting fraud may firmly

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<sup>197</sup> *See id.* at 8-9.

<sup>198</sup> *See id.* at 60.

<sup>199</sup> Bucy, *Carrots and Sticks*, *supra* note 105, at 316.

<sup>200</sup> *Id.*

<sup>201</sup> Ferziger & Currell, *supra* note 121, at 1173.

<sup>202</sup> Faulkner, *supra* note 167, at 9.

<sup>203</sup> Moberly, *supra* note 28, at 1148.

<sup>204</sup> *But see* Ferziger & Currell, *supra* note 121, at 1175 (“[T]he mental experience of anonymous informing is not necessarily negative, and in many cases informants perceive that they will benefit from the experience.”).



believe they have spotted wrongdoing, they often suffer from “nagging doubts that their suspicions are not justified and that they may be, or may be perceived as, ‘crazy.’”<sup>205</sup> Moreover, the psychological pain associated with whistleblowing can be exacerbated when the whistleblower has to deal with federal investigators or bureaucrats, an experience that can, in and of itself, be extremely frustrating.<sup>206</sup>

One source of the psychological pain from whistleblowing is that it requires deviation from a group. An employee must self-identify as “different” from her co-workers in order to blow the whistle. An employee must also accuse members of her professional and, oftentimes, social group of wrongdoing – something that can undermine the employee’s own identity with the group. Anthropological and sociological research indicates that “human beings seeking identity tend to group themselves into relatively small units,” and that “the desire to belong to a small group is a hardwired feature of human nature.”<sup>207</sup> Researcher Fred Alford informs us that most whistleblowers “are in some way broken, unable to assimilate the experience, unable, that is, to come to terms with what they have learned about the world.”<sup>208</sup> The experience of whistleblowing can cause a kind of cognitive dissonance, in which the whistleblower’s belief that she is right grates against her natural psychological need to preserve group affiliation.

The psychological strain of being a whistleblower causes many to lose their families.<sup>209</sup> Most whistleblower cases drag on for years,<sup>210</sup> during which time those closest to the whistleblower have their doubts.<sup>211</sup> Out of fear of these types of psychological costs, many potential whistleblowers are inclined to remain silent even though SOX’s whistleblower provision protects them from workplace retaliation.

On the other hand, some disgruntled employees might gain psychological satisfaction from harming their superiors; but it is doubtful that the same emotional gain accrues from exposing wrongdoing by coworkers as might arise, for example, from exposing the tax fraud of a former spouse.<sup>212</sup> Of

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<sup>205</sup> WEST, *supra* note 19, at 30.

<sup>206</sup> See Ferziger & Currell, *supra* note 121, at 1173.

<sup>207</sup> Elletta Sangrey Callahan et al., *Integrating Trends in Whistleblowing and Corporate Governance: Promoting Organizational Effectiveness, Societal Responsibility, and Employee Empowerment*, 40 AM. BUS. L.J. 177, 186 (2002) [hereinafter Callahan et al., *Integrating Trends*].

<sup>208</sup> ALFORD, *supra* note 124, at 1.

<sup>209</sup> See *id.* at 19.

<sup>210</sup> See *id.*

<sup>211</sup> One whistleblower’s (former) father-in-law told him that if he had been a “real” whistleblower he would have appeared on “60 Minutes.” See *id.* at 1.

<sup>212</sup> The Internal Revenue Service has found that many tax fraud whistleblowers target ex-spouses. The IRS offers an Informants’ Rewards Program that pays rewards to those who “detect[] underpayments of tax” and “detect[] and bring[] to trial and punishment persons guilty of violating the internal revenue laws.” I.R.C. § 7623 (2000). The program was

course, the former spouses of fraudsters in the securities context might tip off securities regulators to their ex-spouses' financial and accounting schemes. But one wonders how much an executive tells her spouse about a pattern of fraud she initiated, and how effectively the spouse can assess and evaluate that information. Clearly, taking an improper personal tax deduction is an easier fraud for a spouse to spot and report to the government than some of the more complex financial and accounting frauds initiated by malfasant managers.<sup>213</sup>

#### 4. Blacklisting

A fourth factor militating against whistleblowing is the potential for exclusion from an industry, popularly known as "blacklisting." While SOX protects whistleblowers from retaliation from their current employers (which would also presumably bar unjustifiable negative employment references), SOX does nothing to stop subsequent discrimination against whistleblowers by other employers.

A common fear of whistleblowers is that they will not be forgiven by corporate America, but instead will "spend their lives in misery, shunned by employers."<sup>214</sup> Whistleblowers are likely to face a kind of "professional ostracization," in which "[c]ompanies, even an entire industry, could 'boycott' a whistleblower."<sup>215</sup> After all, future employers may assume "once a whistleblower, always a whistleblower."<sup>216</sup> Perhaps as a result of "informal

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enacted because violations of the Internal Revenue Code are expressly excluded by the FCA. See 31 U.S.C. § 3729(e) (2000). For a recent study of the program, see generally TREASURY INSPECTOR GEN. FOR TAX ADMIN., DEP'T OF THE TREASURY, REFERENCE NO. 2006-30-092, THE INFORMANTS' REWARDS PROGRAM NEEDS MORE CENTRALIZED MANAGEMENT OVERSIGHT (2006), available at <http://www.treas.gov/tigta/auditreports/2006reports/200630092fr.pdf>. As IRS critics have pointed out, one of the main sources of tips under this program are former spouses of tax cheats. See Ferziger & Currell, *supra* note 121, at 1194 n.269 (quoting Democratic Senator Harry Reid). For those tipsters, the psychological satisfaction of causing harm to someone they hate may outweigh the psychological pain of being a whistleblower.

<sup>213</sup> One of the more amazing things about the collapse of Enron, for example, is how much information about the company's off-the-books partnerships and aggressive accounting techniques was in the public domain but simply too complex for even sophisticated investors to monitor inexpensively. See Richard D. Cudahy & William D. Henderson, *From Insull to Enron: Corporate (Re)Regulation After the Rise and Fall of Two Energy Icons*, 26 ENERGY L.J. 35, 96 (2005).

<sup>214</sup> Fanto, *supra* note 108, at 440; see also Ferziger & Currell, *supra* note 121, at 1173-74.

<sup>215</sup> Bucy, *Carrots and Sticks*, *supra* note 105, at 317; see also Depoorter & De Mot, *supra* note 121, at 159; Hamer, *supra* note 191, at 99.

<sup>216</sup> "[W]ho wants to run the risk of having the whistle blown on him?" Bucy, *Carrots and Sticks*, *supra* note 105, at 317.

blacklist[s]” in “tight-knit fields,” most whistleblowers never work in their fields again.<sup>217</sup>

William Kovacic characterizes the decision to blow the whistle as the liquidation of an individual’s investment in her career.<sup>218</sup> A potential whistleblower should probably assume that revealing fraud will preclude future advancement in the industry.<sup>219</sup> Thus, protection against the loss of a current position is of little economic significance, given that a whistleblower can expect a lifetime of difficulty working in her chosen field.

#### 5. Contractual Commitments and Fiduciary Duties

Even with SOX’s protection against termination for whistleblowing, some knowledgeable corporate insiders may be reluctant to reveal corporate fraud because of a concern for personal liability. Such liability could arise out of (1) a contractual commitment to preserve an employer’s confidences, or (2) state law fiduciary duties of loyalty and obedience.

Employee secrecy agreements are on the rise.<sup>220</sup> Several employers have asserted confidentiality agreements in an effort to prevent whistleblowers from testifying about employer wrongdoing.<sup>221</sup> The degree to which courts will enforce such clauses against genuine whistleblowers is unclear.<sup>222</sup> The SOX whistleblower provisions bar retaliation against an employee engaged in “any lawful act.”<sup>223</sup> One can certainly expect employers to argue that disclosure in violation of a contractual commitment to preserve employer confidences (or to disclose only to internal ombudsmen and the like) constitutes an “unlawful” act *outside* the scope of SOX’s protection. Some commentators have argued that courts should broadly construe the language of SOX to avoid this result,<sup>224</sup> but whether courts will do so is open to doubt.

In addition to contractual concerns, a potential whistleblower may be worried about possible liability for breach of a fiduciary duty – particularly if

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<sup>217</sup> ALFORD, *supra* note 124, at 19.

<sup>218</sup> William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799, 1819 (1996).

<sup>219</sup> *Id.*

<sup>220</sup> See Terry Morehead Dworkin & Elletta Sangrey Callahan, *Buying Silence*, 36 AM. BUS. L.J. 151, 152 (1998).

<sup>221</sup> See *id.* at 153. Perhaps the most famous confidentiality agreement to affect whistleblowing was “The Insider” Jeff Wigand’s non-disclosure agreement, which he violated by appearing on “60 Minutes” – an appearance that cost him all of his company benefits. JOHNSON, *supra* note 21, at 1.

<sup>222</sup> See Dworkin & Callahan, *Buying Silence*, *supra* note 220, at 153.

<sup>223</sup> Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A(a) (Supp. IV 2004).

<sup>224</sup> See Vaughn, *supra* note 111, at 62 (“Including [corporate rules or standards or contractual provisions] within the term, ‘lawful,’ is inconsistent with the most likely meaning of the term and would permit companies effectively to undermine protection and suppress disclosure of their own misconduct by prohibiting most disclosures.”).

she does not have “solid” proof of wrongdoing. Blowing the whistle to outsiders – including regulatory authorities – might even constitute conversion of corporate property, which could certainly be said to violate an employee’s duty of loyalty.<sup>225</sup> Where the information disclosed amounts to a trade secret, further liability could potentially attach.<sup>226</sup>

### C. *Inside Versus Outside Whistleblowing*

SOX evidences a general trend in federal law in favor of intra-organizational, or internal, whistleblowing.<sup>227</sup> But in SOX this trend takes an acute form. SOX envisions whistleblowers as servants of shareholders, rather than servants of law-enforcement officers or the public. Whether that is the best paradigm for whistleblowers is an open and debatable proposition.

Internal whistleblowing is certainly better for an individual company,<sup>228</sup> as it is less disruptive than whistleblowing to the media or government agencies. Moreover, employee morale improves when employees perceive they have the ability to stop their employer from engaging in wrongful conduct.<sup>229</sup> This may not be the best thing for society as a whole, however, since internal whistleblowing gives a corporation the potential chance to cover up a scandal. Furthermore, even if the corporation corrects its fraudulent activity or modifies questionable accounting practices, the market is deprived of useful information if the whistle is never blown outside the organization.

Exploring the relative merit of internal versus external whistleblowing is beyond the scope of this Article. I merely aim to flag this as an aspect of SOX deserving further consideration. The law’s preference for internal whistleblowing may not be the optimal approach. The bounty model developed in the following sections helps strike a better balance of incentives for internal and external whistleblowing.

### III. *QUI TAM* BOUNTIES IN THE FCA CONTEXT: A SENSIBLE PRECEDENT

Given SOX’s limited incentives for potential whistleblowers to go public, a new paradigm must be developed. This Article proposes rewarding whistleblowers with a financial bounty tied to the damages caused by financial and accounting shenanigans. The Federal FCA’s *qui tam* provisions provide a model for developing this bounty scheme, but are currently applied primarily in the procurement and healthcare contexts. To bring bounties to the securities and corporate fraud context, new laws or imaginative interpretations of existing laws are necessary. This section sketches the contours of the FCA’s

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<sup>225</sup> See Baynes, *supra* note 109, at 884, 893.

<sup>226</sup> See Dworkin & Callahan, *Buying Silence*, *supra* note 220, at 153-54.

<sup>227</sup> See Callahan et al., *Integrating Trends*, *supra* note 207, at 190; Moberly, *supra* note 28, at 1151.

<sup>228</sup> See Callahan et al., *Integrating Trends*, *supra* note 207, at 195-96; Hamer, *supra* note 191, at 101.

<sup>229</sup> See Callahan et al., *Integrating Trends*, *supra* note 207, at 196.

*qui tam* provisions, and describes the positive features of the FCA framework. In the next section, I discuss issues and options for implementing FCA-style *qui tam* bounties in the corporate and securities fraud context.

The FCA was adopted in 1863 as “a way of combating the fraud suffered by the Union Army when it received deliveries of defective or nonexistent military supplies.”<sup>230</sup> After reviewing evidence of massive procurement fraud, Congress believed that military contractors, aided and abetted by civil servants, were robbing the Treasury in a way that could undermine the war effort.<sup>231</sup>

Like SEC Rule 10b-5, the most potent and well-known of our securities laws, the FCA is, at its core, an anti-fraud mandate.<sup>232</sup> Under the FCA, it is unlawful to present knowingly to the United States a false or fraudulent claim for payment,<sup>233</sup> to make a false record or statement to get a claim paid,<sup>234</sup> or to make a false record or statement to avoid an obligation to transmit money or property to the government.<sup>235</sup> There are three basic elements to liability under the FCA: (1) presentation of a *claim*; (2) *falsity* or *fraud*; and (3) *knowledge*.<sup>236</sup>

Unlike the securities laws, since its inception, the FCA has included a *qui tam* provision allowing a private “relator” to bring an action on behalf of the government<sup>237</sup> and to recover a share of the government’s damages as a “generous bounty” for bringing the suit.<sup>238</sup> The basis for the FCA’s *qui tam* provision, according to one of the Act’s sponsors in the Senate, was the “old-fashioned idea of holding out a temptation and ‘setting a rogue to catch a rogue.’”<sup>239</sup> Congress’ decision to turn to private actors grew less out of a

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<sup>230</sup> Bucy, *Private Justice*, *supra* note 19, at 44; *see also* James F. Barger, Jr. et al., *States, Statutes, and Fraud: An Empirical Study of Emerging State False Claims Acts*, 80 TUL. L. REV. 465, 470 (2005) (“Diseased mules, defective muskets, and an iconic President’s frustration led to passage of the federal FCA in 1863.” (footnotes omitted)).

<sup>231</sup> *See* KOHN, *supra* note 19, at 204.

<sup>232</sup> *But see* 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-3 (“For the most part, the False Claims Act is not solely a ‘fraud’ statute in the pure sense and may be applicable in cases where there is no common law fraud.”).

<sup>233</sup> 31 U.S.C. § 3729(a)(1) (2000).

<sup>234</sup> *Id.* § 3729(a)(2). While there are five other subsections to the Act’s liability provision, subsections (a)(1) and (a)(2) are the “foundations of the statute.” BOESE, QUI TAM, *supra* note 25, at 22.

<sup>235</sup> 31 U.S.C. § 3729(a)(7). This is the “reverse false claim” provision of the law. 1 BOESE, FALSE CLAIMS, *supra* note 19, at 2-45.

<sup>236</sup> BOESE, QUI TAM, *supra* note 25, at 22. The defendant must know that the claim presented was false or fraudulent, or if the claim was presented by a third party, the defendant must have knowingly caused the claim to be false. *Id.* Generally, damages and reliance are not required elements of an FCA offense. *See* 1 BOESE, FALSE CLAIMS, *supra* note 19, at 2-20, 2-179 to -180.

<sup>237</sup> The United States is a party to every federal *qui tam* suit. 31 U.S.C. § 3730(b)(1); *see also* 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-12.

<sup>238</sup> KOHN, *supra* note 19, at 205.

<sup>239</sup> *See id.*

concern about limited federal resources,<sup>240</sup> and more out of a belief that federal employees were participating in fraud.<sup>241</sup>

Prior to 1986, however, the *qui tam* provisions of the FCA were largely ineffectual due to a provision inserted in 1943 barring *qui tam* actions based on information already known by the government.<sup>242</sup> Thus, a relator could not bring an FCA lawsuit under the *qui tam* section if the government already had information on the underlying fraud, even if the government had chosen not to act on that information. In a particularly odd result, whistleblowers who tipped off regulators prior to filing suit would be barred from claiming a *qui tam* bounty.

In 1986, Congress decided to expand the *qui tam* provisions of the FCA in order to encourage more private enforcement.<sup>243</sup> Congress believed that the “growing pervasiveness of fraud” required “modernization of the Government’s primary litigative tool for combating fraud.”<sup>244</sup> Therefore, Congress amended the law to allow an “original source” relator to pursue a *qui tam* action even when the government is aware of the source’s information prior to the filing of a suit.<sup>245</sup> Only the original source of the information, however, has standing; other potential relators are jurisdictionally barred.<sup>246</sup> The statute defines an original source as one who “has voluntarily provided the information to the Government before filing an action.”<sup>247</sup>

A *qui tam* plaintiff has standing on the ground that the federal government, as the injured party in a contracting case, can assign its right to sue to a relator.<sup>248</sup> The government retains certain rights in connection with an FCA suit filed by a relator. Initially, a *qui tam* complaint is filed “under seal” with

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<sup>240</sup> At the time, of course, there was no Justice Department, and the Attorney General and independent U.S. District Attorneys were overburdened. 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-6.

<sup>241</sup> See KOHN, *supra* note 19, at 205.

<sup>242</sup> See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-13; Bucy, *Private Justice*, *supra* note 19, at 48.

<sup>243</sup> United States *ex rel.* Stone v. Rockwell Int’l Corp., 144 F.R.D. 396, 398 (D. Colo. 1992); see also KOHN, *supra* note 19, at 207.

<sup>244</sup> S. REP. NO. 99-345, at 2 (1986), as reprinted in 1986 U.S.C.C.A.N. 5266, 5266.

<sup>245</sup> Bucy, *Private Justice*, *supra* note 19, at 47. The 1986 amendments were meant to breathe life into the FCA *qui tam* provisions as a way of supplementing limited federal resources in the battle against procurement fraud. See KOHN, *supra* note 19, at 207. The 1986 amendments included other changes meant to encourage private relators to bring suit under the FCA. For example, intervention rights were given to the relator for cases taken over by the government; prior to 1986, there were no such rights. See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 307. The 1986 amendments also increased the minimum award percentages for relators. *Id.* at 305-06.

<sup>246</sup> 31 U.S.C. § 3730(e)(4)(A) (2000).

<sup>247</sup> *Id.* § 3730(e)(4)(B).

<sup>248</sup> Vt. Agency of Natural Res. v. United States *ex rel.* Stevens, 529 U.S. 765, 773-74 (2000); Bucy, *Private Justice*, *supra* note 19, at 44-45.

the federal district court,<sup>249</sup> and a disclosure statement is submitted to the Justice Department.<sup>250</sup> Although the statute allows just sixty days for the government to decide whether to intervene,<sup>251</sup> the government is permitted to seek extensions,<sup>252</sup> and nearly always does.<sup>253</sup> If the government decides to intervene, it assumes primary responsibility for the litigation.<sup>254</sup> Such intervention, however, is rare.<sup>255</sup> Even when it does not intervene, the government may still move for dismissal of *qui tam* cases,<sup>256</sup> and it appears that the government has recently become more aggressive in utilizing this

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<sup>249</sup> See WEST, *supra* note 19, at 13. The requirement that a *qui tam* complaint be filed under seal is designed to “allow the Government time to investigate and to protect the *qui tam* defendant from false allegations.” BOESE, QUI TAM, *supra* note 25, at 43. The failure to file a case under seal can be grounds for dismissal of a *qui tam* complaint. See Erickson *ex rel.* United States v. Am. Inst. of Biological Scis., 716 F. Supp. 908, 911 (E.D. Va. 1989).

<sup>250</sup> The disclosure statement is required by 31 U.S.C. § 3730(b)(2). It is designed to “provide the government with enough information on the alleged fraud so it can make an informed decision on whether to participate in the action or allow the relator to proceed on his own.” United States *ex rel.* Yannacopoulos v. Gen. Dynamics, 231 F.R.D. 378, 381 (N.D. Ill. 2005). The “discoverability” of the disclosure statement has been a major issue in many *qui tam* cases. See *id.* at 384-86; BOESE, QUI TAM, *supra* note 25, at 44.

<sup>251</sup> WEST, *supra* note 19, at 13.

<sup>252</sup> *Id.*

<sup>253</sup> Some cases remain under seal for years. See, e.g., United States *ex rel.* Sarmont v. Target Corp., No. 02-C-0815, 2003 WL 22389119, at \*2 (N.D. Ill. Oct. 20, 2003) (under seal for 10 years). The delay between the filing of *qui tam* cases and the payment of bounties may negatively influence whistleblowing. See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 315.

<sup>254</sup> Bucy, *Private Justice*, *supra* note 19, at 49. Government intervention has a major financial impact on a *qui tam* case: if the government intervenes, the “enormous costs of motions, discovery and trial are borne primarily by the Government, not a private individual or law firm.” BOESE, QUI TAM, *supra* note 25, at 46.

<sup>255</sup> By one count, the government has intervened in less than 20% of the *qui tam* cases filed since the 1986 amendments. See Bucy, *Private Justice*, *supra* note 19, at 52 n.294. That figure likely paints a misleading picture; in many of the cases in which the government “intervenes,” it does so only after the terms of a settlement have been largely worked out by the private relator’s counsel and the defendant. The government and its enforcement attorneys are overworked and may be jaded. See *id.* at 47-49. By another count, the government intervened in 940 of the 5129 cases filed between the adoption of the 1986 amendments and September 2005. See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-4 n.4.

<sup>256</sup> Bucy, *Private Justice*, *supra* note 19, at 70.

right.<sup>257</sup> If the government declines to intervene or to seek dismissal, the private relator may litigate the matter herself.<sup>258</sup>

The government's discretion to intervene, decline intervention, or move for dismissal may help weed out bad cases.<sup>259</sup> In that sense, what Pamela Bucy calls the "dual-plaintiff" mechanism serves as a "quality control" device.<sup>260</sup> The "quality control" aspects of FCA litigation are not limited to the potential for government intervention. The inside status of most relator plaintiffs also improves the *quality* and *relevance* of the information about fraud that underlies a particular suit.<sup>261</sup> Where the relator has little original information, the bounty guidelines likely make the award too low to interest plaintiffs' counsel in filing suit.<sup>262</sup> Moreover, *qui tam* relators are self-selected and likely to be "[e]xceedingly bright and inquisitive."<sup>263</sup> They figured out a complex fraud, learned about the *qui tam* law, and found a lawyer.<sup>264</sup> Unlike a "typical" whistleblower, an FCA whistleblower is more likely to be the type of person to have spotted *real* and *serious* fraud.

The FCA *qui tam* provision is designed to produce "lucrative bounties" for the relator.<sup>265</sup> A *qui tam* plaintiff is entitled to 15-30% of the government's damages from the FCA violations;<sup>266</sup> the relator's share has been "enhanced

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<sup>257</sup> *Id.* at 71. In the past, the government rarely moved to dismiss *qui tam* actions because it had little motivation to do so. If a claim seemed completely without merit, the government could "simply decline to intervene" and, without expending resources trying the case, still recover 70-75% of any proceeds obtained by the relator. 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-178 to -179.

<sup>258</sup> See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-172.

<sup>259</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 197.

<sup>260</sup> Bucy, *Private Justice*, *supra* note 19, at 53.

<sup>261</sup> See Pamela H. Bucy, *Game Theory and the Civil False Claims Act: Iterated Games and Close-Knit Groups*, 35 LOY. U. CHI. L.J. 1021, 1026 (2004) (lauding the FCA for providing "a way for regulators to gain access to high-level, detailed, inside information about wrongdoing").

<sup>262</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 198.

<sup>263</sup> WEST, *supra* note 19, at 30. *But see* Callahan & Dworkin, *Get Rich*, *supra* note 21, at 295-96 (hypothesizing that a bounty structure encourages whistleblowing by younger workers with low self-esteem and low job status).

<sup>264</sup> WEST, *supra* note 19, at 30.

<sup>265</sup> Bucy, *Private Justice*, *supra* note 19, at 12 n.46.

<sup>266</sup> If the government declines to intervene in a *qui tam* case, the plaintiff will recover 25-30% of the government's damages (plus the costs of litigation). 31 U.S.C. § 3730(d)(2) (2000); *see also* BOESE, QUI TAM, *supra* note 25, at 55. If the government does intervene in a case, the relator will receive 15-25% of the government's share. 31 U.S.C. § 3730(d)(1); *see also* BOESE, QUI TAM, *supra* note 25, at 53. The precise percentage a relator receives (between 15% and 25%) depends on a number of variables. The Justice Department believes that only fully litigated cases should trigger the high end of the spectrum, while cases that settle should result in bounties at the lower end. *Id.* Other factors include the significance of the information provided by the relator, the contribution of the relator to the



considerably” in recent years “in an effort to encourage informants to come forward and report fraud.”<sup>267</sup> The average recovery for a *qui tam* relator in a successful FCA case is over one million dollars.<sup>268</sup> As a result of this incentive, quite a few cases are filed.<sup>269</sup> Between 1986 and October 30, 2000, more than three thousand such cases were filed, netting a recovery of over four billion dollars.<sup>270</sup> More private *qui tam* actions are filed each year than private securities litigation actions,<sup>271</sup> which is astounding given that the value of government contracting pales in comparison to the market capitalization of American companies. The *qui tam* provision of the FCA “has proven to be highly effective in recruiting legal talent who have the skill and resources to handle complex, expensive cases.”<sup>272</sup> Large fees encourage “top legal talent to undertake *qui tam* plaintiffs’ work.”<sup>273</sup>

Jill Fisch explains that the FCA’s *qui tam* model offers added value to the government by shifting the costs of “initiating litigation, providing information and investigative assistance, and providing litigation resources and support” to private plaintiffs.<sup>274</sup> She argues:

The substantial bounty awarded to successful relators provides ample incentive for plaintiffs to initiate litigation under the FCA. . . .

The informational contribution of the relator also is substantial. Indeed, the incentive structure of *qui tam* is tailored to place a premium on the contribution of original information, with the intent that the unique access and insight of *qui tam* plaintiffs into the operations of government contractors may enable them to identify instances of fraud that the

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outcome of the case, and the degree to which the relator provided new information unknown to the government prior to the case. 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-204. The Justice Department has developed a more elaborate set of factors to guide determinations of the relator’s share. *Id.* at 4-204 to -206.

<sup>267</sup> 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-10.

<sup>268</sup> Callahan et al., *Integrating Trends*, *supra* note 207, at 194; *see also* Callahan & Dworkin, *Get Rich*, *supra* note 21, at 282 (“[S]uccessful whistleblowers can come away multimillionaires.”).

<sup>269</sup> *See* Callahan et al., *Integrating Trends*, *supra* note 207, at 194.

<sup>270</sup> *See* Bucy, *Private Justice*, *supra* note 19, at 48.

<sup>271</sup> *Id.* at 54.

<sup>272</sup> *Id.* at 58. A financial incentive for whistleblowing, after all, only matters if the award is “perceived as sufficiently substantial to justify the required effort.” Callahan & Dworkin, *Get Rich*, *supra* note 21, at 298.

<sup>273</sup> Bucy, *Private Justice*, *supra* note 19, at 58. Furthermore, the fact that plaintiffs’ counsel are required to file an initial complaint under seal and submit a report to the Justice Department may help weed out inexperienced counsel, who are unable to commit the time and resources to such a venture. *Id.* However, inexperienced counsel would no doubt face a similar obstacle should they choose to file a private securities fraud case, in that they would likely lose out to more sophisticated firms when it came time to appoint class counsel.

<sup>274</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 195.

government would be unable to address on its own. Furthermore, the relator can assist the government during the investigation process. The government has used private plaintiffs to review documents, formulate strategy, and obtain additional information during the course of an investigation. The government has even used a relator to obtain wiretap evidence of fraudulent conduct. . . .

Finally, the relator can supplement the government's litigation effort with private resources.<sup>275</sup>

*Qui tam* cases bring out important inside information.<sup>276</sup> Potential *qui tam* plaintiffs can offer information "about inchoate or on-going malfeasance of which law enforcement is unaware."<sup>277</sup> While a government agency could generally obtain the same information revealed by a whistleblower, it would only be able to do so at considerable cost.<sup>278</sup>

The requirement that a *qui tam* plaintiff be an original source of information means that the revelations underlying an FCA *qui tam* case, unlike the facts prompting a private securities fraud class action lawsuit, are more likely to constitute new and valuable information.<sup>279</sup> Revelations of this nature could contribute to market efficiency in a way that securities fraud cases based on recycled information do not.

This is not to say that the path of a *qui tam* whistleblower is free of the kinds of peril facing a SOX whistleblower. The seal requirement of the FCA *qui tam* provisions, which potentially keeps a case under seal for years, bars a whistleblower from "discussing the case with anyone, including friends, family, and current or potential employers."<sup>280</sup> As a result, finding employment may be difficult, and the whistleblower may experience feelings of isolation.<sup>281</sup> Despite these downsides, however, the litigation history of the FCA after the 1986 amendments suggests that the bounty a relator stands to gain does, in many cases, outweigh the disincentives to being a whistleblower. The financial gains from whistleblowing under the SOX regime are far smaller and cannot play this role.

While the primary information-generating advantage of the FCA model is clear, some have criticized the *qui tam* structure. I would not go so far as those who have characterized the *qui tam* provisions of the FCA as free of "any glaring policy problems";<sup>282</sup> nor do I think the statute's critics<sup>283</sup> are entirely

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<sup>275</sup> *Id.* at 195-96 (footnotes omitted).

<sup>276</sup> See Bucy, *Private Justice*, *supra* note 19, at 53.

<sup>277</sup> *Id.* at 59.

<sup>278</sup> Ferziger & Currell, *supra* note 121, at 1159.

<sup>279</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 201.

<sup>280</sup> WEST, *supra* note 19, at 17.

<sup>281</sup> *Id.*

<sup>282</sup> Hamer, *supra* note 191, at 101.

<sup>283</sup> See, e.g., Kovacic, *supra* note 218, at 1825-41.

correct. Some critics have complained that *qui tam* provisions create vexatious litigation.<sup>284</sup> Of course, with any statute involving a private right of action, the potential exists for cases that lack merit.<sup>285</sup> A “significant number” of *qui tam* cases lack merit, a fact the Justice Department found “unsurprising” given that “any bounty statute will foster opportunism and wishful thinking to some degree.”<sup>286</sup>

However, these objections do not outweigh the significant information-generation advantages of the FCA *qui tam* approach. For one, concern about frivolous cases may be overstated. For the plaintiff, *qui tam* cases are expensive, time-consuming, and involve highly technical issues.<sup>287</sup> Little settlement leverage is to be gained by filing a claim that lacks merit.<sup>288</sup> The point is not that there is no chance of *qui tam* cases lacking merit – indeed, it could be entirely fair to suspect that a *majority* of *qui tam* cases are filed by employees seeking to protect themselves from termination or its ill effects. However, the minimal judicial resources expended in disposing of frivolous cases<sup>289</sup> are more than covered if even a small percentage of *qui tam* cases expose massive fraud. Furthermore, I offer *qui tam*-style bounties not as a *perfect* statutory scheme, but simply as a *better* one than the private securities litigation class action.

Another objection to the FCA *qui tam* provisions involves concern about the effect of relator involvement on resolution of a case. “The most important distinction of the *qui tam* case is an additional – and sometimes explosive and unpredictable – party as plaintiff.”<sup>290</sup> Members of the FCA defense bar no doubt find a relator’s involvement a challenge in settling a case, since an individual relator, unlike a broad and diffuse class, is often looking for personal vindication rather than a financially lucrative settlement. While some *qui tam* relators may be too demanding, impeding “efficient settlement,” the presence of *qui tam* relators reduces the agency costs that arise in class action litigation. Unlike a securities class action, where no client is able to stop collusive settlements by class counsel,<sup>291</sup> in an FCA *qui tam* case the relator

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<sup>284</sup> See, e.g., Bucy, *Private Justice*, *supra* note 19, at 63-64.

<sup>285</sup> “Voices raised against the FCA consistently cite the danger of meritless claims motivated by greed.” Callahan & Dworkin, *Get Rich*, *supra* note 21, at 325.

<sup>286</sup> Stuart M. Gerson, Assistant Attorney Gen., Civil Div., Dep’t of Justice, Remarks Before the 1991 Annual Meeting of the American Bar Association Public Contract Section (Aug. 12, 1991), *reprinted in* BOESE, QUI TAM, *supra* note 25, at 206.

<sup>287</sup> Callahan & Dworkin, *Get Rich*, *supra* note 21, at 326.

<sup>288</sup> *Id.* Moreover, the FCA allows courts to impose defendants’ costs and fees on relators who bring frivolous claims. *Id.*

<sup>289</sup> See Bucy, *Private Justice*, *supra* note 19, at 67.

<sup>290</sup> 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-9.

<sup>291</sup> The lead plaintiff provisions of the PSLRA were, as discussed above, designed to create such a class of plaintiffs. However, institutional investors have been reluctant to seek appointment as lead plaintiffs. See *infra* note 313 and accompanying text.

may play that role. Again, however, the point is not that the FCA *qui tam* provisions are perfect, just that they are better than the securities class action model disfavored by Congress when it adopted the PSLRA.

A further objection to the *qui tam* model is that it increases the burden on regulatory authorities forced to review such actions, monitor their progress, and make decisions about intervention.<sup>292</sup> The Justice Department's Civil Division, charged with enforcing the FCA and overseeing *qui tam* actions, is notoriously slow to make intervention decisions.<sup>293</sup> Evidently, an inadequate level of resources is currently provided to attorneys charged with making such decisions. But that should not be a prominent concern with a *qui tam* model applied in a different context, given the recent resource endowment expansions enjoyed by the SEC.<sup>294</sup> If the SEC, rather than the Justice Department, were put in charge of reviewing insider revelations, it would likely have the staff and resources to accomplish that task more quickly.

Finally, some object to *qui tam* bounties on moral grounds. These critics argue that monetary rewards for whistleblowing may reduce loyalty-related reasons to blow the whistle by commodifying the act of bringing fraud and abuse to light.<sup>295</sup> While some marginal decrease in loyalty-motivated whistleblowing may result, increased whistleblowing motivated by external monetary rewards would likely more than offset that decrease.<sup>296</sup> Many legal scholars and social scientists now agree that the public good trumps whatever ethical drawbacks may exist with "for-profit" whistleblowing.<sup>297</sup>

#### IV. ADOPTING *QUI TAM* BOUNTIES FOR SOX WHISTLEBLOWERS: ISSUES AND OPTIONS

Pamela Bucy predicted in 2002 that "[c]rafting a *qui tam* provision for use in the financial world would not be difficult," because there is sufficient "experience with this mechanism in the false claims context to see how it could

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<sup>292</sup> See Bucy, *Private Justice*, *supra* note 19, at 64.

<sup>293</sup> See *supra* notes 252-53 and accompanying text.

<sup>294</sup> See Pamela Barnett, *SEC Chief Applauds Budget Increase, Promises To Beef Up Staff*, GOVEXEC.COM, Mar. 14, 2003, <http://www.govexec.com/dailyfed/0303/031403cdam2.htm>.

<sup>295</sup> See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 293.

<sup>296</sup> *Id.* This concern may also be minimized given the changing nature of the employment relationship; increased job mobility may diminish employee identification with employers.

<sup>297</sup> *Id.* at 319; see also Hamer, *supra* note 191, at 99-100 ("There is nothing inherently wrong with an appeal to self-interest when the result is beneficial to society."). There are, of course, instances when moral sentiment against bounties resurfaces. See, e.g., Frankel, *supra* note 101, at 11 ("It is doubtful whether honesty should be rewarded with money. A direct monetary reward for honesty is unseemly. Honesty should be considered the rule and not the exception.") (emphasis removed).

be deployed effectively in the financial context.”<sup>298</sup> While I share Professor Bucy’s optimism about the ease of making a case for *qui tam* bounties in the financial and accounting fraud context, I fear her proposed statute raises a number of problematic legal and policy considerations. My position differs from that of Professor Bucy in several ways. First, I argue that existing state false claims acts could be used to provide bounties for SOX whistleblowers without legal reform. Since no new laws would be required, no new constitutional or legal objections would have merit. Second, I argue that bounties could be provided out of the “Fair Funds” created by SOX, rather than out of new civil penalties. Use of the Fair Funds can avoid constitutional infirmity and administrative complexity.

Successfully developing *qui tam*-style bounties for the SOX whistleblower could achieve several policy goals. Most obviously, the use of financial incentives can help overcome the disincentives to a potential whistleblower. Social psychology research supports the notion that if “structured properly, financial incentives should encourage a new type of whistleblower to step forward.”<sup>299</sup> An individual would balance the possibility of a seven-figure reward against the risks of whistleblowing; she would be able to “make a deliberate cost/benefit analysis and determine whether the possible hazards are worth becoming a ‘snitch.’”<sup>300</sup> The FCA precedent shows that financial incentives promote whistleblowing and thus serve the statute’s goals.<sup>301</sup> If increasing the volume of whistleblowing, rather than simply protecting whistleblowers from retaliation, was Congress’ goal in passing SOX, financial incentives would better serve that aspiration. Moreover, financial incentives are structured to increase with the seriousness of the underlying fraud. Since the social value of disclosure of more serious frauds is particularly high, that linkage makes financial bounties a better tool than anti-retaliation provisions for maximizing *effective* whistleblowing.

The bounty model for SOX whistleblowers restructures the role of private actors as monitors of corporate misbehavior. Unlike traditional corporate monitors, employees have an “information advantage . . . because they have more complete knowledge regarding the inner workings of a large corporation.”<sup>302</sup> In this way, we can justify the role of private actors differently: instead of the unconvincing deterrent rationale,<sup>303</sup> private lawsuits in the securities context could be justified as information-generating. Information-generating policies help make markets more efficient, preventing

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<sup>298</sup> Bucy, *Carrots and Sticks*, *supra* note 105, at 318.

<sup>299</sup> Callahan & Dworkin, *Get Rich*, *supra* note 21, at 284.

<sup>300</sup> Callahan et al., *Australian, U.K., and U.S. Approaches*, *supra* note 14, at 907.

<sup>301</sup> *See id.*

<sup>302</sup> Moberly, *supra* note 28, at 1116.

<sup>303</sup> *See* Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 19-30.

value-destroying acquisitions and negative net present value investments.<sup>304</sup> Well-functioning securities markets may increase economic growth by the astounding amount of nearly 2% a year.<sup>305</sup> Moreover, where stocks are mispriced, the effectiveness of monitoring is reduced.<sup>306</sup> By bringing new information about overvalued stocks to light, whistleblowing can aid other corporate monitors (accountants, lawyers, boards of directors) in playing their respective roles.<sup>307</sup>

The quality of information generated by *qui tam* suits outweighs the quality of information, if any, generated by private securities class action lawsuits. In private securities lawsuits, little new information is typically generated. Instead, class action lawyers use information voluntarily provided by companies or piggy-back on information generated by government investigations in filing their suits. The *qui tam* model, because of its original source requirement and public disclosure bar, presumably prevents parasitic suits based on a corporation's voluntary disclosure of wrongdoing and malfeasance.<sup>308</sup>

In addition to generating information, the bounty model offers incentives for whistleblowers to persist even in the face of deliberate efforts by fraudsters to continue to suppress information about fraudulent activity. During the Enron scandal, executives successfully blocked employee complaints through "hostility and obfuscation."<sup>309</sup> Tempted with a massive financial incentive to go public with her suspicions of fraud, Sherron Watkins might have continued to press her claims even after upper management blocked her efforts.

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<sup>304</sup> See Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045, 1083-85 (2006) (explaining how overvalued stock can lead to value-destroying acquisitions and negative net present value investments); Pritchard, *supra* note 163, at 945 ("Fraud on the market may also harm capital allocation by allowing firms to raise money for investment projects that are not cost-justified.").

<sup>305</sup> See Ahdieh, *supra* note 17, at 747.

<sup>306</sup> Lambert, *supra* note 304, at 1095 ("Stock mispricing obviously thwarts the effectiveness of . . . monitoring . . . . If stock is undervalued, directors and institutional shareholders will be too quick to replace incumbent management, and if stock is overvalued, directors and large shareholders may fail to seek replacement when they ought to do so." (footnote omitted)).

<sup>307</sup> Access to information is a necessary predicate to effective monitoring of corporations. See Lisa M. Fairfax, *Achieving the Double Bottom Line: A Framework for Corporations Seeking To Deliver Profits and Public Services*, 9 STAN. J.L. BUS. & FIN. 199, 237 (2004) (lamenting the difficulty of effective monitoring by outsiders and the market "when the corporation has significantly better information regarding the quality of services it renders").

<sup>308</sup> See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-150 to -151.

<sup>309</sup> Moberly, *supra* note 28, at 1121. Sherron Watkins was "unsuccessful" at stopping Enron's fraud because the information she disclosed was "sanitized" by Ken Lay and the law firm of Vinson & Elkins before it made its way to the company's board. *Id.* at 1123.

A number of other advantages to the bounty model exist. Compared to private securities class actions, *qui tam* actions involve drastically reduced discovery costs since a good chunk of the information underlying a relator's case comes directly from the relator. *Qui tam* also reduces the complexity associated with the "lead plaintiff" provisions of the PSLRA and the resulting "class counsel committee" model. *Qui tam* suits operate under a "first to file" rule – if there are multiple proposed relators, the first to file has standing.<sup>310</sup> Moreover, *qui tam*-style mechanisms can help elevate "the value of protecting the larger community over the value of loyalty to those close at hand."<sup>311</sup>

The *qui tam* model has a certain fairness advantage. Even after the PSLRA, plaintiffs' firms like Milberg Weiss surreptitiously paid kickbacks to class representatives.<sup>312</sup> Those class representatives profited more than typical class members for no justifiable reason. The named representative in a large class action lawsuit rarely has brought new information into the public light, nor borne any particular risk. What is the fairness, then, in compensating that named plaintiff more than the unnamed members of the class? In contrast, the whistleblower, as the original source of an allegation of corporate fraud, has brought new information to light at a great personal and professional risk. Compensating that individual – even with what might seem to be a windfall – is more consistent with the demands of fairness.

Ultimately, a *qui tam* bounty model for SOX whistleblowers increases the role that private actors will play in exposing and deterring securities fraud without sending us back to a pre-PSLRA environment. Unlike pre-PSLRA "lawyer-driven litigation," where lawyers "manage litigation to further their own economic interests,"<sup>313</sup> the *qui tam* model offers a hybrid in which a traditional client exercises a fair degree of control. The *qui tam* whistleblower has both the interest and the ability to monitor his lawyer, unlike a dispersed plaintiff class. Indeed, since whistleblowers exposing complex financial fraud may have expertise in finance and accounting that their lawyers lack, whistleblowers might have *more* power over certain aspects of the litigation than their lawyers.<sup>314</sup>

Obviously, a number of technical details would need to be worked out, some of which are beyond the scope of this Article. For example, one open question would be whether, under any potential bounty model, there should be an

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<sup>310</sup> 31 U.S.C. § 3730(b)(5) (2000); *see also* 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-132 to -133.

<sup>311</sup> Bucy, *Private Justice*, *supra* note 19, at 54.

<sup>312</sup> *See supra* note 4 and accompanying text.

<sup>313</sup> Fisch, *Role of the Plaintiff*, *supra* note 27, at 173. There is reason to suspect that the PSLRA did not achieve its objective of reducing lawyer control over litigation. *See id.* at 177-78. Few institutional investors sought status as lead plaintiffs in the early years of the PSLRA; instead, leading plaintiffs' firms like Milberg Weiss collected investors in an effort to obtain "lead plaintiff" status. *Id.* at 177.

<sup>314</sup> *See id.* at 196 (describing the similar role of *qui tam* relators in FCA litigation).

“intervention option” for the SEC. While the private bar might “balk at the prospect of a government approval requirement, the obligation to submit a securities fraud complaint to the SEC . . . prior to filing might be less onerous than legislative restrictions on private rights of action.”<sup>315</sup> In the end, an intervention option probably makes sense.

Of course, there would be some downsides to the adoption of a *qui tam* bounty model. For example, any additional liability exposure might exacerbate SOX’s effect on cross-listed corporations, many of which have chosen to “de-list” from American stock exchanges to avoid SOX’s onerous disclosure requirements. William Kovacic has argued that the FCA *qui tam* provisions deter participation in federal procurement markets.<sup>316</sup> To the extent that corporations notice and respond to *qui tam* exposure, as Kovacic argues, adopting a bounty scheme for SOX whistleblowers might lead to some small additional effect on cross-listed companies. However, compared to the existing costs imposed by SOX’s more onerous disclosure and certification requirements, any *additional* incentive to de-list created by a bounty scheme is likely to be small. After all, the bounty model does not change the amount of exposure for securities fraud (which is already quite large in the face of potential class action lawsuits); instead, it just transfers some money that would have gone to shareholders under a class action scheme to the original source of the information underlying the fraud allegations.

Nor would a *qui tam* bounty model fully satisfy those who have long criticized the entire rationale of private securities fraud class actions. Typically, a corporation pays damages to shareholders, the ultimate owners of a corporation, which is “an essentially circular process whose perverse effects are compounded by the twin facts that (a) public shareholders tend to be diversified (and thus are on both sides of the wealth transfer) and (b) on each such transfer a significant percentage of the transfer payment goes to lawyers and other agents.”<sup>317</sup> While a *qui tam* bounty model would not completely eliminate this problem,<sup>318</sup> it could at least reduce such concerns. Under a *qui tam* model, the lawyer’s share of any settlement or judgment would be based on the amount that the relator receives, since the lawyer works for the relator

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<sup>315</sup> *Id.* at 200.

<sup>316</sup> See generally William E. Kovacic, *The Civil False Claims Act as a Deterrent to Participation in Government Procurement Markets*, 6 SUP. CT. ECON. REV. 201 (1998).

<sup>317</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 7; see also James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509 (1997) (“A reason that the securities class action poorly serves both a compensatory and a deterrent objective is the circuitry problem that arises when the source of a settlement is the corporation that commits the misrepresentation.”).

<sup>318</sup> To the extent that a bounty model actually does increase the rate of whistleblowing, and expose more corporate fraud, it might force fraudulent companies to defend more suits. At least, that might be the case over the short run. The dynamic effect of a bounty model would be to reduce future fraud, and thus, over a longer time horizon, hopefully reduce the total expenditure of shareholder funds on “rent-seeking” attorneys.



and *not* the class. In effect, this would reduce the *percentage* of any settlement or judgment that a lawyer receives. But since *qui tam* bounties could generate information that leads to larger settlements, the plaintiffs' bar might be content even with smaller percentages.

A. *Current State Law Options*

One way to introduce *qui tam* bounties for SOX whistleblowers is through the use of existing state false claims laws. Since state entities, unlike the federal government, regularly invest in private companies' securities, fraud involving those securities might be classified as a "false claim" actionable under state law. Some state laws already contain *qui tam* provisions, and it is entirely conceivable that a corporate or financial fraud whistleblower could, without any change in the law, obtain a significant bounty for exposing ongoing fraud under this theory. This section explores that possibility, something no previous work has recognized.<sup>319</sup>

Nearly every state has some sort of whistleblower statute. Although the majority of these statutes merely contain anti-retaliation protections,<sup>320</sup> a number of states have adopted *qui tam*-style bounty provisions.<sup>321</sup> California,

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<sup>319</sup> To my knowledge, no test case has been filed seeking to recover for securities and corporate fraud using state false claims act *qui tam* provisions.

<sup>320</sup> See Callahan & Dworkin, *Get Rich*, *supra* note 21, at 275-76 & nn.8-9 (reporting in 1992 that "[t]hree-quarters of the states currently have whistleblowing legislation," and that "[t]he nearly uniform focus of these laws is to protect whistleblowers from retaliation and to give them a remedy when retaliation occurs"). Courts could, of course, create incentives for whistleblowing in the corporate and securities fraud context by awarding punitive damages in wrongful discharge cases involving employees who blow the whistle on financial fraud. Generally, however, courts resist punitive damages awards in whistleblower discharge cases. See Callahan & Dworkin, *State Protection*, *supra* note 25, at 129-30. Punitive damages are an unappealing alternative to a true bounty provision for a variety of reasons. Punitive damage determinations focus on the wrongfulness of the defendant's conduct rather than the actual financial market impact of a particular fraud. Moreover, offering punitive damages might provide perverse incentives for whistleblowers to *seek* retaliation as a way of providing the basis for a potential claim for punitive damages. Under a true bounty alternative, it would not be necessary for a whistleblower to actually be the victim of retaliation in order to obtain a substantial financial reward for exposing serious financial fraud.

<sup>321</sup> At one point, the idea of bounty rewards for whistleblowers was almost exclusively a federal one. See MICELI & NEAR, *supra* note 127, at 248. However, as of May 2005, sixteen states and the District of Columbia have *qui tam* provisions. 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-3; *e.g.*, CAL. GOV'T CODE §§ 12650-12655 (West 2007); DEL. CODE ANN. tit. 6, §§ 1203-1205 (2007); D.C. CODE § 2-308.15 (2007); FLA. STAT. ANN. §§ 68.081-.092 (West 2007); HAW. REV. STAT. ANN. §§ 661-21 to -22 (LexisNexis 2007); 740 ILL. COMP. STAT. ANN. 175/1 to 175/8 (West 2007); LA. REV. STAT. ANN. § 46:439 (2007); NEV. REV. STAT. ANN. §§ 357.010-.250 (LexisNexis 2007); TEX. HUM. RES. CODE ANN. §§ 36.002-.117 (Vernon 2007). In addition, legislative proposals to adopt such provisions have been made recently in several states. See 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-3

Delaware, Florida, Hawaii, Illinois, Indiana, Louisiana, Massachusetts, Michigan, Montana, Nevada, New Hampshire, New Mexico, Tennessee, Texas, Virginia, and the District of Columbia have *qui tam* laws, usually “specifically modeled” on the federal provisions.<sup>322</sup> Some of these laws are limited to the healthcare context,<sup>323</sup> but others are broader, containing language that would apply to any false claims against those states.<sup>324</sup> While many of these laws are textually similar to the Federal FCA, they include some important differences. California’s false claims act, for instance, has an enhanced relator award structure – with relators eligible to claim up to 50% of the state’s damages where the state does not intervene.<sup>325</sup> While these laws have been on the books for some time, limited financial resources in most states have meant relatively few enforcement actions.<sup>326</sup>

The use of existing state laws to provide *qui tam*-style bounties to SOX whistleblowers begins with the important recognition that state laws “cover activity not reached by the federal FCA statute. Most notably, the state statutes apply to false claims submitted to state governments in programs funded with exclusively state or mixed state and federal funds.”<sup>327</sup> To the extent that states have invested funds in publicly traded companies, it may be possible to use state false claims acts to provide *qui tam* incentives to corporate and securities fraud whistleblowers.<sup>328</sup> Today, state agencies are significant players in

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to -4 (“False claims bills with *qui tam* provisions have been introduced in Alabama, Arkansas, Colorado, Connecticut, Kansas, Maryland, Minnesota, Mississippi, Missouri, New Jersey, New York, Oklahoma, Pennsylvania, South Carolina, Texas, and Washington.” (footnotes omitted)).

<sup>322</sup> 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-3; *see also* KOHN, *supra* note 19, at 204.

<sup>323</sup> The laws of Louisiana, Texas, New Hampshire, Michigan, and New Mexico fall into this category. 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-3. Although these are the only laws expressly limited to healthcare, the majority of state false claims act cases have been healthcare cases so far. *See* Barger et al., *supra* note 230, at 483.

<sup>324</sup> The laws of California, Florida, Illinois, Nevada, Hawaii, Delaware, Massachusetts, Tennessee, Virginia, Montana, Indiana, and the District of Columbia fall into this category. *See* 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-3.

<sup>325</sup> CAL. GOV’T CODE § 12652(g)(3); *see also* 2 BOESE, FALSE CLAIMS, *supra* note 19, at 6-12. Another example can be found in Texas, which prohibits *qui tam* relators from proceeding with an action if the government chooses not to intervene. *See* Barger et al., *supra* note 230, at 487.

<sup>326</sup> *See* Barger et al., *supra* note 230, at 485.

<sup>327</sup> *Id.* at 487.

<sup>328</sup> There are a number of state and quasi-state entities that might qualify. For example, the State of Wisconsin Investment Board (SWIB), an independent state agency which invests the assets of public employee retirement funds and other state trust funds, has served as a lead plaintiff in securities fraud cases. *See* Fisch, *Role of the Plaintiff*, *supra* note 27, at 177. Wisconsin, unfortunately, has no *qui tam* provision in its false claims act.

American stock markets. Prepaid tuition funds from state universities,<sup>329</sup> workers' compensation insurance funds, and certain state pension and retirement plans<sup>330</sup> are but a few of the ways states invest in public equity markets. States have become major "institutional investors."

Critically, a plaintiff would need to show that a claim about a company's stock price, or about the company itself (such as a statement about earnings or accounting information), constituted a *false claim* under pertinent state law. The plaintiff, in effect, would need to argue that fraud about a stock amounts to a "claim." There are a couple of directions that such an argument could take. Recent FCA case law has established that a false statement need not occur in an actual "claim" for a false claim to be found. In *United States ex rel. Main v. Oakland City University*,<sup>331</sup> a university was accused of falsely stating to the government that it was in compliance with the federal rule that barred compensation of recruiters with contingent fees.<sup>332</sup> Even though the allegedly false statements were made in a "phase-one" application for eligibility, rather than the "phase-two" applications for grants, the court found that a valid FCA claim could lie.<sup>333</sup> Writing for the court, Judge Easterbrook explained:

The University 'uses' its phase-one application (and the resulting certification of eligibility) when it makes . . . a phase-two application for payment. No more is required under the statute. The phase-two application is itself false because it represents that the student is enrolled in an eligible institution . . . .<sup>334</sup>

This does not make all violations of federal regulations FCA fraud.<sup>335</sup> Where a university "accepts federal funds that are contingent on following a regulation, which it then violates," the university has merely breached a contract.<sup>336</sup> However, where the university accepts federal funds *intending* to deviate from regulations with which it pledged to comply, the university exposes itself to liability under the FCA.<sup>337</sup>

When a state government entity buys a stock, it engages in a transaction with either the company that issued the stock (in the case of a new offering) or a third-party holder of those shares (in the case of open market purchases). The party on the other side of that transaction necessarily makes a *claim* on the

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<sup>329</sup> See Press Release, Wash. State Office of the Attorney Gen., Tuition Funds May Be Invested in Stock Market, AG Opinion Says (July 5, 2000), <http://www.atg.wa.gov/pressrelease.aspx?&id=4702>.

<sup>330</sup> See Lucian A. Bebchuk, *Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1798 (2006).

<sup>331</sup> 426 F.3d 914 (7th Cir. 2005).

<sup>332</sup> *Id.* at 916.

<sup>333</sup> *Id.*

<sup>334</sup> *Id.*

<sup>335</sup> *Id.* at 917.

<sup>336</sup> *Id.*

<sup>337</sup> *Id.*

state for the purchase or issuing price of those shares of stock. To the extent that false statements and omissions of material fact (which would amount to securities fraud violations) have been made prior to the transaction, the claim made by the third party for money in exchange for stock would be a *false claim*. The company's misrepresentations and omissions *cause* the claim about the stock's price to be false. Moreover, under SOX, companies are required to certify that their financial reporting is accurate via a CEO statement. Oakland City University faced a similar requirement to certify that it was in compliance with the rule against compensating recruiters with contingent fees – and the court ruled that its false certification constituted a false claim.

It might also be possible to pursue securities fraudsters under a “substandard product or certification” case.<sup>338</sup> Here, imagine that a state investment entity buys stock from a third party via open market purchases. The state would have bought that stock in part based on representations made by the fraudsters. Because the stock is not “worth” what it was represented to be worth, the state is, in effect, buying a substandard product.

The state's individual reliance on the fraudulent statement ought not be required. In FCA litigation, reliance is sometimes required by the courts.<sup>339</sup> As one court held, “[i]n order for a false statement . . . to ‘cause’ the submission of a false claim, . . . the Government would certainly need to prove that it relied on a false statement . . . in the sense that, but for the false statement, it would not have [paid the claim].”<sup>340</sup> But even if the state itself was not personally “aware” of a fraudulent statement, via the fraud-on-the-market theory adopted by the Supreme Court in *Basic*,<sup>341</sup> such fraud could be said to become a part of the stock's price through the actions of arbitrageurs. Since that price is some function of the present discounted value of the expected future earnings of the corporation, the state has been *caused* to purchase a “substandard” product by the fraudster's misstatements or omissions.

Further, one could argue that a securities or financial fraud amounts to a “reverse false claim.” If absent a false statement there would be an obligation to pay the government, then covering up or obscuring that obligation creates a potential reverse false claim.<sup>342</sup> The government could claim that, absent false information, it would demand its money back from the company; that is to say, it would sell its securities. However, the general trend seems to be away from

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<sup>338</sup> See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 1-39 (“The ‘substandard product’ case is one in which a supplier of goods or services provides an inferior substitute in place of the service or product contracted for.”).

<sup>339</sup> See *id.* at 2-174 to -175.

<sup>340</sup> *United States v. Hill*, 676 F. Supp. 1158, 1176 n.25 (N.D. Fla. 1987).

<sup>341</sup> See *supra* notes 45-48 and accompanying text.

<sup>342</sup> See 1 BOESE, FALSE CLAIMS, *supra* note 19, at 2-45 to -60.

allowing contingent claims such as government fines to amount to reverse false claims.<sup>343</sup>

While these potential avenues provide sufficient basis for a state law false claims act case, it may also be possible to amend the definition of “false claim” to make such an argument easier. I have drafted possible language for such an amendment, which is included in the appendix to this Article.<sup>344</sup> In essence, the language strives to make clear that fraud regarding a security owned by a state government amounts to a “false claim” under the applicable state law.

One limitation of the use of state law *qui tam* provisions to generate incentives for whistleblowers is that the recovery available would be capped at a percentage of the state’s investment in a particular stock. While a given state may have hundreds of millions of dollars invested in privately and publicly traded securities, its investment in a particular stock may be small. Moreover, since only some states have general false claims *qui tam* provisions, a potential whistleblower’s ability to file a case alleging a securities false claim is limited. Still, while the potential bounty available is smaller than would be possible under some of the other proposals discussed below, it likely offers a greater incentive to a potential whistleblower than is currently available under SOX. A bounty-seeker would be wise to identify multiple states which had invested in her company,<sup>345</sup> and file *qui tam* suits in each of those jurisdictions.

## B. *Statutory Proposals: Issues and Options*

### 1. Previous Proposals

Pamela Bucy has suggested a statute entitled “Private Justice Cause of Action To Protect National Financial Markets.”<sup>346</sup> Under that proposal, a civil action for a securities fraud violation<sup>347</sup> could be brought by a “private person” suing “for the person and for the United States Government.”<sup>348</sup> A complaint would be filed under seal<sup>349</sup> and the government would have a right to intervene.<sup>350</sup> The private justice relator would be entitled to 15-25% of the proceeds of the action.<sup>351</sup>

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<sup>343</sup> See *id.* at 2-47.

<sup>344</sup> See *infra* app. A.

<sup>345</sup> While this may sound easy in principle, it would be more difficult in practice. It might not always be possible for a whistleblower to identify whether a particular state had invested in his or her company (particularly to the extent that state investment portfolios are either not revealed to the public, or are invested in mutual funds that don’t reveal their precise holdings). Hopefully, counsel would be able to overcome these obstacles.

<sup>346</sup> Bucy, *Private Justice*, *supra* note 19, app. A-2 at 105.

<sup>347</sup> See *id.* at 105 § I(a)(1)-(3).

<sup>348</sup> *Id.* at 107 § II(b)(1).

<sup>349</sup> *Id.* at 107 § II(b)(2).

<sup>350</sup> *Id.* at 108 § II(b)(4).

<sup>351</sup> *Id.* at 110 § II(d)(1).

The most striking feature of Bucy's proposed statute is that a fraudster would be "liable to the United States Government for a civil penalty . . . 3 times the amount of damages" caused by the fraudulent act.<sup>352</sup> To repeat: a person who causes damages under Bucy's statute is liable *to the government for three times the damages caused*. This would be the case even though the government has not itself been damaged by the securities fraud.<sup>353</sup> In effect, Bucy's proposed statute amounts to a dramatic increase in the size of the penalty that could be imposed for securities fraud violations.<sup>354</sup> *Triple* the amount of damages (which can be in the tens or even hundreds of millions of dollars) would be the amount of the potential penalty under this proposal.

It is not clear under Bucy's proposed statute whether the shareholders who suffered damage would still be able to bring a private class action, or whether the private justice model would completely supplant the class action securities fraud lawsuit. Either way, the statute might face constitutional challenge. For example, it could raise double jeopardy concerns for those who view massive civil penalties as "punishment."<sup>355</sup> Although some large civil penalties have already been imposed under the current structure, including a \$10 million civil penalty against Xerox in 2002, and "what might be the largest financial fraud case yet," a \$2.25 billion civil penalty against WorldCom,<sup>356</sup> the average SEC

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<sup>352</sup> *Id.* at 105 § I(a).

<sup>353</sup> In some ways, Bucy's proposal resembles that of Professor Janet Cooper Alexander, who argued a decade ago that class action securities fraud suits should be replaced by regulatory actions enforceable by private attorneys general. *See generally* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487 (1996). However, a key part of Alexander's proposal was a reduction in the amount recoverable in such cases, given what she viewed as grossly excessive damages (in relation to the social cost of fraud) available in class action lawsuits. *See id.* at 1497.

<sup>354</sup> Scholars have long noted the disparity between private class action recoveries and federal and state recoveries. *See* Lorenzo Segato, *A Comparative Analysis of Shareholder Protections in Italy and the United States: Parmalat as a Case Study*, 26 NW. J. INT'L L. & BUS. 373, 442 (2006) ("The SEC, even after the enactment of the Fair Fund provision, does not seem to have sufficient authority 'to recover from wrongdoers sums equal to those that can be recovered in private suits.'" (footnotes omitted)); Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 5 ("Indeed, private securities class actions currently represent the principal means by which financial penalties are imposed in cases of securities fraud and manipulation; in the aggregate, they impose penalties that overshadow those imposed by federal and state authorities and by self-regulatory organizations.").

<sup>355</sup> *See, e.g.*, Todd B. Castleton, Comment, *Compounding Fraud: The Costs of Acquiring Relator Information Under the False Claims Act and the 1993 Amendments to the Federal Rules of Civil Procedure*, 4 GEO. MASON L. REV. 327, 337 (1996) ("[I]f a civil penalty is disproportionately large when compared to the government's actual loss, then the penalty is punishment for the purposes of double jeopardy." (citing *United States v. Halper*, 490 U.S. 435, 446-51 (1989))).

<sup>356</sup> Barry W. Rashkover, *Reforming Corporations Through Prosecution: Perspectives from an SEC Enforcement Lawyer*, 89 CORNELL L. REV. 535, 542 (2004). WorldCom, however, was permitted to satisfy this penalty by paying \$500 million in cash and providing

civil penalty is closer to the \$300,000 range.<sup>357</sup> Bucy's proposal would significantly increase this average. It is unlikely, however, that courts would construe such penalties as criminal punishment, particularly in light of the Supreme Court's decision in *Hudson v. United States*.<sup>358</sup> Furthermore, as double jeopardy only applies to prohibit a *second* criminal punishment, these concerns could only arise in cases in which a large civil penalty combined with criminal prosecution.

Moreover, if Bucy's statute *is* meant to foreclose the private right of action, it could possibly amount to a "taking," entitling potential shareholder plaintiffs to compensation under the Takings Clause.<sup>359</sup> The Takings Clause challenge would likely be weak, however, due to a development that postdates Bucy's proposal. In a little-discussed provision of SOX (section 308(a)), Congress authorized the creation of "Federal Accounts for Investor Restitution," commonly known as "Fair Funds."<sup>360</sup> The idea behind the Fair Funds provision was for the SEC to distribute civil money penalties and the proceeds of disgorgement orders (orders calling on fraudsters to disgorge their ill-gotten gains) to harmed investors.<sup>361</sup> Thus, Bucy's proposal would only run into possible "takings" challenges where no disgorgement order has been issued, and the massive civil penalties are not distributed to shareholders under the Fair Funds provisions. Otherwise, the only thing "taken" from shareholders is their ability to control and manage litigation, which is probably not a cognizable property right.

Bucy's private justice proposal might also be vulnerable to challenges on the basis of standing or separation of powers concerns. Defendants have challenged the FCA *qui tam* provisions as contravening the standing doctrine "because they empower relators to bring actions despite the lack of personal injury in fact, which is necessary to ensure a case or controversy for federal court jurisdiction under Article III."<sup>362</sup> Article III limits federal court

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\$250 million in stock in its post-bankruptcy merger partner (MCI). *SEC v. WorldCom*, Litig. Release No. 18451, U.S. Sec. and Exch. Comm'n, Former SEC Chairman Richard Breeden To Supervise Distribution of SEC's Civil Penalty Against WorldCom (Nov. 10, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18451.htm>.

<sup>357</sup> See Ferziger & Currell, *supra* note 121, at 1171.

<sup>358</sup> 522 U.S. 93, 95 (1997) (holding that the Double Jeopardy Clause was not violated when the government "imposed monetary penalties . . . on petitioners for violation of federal banking statutes, and later criminally indicted them for essentially the same conduct").

<sup>359</sup> For a discussion of how a legislative proposal foreclosing a litigation right might amount to a taking (and an argument that in the case of unimpaired docket plans it does not), see Mark A. Behrens & Manuel López, *Unimpaired Asbestos Dockets: They Are Constitutional*, 23 REV. LITIG. 253, 294-98 (2005).

<sup>360</sup> 17 C.F.R. §§ 201.1100-.1106 (2006).

<sup>361</sup> See *id.* § 201.1100.

<sup>362</sup> 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-306.

jurisdiction to actual “cases” or “controversies.”<sup>363</sup> To have constitutional standing under the case or controversy requirement, a plaintiff must satisfy three requirements: “First, the plaintiff must have suffered an actual or threatened injury. Second, there must be a causal connection between the injury and the conduct that is the basis for the lawsuit. Third, it must be likely that the injury will be redressed if the requested relief is granted.”<sup>364</sup> Cass Sunstein has argued that Congress can legislate around standing requirements by amending statutes to provide bounties to citizen plaintiffs.<sup>365</sup> Other commentators, however, have criticized that interpretation, warning that it would dramatically reduce the constraints of Article III.<sup>366</sup>

Although FCA *qui tam* relators can take shelter in the government’s standing to satisfy Article III,<sup>367</sup> such shelter might not be available where a whistleblower seeks a portion of the shareholders’ damages. As Jill Fisch explains, the assignment rationale for an FCA relator’s standing

proves problematic when extended to the type of corporate compliance claims that form the basis of traditional class actions. It would require a substantial stretch to characterize the government as the victim of a corporation’s violation of . . . securities . . . law.

In cases in which the government is not an injured victim, third-party standing requires that the government have the power to assign its role as prosecutor.<sup>368</sup>

Such assignment in any context poses a further constitutional problem: it could threaten to violate the separation of powers principles<sup>369</sup> contained in the Take Care Clause<sup>370</sup> and Appointments Clause,<sup>371</sup> an argument that the

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<sup>363</sup> U.S. CONST. art. III, § 2; *see also* 1 BOESE, FALSE CLAIMS, *supra* note 19, at 4-306 n.1398.

<sup>364</sup> Hamer, *supra* note 191, at 93 (footnotes omitted).

<sup>365</sup> Cass R. Sunstein, *What’s Standing After Lujan? Of Citizen Suits, “Injuries,” and Article III*, 91 MICH. L. REV. 163, 232-33 (1992).

<sup>366</sup> *See* Fisch, *Role of the Plaintiff*, *supra* note 27, at 188 n.133; *see also* Bales, *supra* note 19, at 400-01 (“The problem with this argument, however, is that the informer’s interest in the litigation arises not from the defendant’s misconduct, but rather from the structure of the litigation itself. The argument also begs the question of whether a concrete personal stake in the litigation suffices to establish Article III standing when the informer is not among those injured by the defendant.” (footnote omitted)).

<sup>367</sup> Under this theory, the relator is “an agent or assignee who is pursuing a cause of action that belongs to the government,” and the “relator need prove only that the government has been injured, proof that generally is part of any case under the FCA.” Fisch, *Role of the Plaintiff*, *supra* note 27, at 189.

<sup>368</sup> *Id.*

<sup>369</sup> *Id.* at 190.

<sup>370</sup> U.S. CONST. art. II, § 3, cl. 4.

<sup>371</sup> *Id.* § 2, cl. 2.



Supreme Court left open with respect to the FCA in *Vermont Agency of Natural Resources v. United States ex rel. Stevens*.<sup>372</sup>

At a minimum, Bucy's proposal to award the government such a massive financial windfall would create severe administrative problems for the SEC. By all accounts, the Fair Funds provision has been a logistical and administrative nightmare.<sup>373</sup> Without the self-identification mechanism of private securities litigation, the SEC has found it difficult to identify those investors who are entitled to damages. As a result, the SEC has been unable to effectively distribute collected funds to wronged investors. Bucy's proposal might exacerbate such problems.<sup>374</sup> To the extent that the proposal involves the SEC's collection of far greater penalties (as well as subsequent distribution of those fines to wronged investors and the "private justice" whistleblower), the proposal might suffer from the same administrative problems as the Fair Funds scheme.

## 2. Fair Funds Amendments

The more straightforward and effective way to provide bounties for SOX whistleblowers is through amendment to the Fair Funds provision of SOX discussed above. The amendment would provide that when a Fair Fund is created as a result of an SEC enforcement action against a security fraudster, the "original source" of the information against the fraudster is entitled to a

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<sup>372</sup> 529 U.S. 765, 778 n.8 (2000) ("[W]e express no view on the question whether *qui tam* suits violate Article II, in particular the Appointments Clause of § 2 and the 'take Care' Clause of § 3."). For a defense of the FCA's *qui tam* provisions under Article II, see Bales, *supra* note 19, at 403-35.

<sup>373</sup> See, e.g., Cox et al., *SEC Enforcement*, *supra* note 7, at 756; Jonathan Peterson, "Fair Funds" Give Investors Recourse, L.A. TIMES, Sept. 27, 2004, Business, at 1; Press Release, House Comm. on Fin. Servs., Kanjorski and Frank Call for Fair Fund Hearings, Reforms (Oct. 3, 2005), available at [http://www.house.gov/banking\\_democrats/pr10032005.html](http://www.house.gov/banking_democrats/pr10032005.html). The Fair Funds scheme has also been criticized on fairness grounds for subordinating a bankrupt corporation's creditors to the claims of damaged investors, thus conflicting with the priority scheme established by federal bankruptcy law. See generally Marvin E. Sprouse III, *A Collision of Fairness: Sarbanes-Oxley and §510(B) of the Bankruptcy Code*, AM. BANKR. INST. J., Oct. 2005, at 8; Zack Christensen, Note, *The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to the Creditors of a Bankrupt Debtor?*, 2005 U. ILL. L. REV. 339. But see Douglas A. Henry, Comment, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259, 262 (2004) (asserting that although the Fair Funds provision of Sarbanes-Oxley may conflict with the intent of section 510(b) of the Bankruptcy Code, it nonetheless "correctly aligns our current financial landscape and the Congressional goals in enacting Sarbanes-Oxley").

<sup>374</sup> Since Bucy could not have anticipated the contours of the Fair Funds provision when making her proposal, I do not mean to suggest that she overlooked these considerations.

15-25% bounty.<sup>375</sup> Such a scheme could be effected administratively; or, in the alternative, “original sources” could be required to file complaints (as under the FCA) which the SEC could subsequently “assume” in pursuing civil enforcement actions. The main advantage of the Fair Funds approach is that it would provide a bounty award to whistleblowers without imposing any additional administrative burdens on the SEC. In fact, one might suspect that awarding bounties out of Fair Funds would actually ease the SEC’s burden, since the whistleblower (a single individual) would take a significant portion of the fund and would be easy to identify. Nor should this simple proposal be subject to serious constitutional infirmity arising from objections to the whistleblower’s standing.<sup>376</sup>

Since the regulations do not specify which victims are to be compensated,<sup>377</sup> it is possible that Fair Funds could already be used to “compensate” whistleblowers. The statute states, in part, 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.”<sup>378</sup> A whistleblower could claim to be the “victim” of such fraud. However, the whistleblower’s damages under the current Fair Fund law would likely be limited to damages for loss of employment, thereby eliminating the significant incentive created by the bounty award.

A further amendment to the Fair Funds provision could increase the amount of money available to whistleblowers and avoid inconsistency in the availability of whistleblower bounties. Currently, the Fair Funds provision

applies only in proceedings where the fined defendant is also required to disgorge funds to the SEC. Thus, if the particular defendant has not garnered any ill-gotten gain for which disgorgement would otherwise be appropriate, no part of the fine imposed upon that defendant can be made available to the victims of that violation.<sup>379</sup>

This limitation of Fair Funds to disgorgement cases should be relaxed to make a bounty drawn from Fair Funds available to whistleblowers in any securities fraud case.

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<sup>375</sup> See *infra* app. B. Where multiple whistleblowers seek recovery from the Fair Fund in this manner, it would probably be wise to import the “first-in-time” rule from the FCA context. The first to provide notice to the SEC would have a claim to a bounty from the Fair Fund; subsequent whistleblowers would not.

<sup>376</sup> See Alexander, *supra* note 353, at 1518 (“[P]rivate plaintiffs in a regulatory remedy securities action, like qui tam relators under the False Claims Act, are suing to enforce an obligation owed to the government. The statutory bounty could be deemed an assignment of the government’s interest. For purposes of standing, the qui tam plaintiff would avoid the problematic citizen-suit approach and would step into the government’s shoes.” (footnote omitted)).

<sup>377</sup> See Rashkover, *supra* note 356, at 543.

<sup>378</sup> Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246(a) (Supp. IV 2004).

<sup>379</sup> Cox et al., *SEC Enforcement*, *supra* note 7, at 754.

Use of Fair Funds amendments to achieve *qui tam*-style bounties for financial fraud whistleblowers would come close to implementing the “regulatory” proposal made a decade ago by Janet Cooper Alexander.<sup>380</sup> She proposed a regulatory sanction – “in effect, a schedule of civil penalties [payable to the government but] enforceable by private litigation” – as a means of providing greater deterrence at a lower social cost.<sup>381</sup> This fine schedule<sup>382</sup> would come to replace the private Rule 10b-5 class action. The obvious difference, of course, is that while “any person” would have standing under Professor Alexander’s proposal,<sup>383</sup> under my proposal, only the “original source” whistleblower would be eligible to reap a bounty. Given that the whistleblower model more closely parallels the federal experience with the FCA,<sup>384</sup> it would likely garner more support on Capitol Hill.

It is important to note that this Fair Funds-based bounty proposal provides bounties, but not necessarily *qui tam*-style rights. That is, use of Fair Funds to reward SOX whistleblowers could be implemented with relatively little pain, but the whistleblowers might lack the litigation management rights that, for example, an FCA *qui tam* relator has. In that sense, some of the “dual plaintiff” advantages of the FCA’s structure might be lost.<sup>385</sup> To the extent that these concerns are significant, the state law *qui tam* solution proposed in the previous subsection may be the superior approach.<sup>386</sup>

### C. Social Security Trust Fund Diversification

The largest recoveries might be available through the existing (or slightly amended) Federal FCA in the same manner as the state false claims act bounty model discussed above. This would depend, however, on one critical policy development that has not yet occurred: investment by the federal government

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<sup>380</sup> See *supra* note 353.

<sup>381</sup> Alexander, *supra* note 353, at 1489.

<sup>382</sup> See *id.* at 1515 (“The amount of the penalty should vary according to relevant circumstances. For example, the penalty should be substantially enhanced if intentional fraud is proved. Penalties should be greater for cases involving larger firms, both because the systemic harm caused by fraud involving such securities is likely to be greater and because a penalty that is devastatingly large to a small firm may be inconsequential to a large one.”).

<sup>383</sup> *Id.* at 1516-17.

<sup>384</sup> See Bucy, *Carrots and Sticks*, *supra* note 105, at 318-22.

<sup>385</sup> See *supra* Part III.

<sup>386</sup> A true *qui tam* model for SOX whistleblower bounties might actually involve notice to the plaintiff class, rather than the government. The FCA *qui tam* model involves a relator suing on behalf of the government for injury to the government. A SOX plaintiff suing on behalf of the government for injury to *shareholders* would not be in exactly the same position. Further research could explore the merits of a model in which a whistleblower gives notice to the plaintiff class and then receives a share of the class recovery.

of all or a portion of the Social Security Trust Fund in public equity markets.<sup>387</sup> Although often confused with privatization of the social security system,<sup>388</sup> diversification is actually a far less extreme reform proposal<sup>389</sup> which does not raise all of the same policy concerns.<sup>390</sup> Whereas privatization entails earmarking particular funds for particular workers, diversification merely involves investing current funds in a wider variety of income-generating assets.

The proposal to partially invest the Social Security Trust Fund in public equity markets has been floating around since at least the late 1990s.<sup>391</sup> The main impetus for diversifying current investment in treasury bills is to increase the Fund's liquidity in anticipation of increasing entitlement outlays upon the retirement of the bulk of the Baby Boom generation.<sup>392</sup>

If the Social Security Trust Fund were invested in private companies' stocks, the government would then have a basis to assert that corporate or securities fraud amounted to a "false claim" on federal resources.<sup>393</sup> As with

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<sup>387</sup> This Article does not endorse such a proposal; it merely recognizes that adoption of Social Security Trust Fund diversification would open a new avenue for using *qui tam*-style bounties to reward SOX whistleblowers.

<sup>388</sup> For an explanation of this confusion and a lucid untangling of it, see Regina T. Jefferson, *Privatization: Not the Answer for Social Security Reform*, 58 WASH. & LEE L. REV. 1287, 1293-94 (2001).

<sup>389</sup> See Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 996 (2000).

<sup>390</sup> For example, privatization of social security accounts would incur massive administrative expenses. See James E. Hennessey, Note, *Keeping the Promise: Will the Bush Administration's Plan To Privatize the Social Security System Actually Work?*, 11 CONN. INS. L.J. 433, 452 (2005) (estimating administrative costs of nearly four billion dollars a year); Jefferson, *supra* note 388, at 1322 (predicting that "the conversion from a single plan to a program containing 150 million individual accounts would significantly increase [administrative] cost[s]").

<sup>391</sup> See generally THE CENTURY FOUND., INVESTING THE SOCIAL SECURITY TRUST FUNDS IN STOCKS (1999), available at [http://www.socsec.org/facts/Issue\\_Briefs/PDF\\_versions/8issbrf.pdf](http://www.socsec.org/facts/Issue_Briefs/PDF_versions/8issbrf.pdf).

<sup>392</sup> For the case for investing social security funds in private markets, see ROBERT M. BALL, *A Public-Private Investment Strategy*, in INSURING THE ESSENTIALS: BOB BALL ON SOCIAL SECURITY 233 (Thomas N. Bethell ed., 2000).

<sup>393</sup> The federal government already invests funds in private stock markets on behalf of government employees who have contributed to the federal defined contribution retirement plan known as the Thrift Savings Plan ("TSP"). See generally TSP Features for Civilians, <http://www.tsp.gov/features/index.html> (last visited Feb. 1, 2007). To the extent that contributions by an employee have not "vested" (and become the employee's property), such investment might enable the federal government to make a claim of securities fraud amounting to a false claim. However, uncertainty about whether TSP accounts are government property or individual property would complicate such a claim. To the extent that a TSP account is an individual's property, with the government – by way of the Thrift Savings Board – serving solely as plan trustee, the false claim would not "cause" loss to the government. Moreover, TSP investment options are limited to index funds (funds that index

the state law cause of action discussed above, the main legal hurdle to overcome would be the requirement of showing a “claim.” However, “even if the false claim is made to a party other than the government, it will be actionable under the FCA if payment of the claim would result in a loss to the United States.”<sup>394</sup> False claims made about a corporation’s profits or earnings, for example, would likely result in the loss of money by the United States, which would otherwise have pulled Social Security funds out of those securities. A modest redefinition of “false claim” would pave the way for the use of the FCA as a means of providing *qui tam* bounties to corporate and securities fraud whistleblowers in the event that current interpretations of “claim” prove inadequate.<sup>395</sup>

#### D. *Asymmetric Insider Trading Liberalization*

There is also a “market” solution to the currently inadequate incentives for employees to blow the whistle on corporate and securities fraud. Under this solution, first proposed by Michael Abramowicz<sup>396</sup> and more recently revisited by Thomas Lambert<sup>397</sup> and Bruce Kobayashi and Larry Ribstein,<sup>398</sup> whistleblowers would be afforded a brief period of time (immediately preceding the blowing of the whistle) during which they could engage in short-selling on the basis of material, non-public information. Abramowicz suggested that if insider trading in overvalued securities were permitted, trading in “shorts” on a corporation could come to replace the whistleblower suit.<sup>399</sup> Instead of suing, for example, in a *qui tam* bounty fashion, an employee would simply buy shorts on the corporate stock, release the information, and then sell those shorts.<sup>400</sup> The market would price the value of the insider’s disclosure<sup>401</sup> and make subsequent civil enforcement unnecessary. Similarly, Lambert proposed an asymmetric insider trading liberalization for overvalued equity products wherein “price-decreasing” insider trading would

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the market as a whole, or some subsection of it) which might make claims of loss causation difficult. See Craig Copeland, *Social Security Reform Issues*, 58 WASH. & LEE L. REV. 1203, 1215 (2001).

<sup>394</sup> WEST, *supra* note 19, at 2.

<sup>395</sup> See *infra* app. A.

<sup>396</sup> See Michael Abramowicz, *Market-Based Administrative Enforcement*, 15 YALE J. ON REG. 197, 219-20 (1998); Michael Abramowicz, *The Law-and-Markets Movement*, 49 AM. U. L. REV. 327, 360-61 (1999) [hereinafter Abramowicz, *Law-and-Markets*].

<sup>397</sup> See generally Lambert, *supra* note 304.

<sup>398</sup> See Kobayashi & Ribstein, *supra* note 129, at 66-68.

<sup>399</sup> Abramowicz, *Law-and-Markets*, *supra* note 396, at 360.

<sup>400</sup> *Id.* at 361.

<sup>401</sup> *Id.*; see also Kobayashi & Ribstein, *supra* note 129, at 68 (“[A]llowing trading profits lets the whistleblower go directly to the market with her information . . . [There she] reaps something approximating the value of her information through precise valuation in the efficient stock market.”).

be allowed but “price-enhancing” insider trading would not.<sup>402</sup> While Lambert’s proposal goes further than the one outlined here (in that it permits any insider, not just a whistleblower, to bet against her company if she believes the stock is overvalued),<sup>403</sup> much of the logic is the same. Finally, Ribstein and Kobayashi’s proposal is even broader: they would allow not just an insider, but also a “current or past employee . . . who is not technically an insider for insider trading purposes,” to trade in corporate stock, reasoning that trading incentivizes people to engage in efforts to expose fraud.<sup>404</sup>

Despite the economic case to be made for abolishing insider trading prohibitions,<sup>405</sup> such a proposal, on a general level, is very unlikely to find a receptive audience on Capitol Hill. Insider trading strikes the public as “fundamentally unfair.”<sup>406</sup> Indeed, the expansion of prohibitions on insider trading to include “misappropriation” of information from a party to whom one owes fiduciary duties,<sup>407</sup> and even into areas where no fiduciary duties exist but a party has made a commitment to preserve certain confidences,<sup>408</sup> suggests that, if anything, our law is headed on a trajectory of banning more kinds of insider trading.

An exception, however, could be carved out for insiders blowing the whistle on corporate fraud. Such whistleblowers could be permitted to sell a company’s shares short prior to revealing fraud to external corporate monitors or the government.<sup>409</sup> Numerous studies have documented that a company’s stock price typically falls upon the filing of a securities class action.<sup>410</sup> Allowing insiders to trade on the basis of their knowledge of (1) ongoing fraud, and (2) imminent revelation of that fraud, would provide “a means of rewarding whistleblowers with a ‘bounty’ for conveying information (via their

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<sup>402</sup> See Lambert, *supra* note 304, at 1048 (“The reason for the proposed asymmetric treatment is that price-decreasing insider trading provides significantly more value to investors than price-increasing insider trading.”).

<sup>403</sup> See *id.*

<sup>404</sup> See Kobayashi & Ribstein, *supra* note 129, at 28-29.

<sup>405</sup> See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). The real economic “crime” of insider trading is that, since one party to an affected transaction has more information about the underlying value of a security than the other, the bid-ask spread in securities transactions will increase and markets will not clear as quickly as if both parties had the same information but different information-processing functions. See Lambert, *supra* note 304, at 1051; see also Kobayashi & Ribstein, *supra* note 129, at 74. Although the bid-ask spread rationale may justify the ban on insider trading, it is rarely offered in defense of the ban in political circles.

<sup>406</sup> Lambert, *supra* note 304, at 1050; see also MANNE, *supra* note 405, at v (“Probably no aspect of modern corporate life has been more roundly condemned than insider trading.”).

<sup>407</sup> *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

<sup>408</sup> See, e.g., 17 C.F.R. § 240.10b5-2 (2005).

<sup>409</sup> See *infra* app. C.

<sup>410</sup> Coffee, *Reforming the Securities Class Action*, *supra* note 5, at 6.

trading) that the stock price is overvalued.”<sup>411</sup> Such a move would also enhance the efficiency of markets and make future Enrons less likely.<sup>412</sup>

Allowing a whistleblower to bet against a stock immediately prior to disclosing inside information would certainly be upsetting to the party on the other side of the transaction (that is, the “long” on the option contract). However, if the other side is diversified (has longs and shorts in various stocks), that investor should not be terribly upset. To the extent that such insider trading by whistleblowers improves the overall performance of markets, a diversified investor should reap the long term benefits of allowing asymmetric insider trading.

Allowing insider trading by whistleblowers prior to disclosure also offers a way to let the market “value” a claim, thereby serving the interest of judicial economy. In a way, short-selling is a bet about the merits of the underlying securities fraud allegation. If the market, upon learning of a particular whistleblower’s accusations of fraud, determines either that those accusations are (1) not credible, or (2) have been previously disclosed (and incorporated into the company’s stock price), then the company’s shares will not fall and the short purchased by the whistleblower will have no value. A whistleblower whose faith in her accusations exceeds the market’s will not profit – and could suffer a loss – if she purchases shorts prior to disclosure. That threat might deter opportunistic behavior by employees and vexatious whistleblowing.

One response to suggestions that insiders be allowed to bet against corporate stock price is that it might encourage mismanagement. There are, however, reasons to discount such an objection.<sup>413</sup> Any concern that allowing asymmetric insider trading might encourage revelation of accounting and financial fraud by whistleblowers in this damaging way<sup>414</sup> should be mitigated by the availability of state law fiduciary duty claims against whistleblowers who intentionally damage the corporation or harm its shareholders.

There is a certain irony that this insider trading proposal results in part from the collapse of Enron, a company that prided itself on propagating the idea that *everything* (oil, natural gas, pipeline capacity, broadband spectrum) could be traded.<sup>415</sup> Asymmetric liberalization of insider trading prohibitions would represent a move toward trading in insider information about corporate fraud.

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<sup>411</sup> Lambert, *supra* note 304, at 1111.

<sup>412</sup> See Macey, *supra* note 82, at 397 (“[A]nother key lesson from the collapse of Enron is that improving traditional mechanisms of market efficiency provides a very effective way of reducing the probability that such debacles will occur in the future. In particular, improving market participants’ ability to short stock and to buy and sell single stock index futures will provide effective ‘early warning systems’ to alert the public and regulators of companies riddled with financial fraud.”).

<sup>413</sup> See Lambert, *supra* note 304, at 1112-13.

<sup>414</sup> See Martha Neil, *Chamber of Commerce Pushes Probe*, A.B.A. J. E-REPORT, Mar. 19, 2004, available at 3 No. 11 A.B.A. J. E-Report 3 (Westlaw) (relating a judge’s concern that a lawyer attempted to depress a company’s stock price to aid a short-selling client).

<sup>415</sup> See Gordon, *supra* note 85, at 1125.

## CONCLUSION

For most of this country's post-war history, the role of private actors in securities litigation has been on the rise. Two events altered and punctuated this trajectory. First, the Republican political victories of 1994 paved the way for the implementation of policies drawing on the academic criticism of the private securities class action lawsuit. Second, the collapse of several major American companies just a few years later forced Congress to adopt a reform package. Constrained by the political legacy of the mid-1990s, Congress did not roll back its restrictive regulation of private securities litigation but instead adopted a collection of recycled corporate governance proposals. One novel idea, however, did emerge from the 2002 SOX legislation: the idea that employees of publicly traded companies could play a major role in exposing ongoing financial and accounting fraud.

While SOX insulates a potential whistleblower from some of the more obvious methods of employment-related retaliation, it offers little or no hope of assuaging the other severe disincentives to whistleblowing such as fear of social ostracism or blacklisting. The only way to motivate whistleblowers to brave these obstacles and expose major corporate fraud is to use the old-fashioned "carrot." A significant financial bounty would – at some level – outweigh the pecuniary and non-pecuniary drawbacks of whistleblowing.

The Federal FCA demonstrates that bounty schemes can be effectively integrated into anti-fraud regimes. The FCA has led to thousands of revelations of ongoing procurement fraud and recovered billions of dollars for the federal treasury. A similar model should be adopted to encourage SOX whistleblowers to expose complex corporate and financial fraud.

Several paths exist to integrate whistleblower bounties into the securities fraud context. New legislation could be adopted to create an FCA-style "relator" litigation model, but such legislation might create administrative complexities for the SEC and could be vulnerable to constitutional challenge. A more modest legislative reform, which would avoid such concerns, would be to provide for distribution of some share of the Fair Funds currently generated through SEC civil enforcement to the "original source" of the information that led to the SEC's investigation. More ambitious legislative reform could include measures to accompany the diversification of the Social Security Trust Fund or an asymmetric relaxation of current prohibitions on insider trading.

It is, though, entirely possible that bounties could be provided under current law, on a more limited scale, using state false claims acts. A test lawsuit by a whistleblower could be filed claiming that fraud on the market concerning a security held by state entities amounts to a false claim against the state. While such a lawsuit would face some legal obstacles, minor legislative tinkering could make such a suit more viable. Enhancing the incentives for effective whistleblowing in this manner would bring more information to the stock markets and improve the efficiency of resource allocation across the economy.



## APPENDIX: STATUTORY AND REGULATORY PROPOSALS

In this section, new insertions are indicated by underlined text

A. *Definition of a “False Claim”*

*Amendment to 31 U.S.C. § 3729(c) (2000) or equivalent state false claims act provision*

(c) CLAIM DEFINED. For purposes of this section, “claim” includes any request or demand, whether under a contract or otherwise, for money or property which is made to a contractor, grantee, or other recipient if the United States Government [or applicable state] provides any portion of the money or property which is requested or demanded, or if the Government will reimburse such contractor, grantee, or other recipient for any portion of the money or property which is requested or demanded. A claim includes a demand for payment of money for a share of stock.

B. *Fair Funds Amendment*

*Amendment to 17 C.F.R. § 201.1100 (2006)*

§ 201.1100. Creation of Fair Fund.

In any agency process initiated by an order instituting proceedings in which the Commission or the hearing officer issues an order requiring the payment of disgorgement by a respondent and also assessing a civil money penalty against that respondent, the Commission or the hearing officer may order that the amount of disgorgement and of the civil penalty, together with any funds received pursuant to 15 U.S.C. 7246(b), be used to create a fund for the benefit of (1) investors who were harmed by the violation and (2) an original source of the information.

(a) For the purposes of this paragraph, “original source” means an individual who has direct and independent knowledge of the information on which the allegations are based and has voluntarily provided the information to the Government prior to the Government filing an action.

(b) Any original source of the information shall be entitled to 15-25% of the money deposited in the Fair Fund, depending on the source’s contribution to the litigation.

C. *Insider Trading Exception*

*Amendment to 17 C.F.R. § 240.10b5-1(a) (2005)*

(a) *General.* The “manipulative and deceptive devices” prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and § 240.10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively,

to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information. However, no one who trades on the basis of material nonpublic information about ongoing fraud in violation of any Commission rules and then promptly makes such information available to the Government will be liable under this section.