ATTACHING CRIMINAL LIABILITY TO CREDIT RATING AGENCIES: USE OF THE CORPORATE ETHOS THEORY OF CRIMINAL LIABILITY

Nan S. Ellis, Steven B. Dow

INTRODUCTION

Assume the following facts: During 2006, a state public pension fund invests $1.3 billion in securities issued by three special purpose vehicles. The securities are all rated AAA (the highest rating possible) by Standard and Poor's (S&P), Moody's, and Fitch at the time of the investment. Because of the nature of the securities (mortgage backed collateralized debt obligations (CDOs)) and the fact that the pension fund has no access to information about the underlying assets, it is unable to judge independently the risk involved. Instead, the pension fund relies wholly on the ratings provided by the credit rating agencies (CRAs) and on representations made in the offering materials put together by the issuer and the CRAs. Unfortunately, the pension fund does not know that the underlying assets consist entirely of risky subprime mortgages held as mortgage-backed securities. Additionally, the pension fund does not know the role that the CRAs played in creating the complex derivative securities or that the CRAs were paid $1 million for rating them only if the issue was successfully marketed. Further, the pension fund is not aware that the mathematical models used to generate the ratings were based on unrealistic assumptions about the housing market and that these models were not changed as the housing market began to deteriorate. By contrast, the CRAs do know that their models were inadequate, that their ratings were misleading, and that they had too few trained personnel to perform the rating analysis. In addition, when these flawed models did not provide the high ratings desired, the CRAs lowered their standards and continued to enter data until they were able to assign the AAA rating sought by the issuer. As the housing market was thrown into turmoil, the CRAs assured investors that the securities would weather the crisis. Based on the guarantees of the rating agencies, investors continue to hold onto these securities. All three investments fail and the pension fund loses its total investment of $3.1 billion.

This scenario is not fiction. It is based on the allegations made by the California Public Employees' Retirement System against Moody's, Standard and Poor's, and Fitch.[1] This was not an isolated incident. Rating structured financial offerings like the CDOs outlined above was lucrative for CRAs. By 2007, structured finance accounted for fifty-three percent of Moody's total revenues; revenues from structured finance grew 800% for Standard & Poor's from 2002 to 2006; Fitch's profits were up twenty-two

1. Complaint, Cal. Pub. Employees' Ret. Sys. v. Moody's Investors Serv., No. CGC-09-490241 (Cal. Super. Ct. July 9, 2009)[hereinafter CalPers Complaint].

percent in 2007.[2] Because the potential profits were so great, the pressures to create and rate these issues highly were immense. CRAs continued to rate structured finance without written procedures, without rationale for deviations from their models, and without policies to address the known deficiencies in their models.

Because borrowers inevitably know more about their business operations and the risks involved in investing than investors, there is a situation of asymmetric information,[3] which could hinder the efficient allocation of capital throughout the economy. Economists have long recognized that because of these information asymmetries, intermediaries are necessary to ensure a smooth flow of credit throughout the economy.[4] CRAs fulfill this role. In theory, CRAs act as neutral third parties providing unbiased information with respect to the creditworthiness of investments offered.[5] They serve as gatekeepers, protecting both public

2. CalPers Complaint, *supra* note 1, at ¶¶ 43-46.

3. *See generally* George Akerlof, *The Market for Lemons: Quality Uncertainty and Market Mechanism*, 84 Q. J. OF ECON. 488 (1970) (giving examples of some of the effects of asymmetric information); Stephane Rousseau, *Enhancing the Accountability of Credit Rating Agencies: The Case for a Disclosure-Based Approach*, 51 MCGILL L.J. 617, 622 (2006) ("Inevitably, information asymmetry exists in the debt market because issuers have superior information regarding their creditworthiness than do investors."); Lawrence J. White, *Credit Rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response*, 25 J. INT'L BANKING L. & REG. 170, 174 (2010) ("The critical problem is one of asymmetric information: The borrower usually knows more about the prospects for repayment than does the lender.").

4. *See, e.g.*, Harold Furchtgott-Roth, Robert W. Hahn & Anne Layne-Farrar, *The Law and Economics of Regulating Ratings Firms*, 3 J. COMPETITION L. & ECON. 49, 76 (2007) ("[I]nformation asymmetries between buyers and sellers created an opening for independent rating firms."); Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140, 143 (2009) ("Rating agencies emerged in the financial market at the beginning of the twentieth century, likely to help level the information imbalance that inherently exits in lending relationships."); Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 632 (1999) ("Rating agencies may exist because of information asymmetry between debt issuers and investors."); Frank Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis* 2 (U. San Diego, Research Paper No. 09-015, 2009), *available at* http://ssrn.com/abstract=1430653 ("In financial markets, to the extent that sellers cannot credibly make such disclosures, there are incentives for information intermediaries to play this role."); White, *supra* note 3, at 5 ("Credit rating agencies are one potential source of help for piercing the fog of asymmetrical information . . . .").

5. *See* Joshua D. Krebs, *The Rating Agencies: Where We Have Been and Where Do We Go From Here?*, 3 J. BUS. ENTREPRENEURSHIP & L. 133, 134 (2009) ("The function of these reputational intermediaries is to act as neutral third party advisors to the investment process."); *see also* Sulette Lombard, *Credit Rating Agencies as Gatekeepers: What Went Wrong?* (2009), at 2, *available at* http://www.clta.edu.au/professional/papers/conference2009/LombardCLTA09.pdf ("The function of credit rating agencies is to 'rate' investment and credit instruments to make it easier for non-specialist investors to determine the risk

and individual investors. CRAs have an important quasi-public function[6] to perform within the economy. They fulfill this obligation, however, only if the ratings they assign are accurate. Unfortunately, they failed to fulfill this obligation in the years prior to the global financial crisis (GFC). By inaccurately rating the CDOs and other complex derivatives largely backed by subprime mortgages, they created a market for those securities.[7] This provided incentives for mortgagors to issue increasingly risky home mortgages and to create increasingly risky CDOs, both of which fueled the bubble that eventually led to the GFC.[8] CRA analysis and rating of these CDOs could, and should have, prevented the bubble from expanding. Unfortunately, the riskiness of the mortgages and mortgage tranches on which the CDOs were written was not accurately reflected in the credit ratings assigned. Using inadequate models, fed with insufficient data, and motivated by the payments received from the issuers, CRAs evaluated the securities and assigned them unjustifiably high ratings.[9]

The scenario outlined above illustrates the questions considered in this article. CRAs were instrumental in allowing the GFC to develop. Their ratings fueled demand for more structured financial products and put

inherent to particular investments."). A credit rating agency is defined to be a person (a) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (b) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (c) receiving fees from either issuers, investors, or other market participants, or a combination thereof. Credit Rating Agency Reform Act of 2006, Pub. L. No.109-291, 120 STAT. 1328, 15 U.S.C.A. § 3(a)(61).

6. *See, e.g.*, Lois R. Lupica, *Credit Rating Agencies, Structured Securities, and the Way out of the Abyss*, 28 REV. BANKING & FIN. L. 639, 654 (2009) ("The criteria developed and operationalized by rating agencies influence the level of activity of the finance markets, the allocation of capital, as well as the cost of credit."); Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 8 (2002) ("The existence and almost universal acceptance of ratings make it much easier for investors in the capital markets to assess the creditworthiness of a given issuance of securities. In this sense, ratings can be thought of as a public good.").

7. *See* Kia Dennis, *The Ratings Game: Explaining Rating Agency Failures in the Build Up to the Financial Crisis*, 63 U. MIAMI L. REV. 1111, 1118 (2009) (noting that "Fitch, Moody's and S&P . . . played a substantial role in the development of the market for mortgage backed securities."); David J. Matthews, *Ruined in a Conventional Way: Responses to Credit Ratings' Role in Credit Crises*, 29 NW. J. INT'L L. & BUS. 245, 252 (2009) ("High ratings for senior tranches allowed many RMBS issuances to be originated at lower interest rates than would have been possible had lenders used only traditional debt financing. These factors forced origination standards down as the pool of qualified borrowers shrank.").

8. *See* Aaron Unterman, *Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53, 54 (2009) (explaining how financial bubbles are generated both generally and with respect to the subprime housing market).

9. *Id.*

pressure on mortgage originators to issue increasingly risky mortgages. When the housing market crashed, the impacts were felt worldwide. Why was this allowed to happen? Where were the regulators? What recourse do investors have? The answers, as we will discuss, are that CRAs are subject to little administrative oversight, they were expressly excluded from Section 11 liability under the 1933 Securities Act, and they were largely immune from civil liability based on negligence or fraud.

In the aftermath of the GFC, much attention has been paid to identifying its causes. Policy-makers have attempted to formulate policy designed to regulate the conduct of the players in the financial markets in order to prevent future crises. One such attempt was the enactment of The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[10] With respect to CRAs, the reforms of Dodd-Frank have been criticized as inadequate. Previous work has examined the provisions of Dodd-Frank meant to address the conflicts of interest created by the issuer-pays model and found those provisions to be lacking.[11] Further, while many have argued that CRAs should be subject to civil liability—much like other financial professionals[12]—there have been problems implementing these provisions. This scenario provides an opportunity to explore another alternative—imposing criminal liability upon corporations for conduct such as that exhibited by CRAs prior to the GFC.

Criminal liability has always served both as an alternative and a supplement to civil liability. The mens rea requirement of criminal law,[13]

10. Dodd Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203, § 2, 124 Stat. 1376, 1386 (2010) (codified at 12 U.S.C. § 5301).

11. *See, e.g.*, Nan S. Ellis, Lisa M. Fairchild & Frank D'Souza, *Conflicts of Interest in the Credit Ratings Industry after Dodd-Frank: Continued Business as Usual?*, 7 VA. L. & BUS. REV. 1 (2012) (explaining that under the issuer pays model, CRAs are paid by the issuer of the securities that they are rating); Deryn Darcy, *Credit Rating Agencies and the Credit Crisis: How the "Issuer Pays" Conflict Contributed and What Regulators Might Do About It*, 2009 COLUM. BUS. L. REV. 605, 622 (2009)(discussing the "issuer pays" model and its risks); Timothy E. Lynch, *Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment*, 59 CASE W. RES. L. REV. 227, 239-40 (2009)(discussing CRA's transition from a "subscriber pays" revenue model to an "issuer pays" model).

12. *See, e.g.*, Nan S. Ellis, Lisa M. Fairchild & Frank D'Souza, *Is Imposing Liability on Credit Rating Agencies a Good Idea?: Credit Rating Agency Reform in the Aftermath of the Global Financial Crisis*, 17 STAN. J.L. BUS. & FIN. 175, 177 (2012) (discussing the "potential for civil liability stemming from the GFC, based upon both common law and statutory liability.").

13. H.L.A. HART, PUNISHMENT AND RESPONSIBILITY 187 (1968) ("In all advanced legal systems liability to conviction for serious crimes is made dependent, not only on the offender having done those outward acts which the law forbids, but on his having done them in a certain frame of mind or with a certain will."). The intent requirement is referred to as mens rea.

however, has traditionally imposed barriers in terms of attaching criminal liability to corporations. In this article, we consider whether attaching criminal liability to CRAs would serve valid public policy objectives and how the intent requirement can be met. Specifically, in Part I we outline the different philosophies and objectives of criminal and civil liability. We highlight the objectives of deterrence, retribution and rehabilitation as hallmarks of criminal law. Much recent scholarly attention has focused on the pragmatic difficulties of imposing sanctions upon corporations found guilty of criminal behavior.[14] We intend, however, to consider the philosophical appropriateness of imposing criminal liability upon a corporation. In doing so, we first outline the literature considering application of criminal liability to corporations. This section will focus on the barriers created by the intent, or mens rea, requirement and the various models adopted by the courts and advanced by legal scholars to meet the mens rea requirement in the context of corporate crime. In this part, we outline the traditional model of respondeat superior and argue that it is inadequate because it fails to consider the role that corporate culture plays in encouraging crime by corporate employees.[15] We conclude Part I by outlining the corporate ethos model as a useful alternative. The corporate ethos model is based on the belief that "organizations possess an identity that is independent of specific individuals who control or work for the organization,"[16] and corporate criminal liability is appropriate if the government can prove that the corporate ethos encouraged corporate employees to engage in wrongdoing. In Part II we turn our attention to the role that CRAs played in the GFC, paying particular attention to rewards and incentives that might have encouraged misconduct. In this part we will outline the lack of meaningful regulation of CRAs, including the relevant sections of Dodd-Frank, and the limits of civil liability. Finally, in Part III

14. *See, e.g.*, John C. Coffee Jr., "*No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 386-87 (1981) (noting that "moderate fines do not deter, while severe penalties flow through the corporate shell and fall on the relatively blameless."); John Hasnas, *Where is Felix Cohen when we Need Him?: Transcendental Nonsense and the Moral Responsibility of Corporations*, 19 J.L. & POL'Y 55, 76 (2010) (arguing that "it is impossible to punish a corporation."); Eliezer Lederman, *Criminal Law, Perpetrator and Corporation: Rethinking a Complex Triangle*, 76 J. CRIM. L. & CRIMINOLOGY 285, 309-24 (1985) (discussing the practical weaknesses of punishing corporations); John B. McAdams, *The Appropriate Sanctions for Corporate Criminal Liability: An Eclectic Alternative*, 46 U. CIN. L. REV. 989, 990 (1977) (examining proper sanctions for "corporate criminal liability.").

15. This inability has been called "the blackest hole in the theory of corporate criminal law." Brent Fisse, *Restructuring Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions*, 56 S. CAL. L REV. 1141, 1183 (1983).

16. Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1099 (1991).

we will consider imposition of criminal liability under the corporate ethos model. This section will examine the corporate culture of the CRAs and outline how that culture played a role in encouraging the mis-rating of mortgage-backed securities and CDOs prior to the GFC. We will conclude that the reforms of Dodd-Frank, as presently implemented, are inadequate to prevent similar misconduct in the future and argue for imposition of criminal liability. We believe that imposition of criminal liability will best serve the public policy objectives of retribution, deterrence and rehabilitation.[17]

I. ATTACHING CRIMINAL LIABILITY TO CORPORATIONS

A. Criminal Law vs. Civil Law

The public policy objectives served by imposition of civil liability differ significantly from those of criminal law. Civil liability is largely compensatory—the judgments imposed serve to compensate injured plaintiffs. Criminal law is largely punitive—the fines and other sanctions imposed serve to punish criminal defendants.[18] While both criminal and civil liabilities are intended to deter future misconduct, the similarities end there. Criminal law acts as a vehicle to punish wrongdoers, as a deterrent against future wrongdoing, and serves a rehabilitative function.[19]

In the case of corporate crime, retribution—one of the goals of criminal law—is achieved through assessment of a fine on the corporation.[20] To the extent that criminality is based on an assessment of

17. By advocating adoption of the corporate ethos model for finding the requisite *mens rea*, we are expressly rejecting both the traditional *respondeat superior* model and strict liability. *See* Joshua Fershee, *Choosing a Better Path: The Misguided Appeal of Increased Criminal Liability After Deepwater Horizon*, 36 WM. & MARY ENVTL. L. & POL'Y REV. 1 (2011) (rejecting application of strict liability to environmental crimes).

18. For a discussion of the difference between damages awarded in civil suits and fines imposed in the criminal context, see Dan M. Kahan, *Social Meaning and the Economic Analysis of Crime*, 27 J. LEGAL STUD. 609, 619 (1998) ("Just as fines fail to express condemnation relative to imprisonment of natural persons, so civil damages fail to express it relative to criminal liability for corporations. Indeed, like fines, civil damages seem to connote that society is 'pricing' corporate crime.").

19. Ashley S. Kircher, *Corporate Criminal Liability Versus Corporate Securities Fraud Liability: Analyzing the Divergence in Standards of Culpability,* 46 AM. CRIM. L. REV. 157, 170 (2009) ("The goals of imposing corporate criminal liability are retribution, rehabilitation and deterrence."); Regina A. Robson, *Crime and Punishment: Rehabilitating Retribution as a Justification for Organizational Criminal Liability*, 47 AM. BUS. L. J. 109 (2010) (arguing for a renewed focus on retribution as a goal of criminal law).

20. Kircher, *supra* note 19, at 170 ("[T]he fine is meant to be proportional to the harm committed by the corporate offender in an effort to satisfy the public's demand for justice.").

the individual wrongdoer's intent, action, and voluntariness, it makes sense to punish the individual who violates accepted societal norms. By contrast, imposition of punishment upon a corporation can be problematic. To what extent can one judge the intent, action, and voluntariness of a corporate entity?[21] In other words, is the corporate entity deserving of punishment for the actions of an individual employee? Another problem with punishing a corporation by imposing criminal liability upon the corporate entity is the fact that there are negative spillover effects.[22] By punishing the corporate wrongdoer, we are simultaneously punishing innocent shareholders, employees, and consumers.[23] Nevertheless, retribution is an important public policy goal furthered by imposition of criminal penalties upon corporations.[24]

21. In other words, to what extent can a corporation be deemed blameworthy if it lacks consciousness? Robson, *supra* note 19, at 128. We will argue that imposition of liability upon a corporation based on the corporate ethos theory makes more sense from a retributive standpoint than imposition based on the traditional notions of respondeat superior. Under respondeat superior, liability can be imposed on a corporation for the action of an individual employee even if all possible actions have been taken by a corporation to prevent it. *See infra* note 42 and accompanying text (describing how a corporation may be held liable for antitrust violations of its employees). By contrast, under the corporate ethos theory, liability is only imposed on a corporation to the extent that the corporate culture actually encouraged the illegal conduct.

22. *See* Cheryl L. Evans, *The Case for More Rational Corporate Criminal Liability: Where Do We Go From Here?*, 41 STETSON L. REV. 21, 23 (2011) ("Certainly, charging a company for the actions of one or more persons, in some circumstances, will directly harm innocent participants, such as shareholders or even important end-users of products."); Lisa M. Fairfax, *On the Sufficiency of Corporate Regulation as an Alternative to Corporate Criminal Liability*, 41 STETSON L. REV. 117, 124-25 (Fairfax terms this the "innocent shareholder critique."); Marcia Narine, *Whistleblowers and Rogues: An Urgent Call for an Affirmative Defense to Corporate Criminal Liability*, 62 CATH. U. L. REV. 41, 56 (2012) ("Vicarious corporate liability requires the cost of wrongdoing to be passed onto innocent parties who have not committed the illegal acts and do not have the ability to stop them."); *see also* Pamela H. Bucy, *Trends in Corporate Criminal Prosecutions*, 44 AM. CRIM. L. REV. 1287, 1288 (2007) ("[T]here is no question that criminal prosecution of a corporation has a tremendous impact on the corporation and its community, employees, customers and lenders"). *But see*, Sara Sun Beale, *A Response to the Critics of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1481, 1485 (2009) (arguing that concern about the spillover effects are overrated and pointing out that such arguments apply equally to civil liability including punitive damages and that these same third parties might benefit from the corporate wrongdoing so it seems incongruous to be concerned about them bearing a small part in the penalties imposed).

23. Hasnas, *supra* note 14, at 77 ("The characteristic that all of these stakeholder groups share is that their members are innocent of personal wrongdoing."). Because of this, Hasnas argues imposition of corporate criminal liability is "inherently unjust." Hasnas, *supra* note 14, at 76.

24. *See generally* Lawrence Friedman, *In Defense of Corporate Criminal Liability*, 23 HARV. J.L. & PUB. POL'Y 833 (2000) (responding to critics of corporate criminal liability and defending the concept); Robson, *supra* note 19 (arguing that inclusion of criminal

Another goal of criminal law is to deter misconduct. To the extent that deterrence is a justification for imposition of criminal penalties, it is traditionally broken down into specific and general deterrence. Specific deterrence is intended to deter this particular defendant from committing criminal acts in the future; general deterrence is intended to deter other similarly situated individuals from engaging in similar misconduct.[25] Deterring agent misconduct has, in fact, been termed the "enduring policy behind criminally punishing corporations."[26] Imposing criminal liability upon the corporation is designed to deter corporate employees from engaging in misconduct and, at the same time, influence those in positions of power to properly monitor their subordinates. Here, the public policy goal of deterring misconduct is shaped by the increasingly dominant role that corporations play in society.[27] In other words, because corporate conduct has the potential to greatly impact society, it is important that corporations be deterred from engaging in misconduct that would negatively affect society. However, the corporation may view most potential fines, even criminal fines, as a "cost of doing business," and as such, fines may not provide sufficient incentives to deter misconduct or for corporations to develop effective training and compliance programs.[28]

A final goal of criminal law is rehabilitation. In the corporate context, rehabilitation is based on the belief that imposing criminal sanctions can encourage a corporation to change its corporate culture.[29] Here, "the use of the criminal law should be directed primarily toward enabling the

penalties towards corporate actors may have the effect of focusing organizational criminal liability towards areas worthy of criminal penalties and sanction).

25. Narine, *supra* note 22, at 54; Andrew Weissmann, *A New Approach to Corporate Criminal Liability*, 44 AM. CRIM. L. REV. 1319, 1325 (2007).

26. George R. Skupski, *The Senior Management Mens Rea: Another Stab at a Workable Integration of Organizational Culpability into Corporate Criminal Liability*, 62 CASE W. RES. L. REV. 263, 268 (2011).

27. Corporations are capable of causing significantly more harm than individual misconduct. Lucian E. Dervan, *Reevaluating Corporate Criminal Liability: The DOJ's Internal Moral - Culpability Standard for Corporate Criminal Liability*, 41 STETSON L. REV. 7, 10 (2011) ("[I]t is vital to society that entities as powerful as corporations be accountable for their actions in both the civil and criminal arenas."); Skupski, *supra* note 26, at 268 (citing MARSHALL B. CLINARD & PETER C. YEAGER, CORPORATE CRIME 8 (2006) which outlines the costs of corporate crime as including "injuries, deaths, and health hazards.").

28. Narine, *supra* note 22, at 57-58.

29. U.S. DEP'T OF JUSTICE, U.S. ATTORNEY'S MANUAL § 9-28.200 (2008) ("Indicting corporations for wrongdoing enables the government to be a force for positive change of corporate culture . . . ."); Kircher, *supra* note 19, at 170 ("[I]t is believed that imposing sanctions on a corporation can correct the organization's corporate culture and that criminal sanctions can result in an all-encompassing and radical reconstruction of the corporation's ethos.").

corporation to reform itself."[30] The focus is on what steps the corporation can take to assure that similar wrongdoing is unlikely to occur in the future. Most corporations already have compliance programs in place. In the case of corporate crime, the existing compliance program has obviously failed to prevent the wrongdoing. Rehabilitation asks the corporation to explore why such programs failed. In the case of a rogue employee who circumvented the monitoring mechanisms and ignored training, dismissal of that employee might be enough. On the other hand, where the formal compliance program is not inculcated as part of the informal culture, action must be taken to reform that culture so that it is in alignment with the formal compliance culture.[31] In the case of continued or systemic violations despite the presence of a compliance program, criminal prosecution can mandate or encourage the type of change needed in corporate culture and, thus, fulfill the rehabilitative goal of criminal law.[32]

B. Attaching Criminal Liability to Corporations: Respondeat Superior

Because of the severity of criminal sanctions, criminal liability is not imposed lightly. Among other safeguards, in order to attach criminal liability, the defendant must have committed the act intentionally—the so-called mens rea requirement.[33] This requirement creates difficulties in imposing criminal liability in the case of corporate wrongdoing.[34] The

30. Peter J. Henning, *Corporate Criminal Liability and the Potential for Rehabilitation*, 46 AM. CRIM. L. REV. 1417, 1428 (2009).

31. Henning, *supra* note 30, at 1430 ("The real issue is when there is a breakdown in the company's compliance effort traceable to a corporate culture that pressures employees to engage in risky conduct, despite the presence of systems designed to prevent violations."). One way in which such culture change has been mandated at the federal level is through the use of Deferred Prosecution Agreements (DPAs) and non-prosecution agreements (NPAs). Peter Henning argues that the use of DPAs and NPAs meet the rehabilitation policy objective. Henning, *supra* note 30, at 1420.

32. It has been asserted that by "focusing more on prospective questions of corporate governance and compliance, and less on the retrospective question of the entity's criminal liability, federal prosecutors have fashioned a new role for themselves in policing, and supervising, corporate America." Peter Spivack & Sujit Raman, *Regulating the "New Regulators": Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 161 (2008).

33. Barry J. Pollack, *Time to Stop Living Vicariously: A Better Approach to Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1393, 1394 (2009).

34. *See also* Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 405 (1958) (positing that what differentiates a crime from a tort is that a crime entails a "pronouncement of the moral condemnation of the community"); Henning, *supra* note 30, at 1420 ("My position is that designating conduct as criminal is important apart from any sanction imposed and that the application of the criminal law to an actor in society is a means to express a moral judgment about the actor's conduct."); William S. Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability*, 37 AM.

problem is relatively straightforward. Corporations as legal fictions cannot have intent; only corporate agents can intend their actions. Courts seeking to attach criminal liability have dealt with this in a few ways. In some cases, the individuals involved in the wrongdoing are prosecuted individually.[35] For example, in the aftermath of Enron, prosecutors

CRIM. L. REV. 1285, 1292 (2000) ("[O]nly criminal punishment involves expressing moral censure and moral condemnation."); Weissmann, *supra* note 25, at 1324 ("Criminal law, after all, is reserved for conduct that we find so repugnant as to warrant the severest sanction."). *See generally* Patricia Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter*, 2006 COLUM. BUS. L. REV. 81 (2006) (imposing criminal liability in the case of corporate wrongdoing is difficult when there is an intentional act requirement). Some argue that what sets criminal liability apart from imposition of civil liability is the "moral scorn and condemnation that only criminal punishment entails." Kircher, *supra* note 19, at 170. To the extent that criminal law assigns liability based on the moral accountability of the wrongdoer, attaching criminal liability to corporations for the actions of its agent is problematic. A corporation is "an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it . . . ." Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 636 (1819). Skupski argues that "American courts borrowed from English common law the view that a corporation is merely an aggregation of its individual members and may act only through those members in their individual capacities" and that this view was "entirely inconsistent with the imputation of criminal liability." Skupski, *supra* note 26, at 266. Miriam Baer outlines two views of the corporate form—the communitarian view (which views the corporation as a social institution with an "identifiable personality") and the contractarian view (which views the corporation as a "nexus of contracts."). Miriam H. Baer, *Organizational Liability and Tension Between Corporate and Criminal Law*, 19 J.L. & POL'Y 1, 4 (2010). Patricia Abril and Ann Morales Olazábal discuss what they term the "nominalist" and "realist" theories of corporate personality. Under the nominalist theory, corporations are viewed as the mere name for a group of individual actors. By contrast, under the realist theory, corporations are viewed as having a unique culture independent from the individual actors. Abril & Olazábal, *supra*, at 103. In many ways this underlies the debate about whether or not a corporation can be morally responsible. If one views a corporation as merely an organization of individuals, the corporation itself has no moral responsibility. In his seminal piece on corporate responsibility Manuel Velasquez took this position. *See* Manuel Velasquez, *Why Corporations Are Not Morally Responsible for Anything They Do*, 2 BUS. & PROF'L ETHICS J. 1, 7 (1983) (arguing that moral responsibility for wrongdoing within the corporation rests solely on the individual actor).

Others have argued, based primarily on organizational theory, that corporations can have a conscience. *See, e.g.*, Kenneth E. Goodpaster & John B. Matthews, *Can a Corporation Have a Conscience*?, 60 HARV. BUS. REV. 132 (1982) (arguing that corporate actors should act as people in regards to moral and ethical decisions and advocating that corporations develop consciences towards specific issues); *see also* Sarah Kelly-Kilgore & Emily M. Smith, *Corporate Criminal Liability*, 48 AM. CRIM. L. REV. 421, 422 (2011) ("Corporate criminal liability developed as courts struggled to overcome the problem of assigning criminal blame to fictional entities in a legal system based on the moral accountability of individuals.") (internal footnote omitted). For a discussion of the philosophical justifications for assigning moral responsibilities to corporations, see, e.g., Peter French, *The Corporation as a Moral Person*, 16 AM. PHILOSOPHICAL Q. 207 (1970).

35. Some scholars have argued that civil liability should be imposed on the corporate

targeted corporate officers rather than the corporation.[36]

Alternatively, criminal liability can be imposed upon the corporate entity. Courts have utilized a number of theories to overcome the mens rea hurdle in the case of corporate misconduct. Traditionally, liability has been attached under the agency doctrine of respondeat superior.[37] In order to attach criminal liability to a corporation under respondeat superior, an individual must have committed the criminal act: 1) within the scope of his/her employment; and 2) at least, in part, to benefit the corporation. In addition, 3) it must be possible to identify a culpable individual.[38]

1. Within the Scope of Employment

The first requirement to attach liability to the corporation for criminal acts committed by an employee is that the act must be committed within the scope of the agent's employment. This requirement is met if the employee-agent is acting with either actual or apparent authority.[39] A

entity with criminal liability imposed on the individual corporate wrongdoers. *See generally* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 691-92 n.12 (1997) (noting that scholars have discussed the merits of criminal and civil liability in various scenarios and how based on the issue at hand, sometimes imposing individual liability is optimal and in other cases, imposing liability on the group or corporate actor as a whole produces optimal results). This alternative ignores, however, the role that the corporate actor played in encouraging or rewarding the wrongdoing. At least one scholar has argued that criminal liability should be attached to the individual actors within CRAs. David A. Maas, *Policing the Rating Agencies: The Case for Stronger Criminal Disincentives in the Credit Rating Market*, 101 J. CRIM. L. & CRIMINOLOGY 1005 (2011) (arguing for the application of targeted criminal law). Instead of individual criminal liability, we intend to focus on the extent to which criminal liability could and should attach to CRAs—the corporate entities—for inaccurate ratings such as the ratings issued leading up to the GFC.

36. Kelly-Kilgore & Smith, *supra* note 34, at 422 n.7.

37. Kircher, *supra* note 19, at 157; Weissmann, *supra* note 25, at 1319 n.1. Corporate criminal liability was first imposed in the case of New York Central and Hudson River R.R. Co. v. United States, 212 U.S. 481 (1909). In that case, the court reasoned that it is "only a step farther" to hold a corporation criminally liable under circumstances where they would be clearly held civilly liable under the doctrine of respondeat superior. *Id.* at 494. It continued:

> We see no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents whom it has entrusted authority to act.

Id. at 495. Insulating corporations from criminal liability would "virtually take away the only means of effectually controlling" corporations and would allow the law to "shut its eyes to the fact that the great majority of business transactions in modern times are conducted through" corporations. *Id.* at 496, 495.

38. Bucy *supra* note 22, at 1289.

39. *See* RESTATMENT (THIRD) OF AGENCY § 7.04 (2006) ("A principal is subject to

corporation is criminally liable for the criminal acts of an employee when that employee is acting under the express direction of the corporation (actual authority)[40] or if the prosecution can prove that the employee-agent was acting with apparent authority. Under apparent authority, the corporation faces criminal liability where a third-party reasonably believed that the agent had authority to perform the act at issue.[41] This is true even if the action was expressly forbidden by the corporation and even if the corporation has taken efforts to deter such conduct.[42] In addition, under federal law, there are circumstances where criminal liability may be imputed to the corporation even for actions taken by lower level employee-agents.[43]

liability to a third party harmed by an agent's conduct when the agent's conduct is within the scope of the agent's actual authority."); *id.* § 7.08 ("A principal is subject to vicarious liability for a tort committed by an agent . . . when actions taken by the agent with apparent authority constitute a tort . . . .").

40. Kelly-Kilgore & Smith, *supra* note 34, at 424 ("Actual authority attaches when a corporation knowingly and intentionally authorizes an agent to act on its behalf . . . .").

41. Kelly-Kilgore & Smith, *supra* note 34, at 424-25.

42. *See, e.g.*, United States v. Hilton Hotels Corp., 467 F.2d 1000, 1004 (9th Cir. 1972) (corporations are liable for the acts of their agents "even though their conduct may be contrary to their actual instructions or contrary to the corporation's stated policies."); United States v. Basic Constr. Co., 711 F.2d 570, 573 (4th Cir. 1983) ("[A] corporation may be held criminally responsible for antitrust violations committed by its employees if they were acting within the scope of their authority, or apparent authority, and for the benefit of the corporation, even if . . . such acts were against corporate policy or express instructions."); Pamela H. Bucy, *Corporate Criminal Liability: When Does it Make Sense?*, 46 AM. CRIM. L. REV. 1437, 1441 (2009) ("Courts deem criminal conduct to be 'within the scope of employment' even if the conduct was specifically forbidden by corporate policy and the corporation made good faith efforts to prevent the crime."); Narine, *supra* note 22, at 52 ("Even though courts found the issue of corporate responsibility for the acts of employees a difficult one, subsequent courts held companies liable for their employees' actions even if the employee violated clear policies and directives."); Weissmann, *supra* note 25, at 1320 ("[A] corporation can be held liable for agents no matter what their place in the corporate hierarchy and regardless of the efforts in place on the part of corporate managers to deter their conduct."). The penalty imposed may, however, be reduced if the corporation can demonstrate that it has policies in place designed to avoid the criminal behavior. *See* U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (2009) (subtracting points from culpability score when compliance program is in place).

43. *See* In re Hellenic, Inc., 252 F.3d 391, 395 (6th Cir. 2001) (acknowledging the fact that courts are not in agreement as to whether to impute liability from the actions of lower-level employees; instead the decision is typically based on the scope of the agent's responsibilities rather than his or her rank); Kelly-Kilgore & Smith, *supra* note 34, at 425 ("[A] corporation may be liable for the actions of its agents regardless of the agent's position within the corporation."). Whether or not criminal liability can be imputed to the corporation for actions by lower level employees under state law depends on the state. *See* Kelly-Kilgore & Smith, *supra* note 34, at 426 (noting that some states have imputed actions onto the corporation even when board of directors did not specifically approve the employees behavior). An alternative approach is advocated by the Model Penal Code.

2. Acts Must be Designed to Benefit the Corporation

The second requirement needed to impute criminal liability to a corporation is that the agent's actions must be designed, at least in part, to benefit the corporation.[44] It is not necessary, however, that the corporation actually receive any benefit;[45] nor is it necessary that the individual agent act for the corporate benefit only with no regard for his/her individual interest.[46] Further, the mere fact that the agent is acting in violation of a corporate rule or policy will not insulate the corporation from liability.[47] In other words, the corporation is liable regardless of the steps that it has taken to prevent the wrongdoing, even if no one in the corporation other than the wrongdoer is aware of the conduct.[48]

3. Identification of culpable individual

In order to attach liability under respondeat superior, corporations are held liable only if a specific guilty individual can be identified.[49] Therefore, it is possible for corporations to escape liability where no individual agents are found with the requisite intent. This means that it is possible for a corporation to escape liability where a group of individuals contribute to

---

Under this approach, corporations are criminally liable if the criminal conduct was "authorized, requested, commanded, performed, or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment." MODEL PENAL CODE § 2.07(1)(c)(Proposed Official Draft 1962). Thus, the Model Penal Code uses a *respondeat superior* approach but limits liability to the conduct of high level employees.

44. Standard Oil Co. v. United States, 307 F.2d 120, 129 (1962) ("[T]he corporation does not acquire that knowledge or possess the requisite state of mind essential for responsibility, through the activities of unfaithful servants whose conduct was undertaken to advance the interests of parties other than their corporate employer.") (internal quotation marks omitted); Weissmann, *supra* note 25, at 1320, 1330.

45. Caitlin F. Saladrigas, *Corporate Criminal Liability: Lessons from the Rothstein Debacle*, 66 U. MIAMI L. REV. 435, 441 (2012).

46. Bucy, *supra* note 42, at 1441 ("Courts also deem criminal conduct by a corporate agent to be with the intent to benefit the corporation, even when the corporation received no actual benefit") (internal quotation marks omitted); Weissmann, *supra* note 25, at 1320.

47. Kelly-Kilgore & Smith, *supra* note 34, at 427.

48. Bucy, *supra* note 16, at 1103.

49. Kircher, *supra* note 19, at 159 ("[P]articularly with respect to specific intent crimes, the respondeat superior approach is highly problematic because the corporate structure can make it difficult to locate and establish the guilt of agents who possess the requisite intent and, thus, the corporate defendant has the advantage of being able to create reasonable doubt as to each agent and to escape liability altogether."). *But see* Stacey Neumann Vu, *Corporate Criminal Liability: Patchwork Verdicts and the Problem of Locating a Guilty Agent*, 104 COLUM. L. REV. 459 (2004) (arguing that corporations should be criminally liable even when the specific guilty individual has not been identified).

the crime, but no single individual can be identified with knowledge of wrongdoing. As a partial response to this shortcoming, courts have in some cases imputed intent under the willful blindness or the collective knowledge doctrines.[50]

Under the willful blindness doctrine, a corporation can be found liable where it is found to have deliberately disregarded the occurrence of criminal conduct. This might happen, for example, where a manager becomes aware of criminal activity by an employee but makes no attempt to further investigate or to halt the activity.[51] Under this doctrine, the corporate mens rea requirement is satisfied by the actual knowledge or conscious avoidance by the manager.[52] The collective knowledge doctrine is similar. Here the aggregate knowledge of all or some of the employees is imputed to the corporation. In other words, various agents' actions and states of mind are aggregated and imputed to the corporation.[53] This allows the corporation to face liability where no single employee is at fault[54] or where the actions of the individual employees are so compartmentalized that no one individual is entirely at fault.[55] For example, under the doctrine of collective knowledge it would be possible to impose liability upon a corporation for securities fraud based on misrepresentation of fact, even where the corporate officer making the statement had no knowledge that the statement he was making was false, if another corporate officer had the requisite knowledge.[56] While some courts have accepted this doctrine,[57]

50. Kelly-Kilgore & Smith, *supra* note 34, at 431-32.

51. Vu, *supra* note 49, at 473 ("A willful blindness instruction in the corporate context allows the jury to make a finding of knowledge where the corporation was suspicious of criminal conduct yet failed to make inquiries, thereby choosing to remain ignorant."). This is also referred to as the "ostrich" instruction. Geraldine Szott Moohr, *Playing with the Rules: An Effort to Strengthen the Mens Rea Standards of Federal Criminal Laws*, 7 J.L. ECON. & POL'Y 685, 696 (2011).

52. Kelly-Kilgore & Smith, *supra* note 34, at 431. Relevant factors include whether the management ratified the conduct or consciously avoided discovering it, whether the corporation expressly forbade the practice, and the number of times such conduct occurred. Vu, *supra* note 49, at 473.

53. Kircher, *supra* note 19, at 160 ("[W]here no culpable employee can be found, some courts have decided to aggregate corporate agents' actions and states of mind and impute them to the corporation.").

54. Kelly-Kilgore & Smith, *supra* note 34, at 431; Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 763 (1992) (describing how collective knowledge "enables courts to find liability in cases in which the corporation seems 'justly to blame' for the crime, but no single individual has the required mens rea.").

55. Kelly-Kilgore & Smith, *supra* note 34, at 431-32; Skupski, *supra* note 26, at 281-85.

56. *In re* Worldcom, Inc. Sec. Litig., 352 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) (to "carry their burden of showing that a corporate defendant acted with scienter, plaintiffs in securities fraud cases need not prove that any one individual employee of a corporate

other courts have only used it to impute liability to corporations when coupled with willful blindness.[58] Some courts have refused to recognize this doctrine at all.[59]

While respondeat superior is the traditional model of imposing criminal liability upon the corporation, it has been the target of intense criticism by commentators.[60] Taken together, these arguments posit that it

defendant also acted with scienter. Proof of a corporation's collective knowledge and intent is sufficient."); *In re* Dynex Capital, Inc. Sec. Litig., No. 05 Civ. 1897 (HB), 2006 WL 314524, at *9, *12 (S.D.N.Y. 2006) ("A plaintiff may, and in this case has, alleged scienter on the part of a corporate defendant without pleading scienter against any particular employees of the corporation."); *see also* Kevin M. O'Riordan, Note, *Clear Support or Cause for Suspicion? A Critique of Collective Scienter in Securities Litigation*, 91 MINN. L. REV. 1596, 1609-11 (2007) (discussing the *Dynex* line of cases).

57. *See, e.g.*, Abril & Olazábal, *supra* note 34, at 116-20 (identifying and describing decisions that used collective knowledge doctrine).

58. *See* Thomas A. Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 GEO. WASH. L. REV. 210, 236-37 (1997) ("[N]o company was ever convicted without having acted in some conscious, culpable manner. . . . Rather, when courts have aggregated knowledge, they invariably have done so as a technique in response to willful blindness to inculpatory knowledge.").

59. *See, e.g.*, *In re* Apple Computer, Inc., 127 F. App'x 296, 303 (9th Cir. 2005) ("A corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter at the time he or she makes the statement."); Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004) (it is "appropriate to look to the state of mind of the *individual corporate official or officials* who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein . . . .") (emphasis added); Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435 (9th Cir. 1995) ("[T]here is no case law supporting an independent collective scienter theory.") (internal quotation marks omitted); *see also In re* Apple Computer, Inc., Sec. Litig., 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002), *aff'd* 2005 U.S. App. LEXIS 5511 (9th Cir. Apr. 4, 2005). It is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false. A defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter, i.e., knows that the statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she makes the statement.
Stacey Neumann Vu concluded that "the corporate knowledge and willful blindness doctrines, as they stand, have limited use in overcoming the prosecutorial problem of locating an agent and establishing guilt when a corporation has committed a specific intent crime." Vu, *supra* note 49, at 475; *see also* Kircher, *supra* note 19, at 162-63 (discussing courts rejecting the collective scienter doctrine); O'Riordan, *supra* note 56, at 1607-09 (discussing *In re Apple Computer, Inc., Sec. Litig.* 243 F. Supp. 2d 1012).

60. Thus, many have argued that vicarious liability is not appropriate in the case of criminal liability. *See, e.g.*, Laufer & Strudler, *supra* note 34, at 1311 (noting that "[t]he risk of unfairly casting moral blame and criminal liability on an entity is greater with vicarious liability. . . . Vicarious fault does not asses the entity's contribution to its agents' wrongdoing.") (internal footnote omitted); *see also* Moohr, *supra* note 51, at 685 (arguing "the diminished significance of the *mens rea* element is part of the trend to overcriminalize.") (emphasis in original).

is unfair to impose criminal liability upon a corporation under the respondeat superior model due its weaknesses.[61]

First, the doctrine fails to recognize the inherent differences between civil and criminal law. As mentioned above, the primary purpose of civil law is compensatory. Thus, one goal of holding a corporation vicariously liable for the torts committed by its agents relates to the corporation's ability to best compensate the injured party. As such, tort liability can be seen as a cost of doing business; its likelihood is reflected in the cost of the products or services sold and the corporation typically obtains insurance to cover tort judgments. Any deterrent effect is viewed as a "byproduct of the desired compensation."[62] The goals of retribution and rehabilitation are absent entirely.

Second, the respondeat superior model fails to provide adequate deterrence. Arguably, under respondeat superior, the corporation is incentivized to monitor and police its employees to avoid criminal charges.[63] In this way, both types of deterrence are promoted – the individual employee is discouraged from engaging in criminal misconduct, and his or her supervisors are encouraged to monitor and influence their employees to refrain from criminal misconduct. The typical way that corporations act to deter wrongdoing is by adopting corporate codes of conduct and compliance programs. The existence of such codes or corporate rules will not, however, insulate the corporation from liability for the actions of an agent in violation of those rules. Moreover, under respondeat superior the existence of corporate compliance programs is only relevant at sentencing.[64] In addition, oftentimes corporations have formal rules in place, while at the same time incentivizing contrary behavior. Therefore, it is argued that attaching liability under respondeat superior provides inadequate incentives for corporations to develop, implement, and enforce effective corporate compliance programs.[65] Some commentators

---

61. Evans, *supra* note 22, at 25 (questioning whether blanket application of respondeat superior is fair to corporations); Kircher, *supra* note 19, at 159 ("Fairness requires that 'a corporation should neither escape liability nor be held criminally responsible simply because it is a collective body.'") (quoting Moohr, *infra* note 76, at 1364).

62. Skupski, *supra* note 26, at 271.

63. Skupski, *supra* note 26, at 268 (describing the "enduring policy behind criminally punishing corporations" as one of "deterring agent misconduct by allocating risk of criminal liability to the corporation to incentivize greater control of its agents.").

64. Evans, *supra* note 22, at 26; Narine, *supra* note 22, at 45.

65. Bucy, *supra* note 42, at 1441 ("[T]his standard provides no incentives for companies to expend resources to institute effective compliance programs."). Some scholars have concluded that the objective of deterrence would be better met by imposition of civil liability and that the higher costs of borne by society where criminal liability is imposed are not justified by the minimal deterrent effect. *See* Henning, *supra* note 30, at 1425-26 (summarizing arguments that deterrence is better achieved through civil rather than

have argued that respondeat superior actually creates "contrary control incentives."[66] In other words, it is argued that the type of strict liability imposed by respondeat superior[67] creates an incentive for corporations to "forgo preventative measures or to obscure misconduct."[68]

Third, some argue that the model of respondeat superior fails to serve any real retributive function. The goal of retribution as a part of criminal law stems from the belief that is proper to punish wrongdoers when their conduct is morally repugnant. The problem in the case of respondeat superior is obvious; liability is imposed upon the corporation without finding the corporation morally culpable.[69] Because the doctrine of respondeat superior ignores issues of corporate culture, it fails to "'distinguish between [the corporation or the individual that is] culpable and those that are not.'"[70]

criminal liability).

66. Skupski, *supra* note 26, at 273.

67. Arguably, this is strict liability because liability is unrelated to the conduct of the corporation. Even if the corporation has strict rules in place and a strict compliance program, it will face liability for the conduct of "rogue" agents. *See* Skupski, *supra* note 26, at 273 (discussing this example and labeling it strict liability).

68. Skupski, *supra* note 26, at 274. *See* Assaf Hamdani & Alon Klement, *Corporate Crime and Deterrence,* 61 STAN. L. REV. 271, 276 (2008) ("When they cannot eliminate misconduct, firms might respond to the threat of harsh sanctions by reducing their monitoring effort."); *see also* Pollack, *supra* note 33, at 1393 (arguing that corporations have sufficient incentives to create and enforce strong compliance programs and that exempting corporations who have such programs from liability does nothing to change the incentives, as "[c]ontinuing to expose corporations that lack adequate compliance programs to vicarious liability while shielding those that do have such programs adds no meaningful additional incentive to corporations to create and maintain such programs."). Narine argues that the present system provides little incentives for corporate management to monitor employee behavior. Narine, *supra* note 22, at 45 ("Ironically, this means that companies receive the maximum benefit from compliance programs that *appear* to comply with the Guidelines but that do not *actually* detect or deter wrongful conduct.") (emphasis in original).

69. *See* Bucy, *supra* note 16, at 1104 ("Under this approach all corporations, honest or dishonest, good or bad, are convicted if the government can prove that even one maverick employee committed criminal conduct."); Dervan, *supra* note 27, at 10 ("[T]he current standard allows conviction of corporations when the entity has engaged in no morally culpable behavior."); Evans, *supra* note 22, at 28 ("[C]riminal conviction connotes moral blameworthiness and should be reserved for those instances in which the government can point to a substantive wrong in the corporation's compliance practices, leadership, culture, or internal controls."); *see also* Laufer & Strudler, *supra* note 34, at 1297 ("Perceptions of fairness and justice hinge on the degree of attenuation between the acts and intentions of corporate and human persons."). Some scholars compare imposing liability on a corporation that has a compliance program in place to deter corporate misconduct to imposing liability on someone who lacks mental capacity. *See, e.g.*, Weissmann, *supra* note 25, at 1328 ("A corporation that has taken all practical efforts to prevent the conduct that forms the basis of a current criminal charge is similarly lacking in volition.").

70. Bucy, *supra* note 42, at 1442. *See, e.g.*, Dervan, *supra* note 27, at 10 (asking us to

Fourth, utilizing the respondeat superior model promotes inconsistent enforcement by being both under and over-inclusive. Some commentators have argued that the theory is over-inclusive, giving prosecutors too much discretion and forcing even innocent corporations to accept responsibility to avoid prosecution.[71] This argument recognizes the moral stigma that

consider "the moral distinction between a corporation whose board of directors encourages employees to engage in illegal behavior and a corporation that, through utilizing an effective compliance program, discovers and punishes a rogue employee who acted against direct corporate and managerial instructions to the contrary."). Arguably, the lack of any real retributive function could be overlooked if the deterrent effect was strong. *See* Skupski, *supra* note 26, at 278 (arguing that consideration of the deterrent purpose is greater than the consideration of retribution). But, as we have just discussed, the deterrent effect is ambivalent at best.

71. *See, e.g.*, Abril & Olazábal, *supra* note 34, at 113 (emphasizing that respondeat superior sometimes leads to unwarranted broad liability); Weissmann, *supra* note 25, at 1322 (arguing that under current policy "no *systemic* checks effectively restrict the government's power to go after corporations.") (emphasis in original); *see also* Henning, *supra* note 30, at 1418-19 (providing an overview of the argument that prosecutorial discretion leads to over-inclusiveness). This argument is based on the fear that corporations, even innocent corporations, will settle or enter into settlements rather than risk the possibility of criminal conviction and the serious consequences.

Because the actions of a single low-level employee can trigger corporate criminal liability under this doctrine, it is possible for a corporation to face liability even where it actually enforces policies designed to prevent such actions. In other words, as we will discuss doctrines that attempt to attach criminal liability based upon ideas of corporate culture will look at the extent to which the informal culture of a corporation encourages and rewards the criminal behavior. It is, however, possible that under the doctrine of respondeat superior for a corporation to be criminally liable even when the culture neither encourages nor rewards criminal behavior. We will argue that theories based on corporate culture better strike the balance and are neither over nor under inclusive. *See infra* text accompanying notes 148-149.

From this argument, one might conclude that a myriad of criminal lawsuits were brought against corporations in the wake of the GFC. The opposite is in fact true. According to the *Wall Street Journal*, very few criminal cases have been brought against corporate executives involved in actions as part of the GFC. *See* Jean Eaglesham, *Missing: Stats on Crisis Convictions*, WALL ST. J., May 13, 2012, *available at* http://online.wsj.com/article/SB10001424052702303505504577401911741048088.html (observing that only one case pursued by the Justice Department deals with a Wall Street firm's wrongdoing that directly impacted the financial crisis)); *see also* Peter Lattman, *A Star Panel Debates Financial Crisis Prosecutions*, N. Y. TIMES (Feb. 2, 2012, 4:01 PM), http://dealbook.nytimes.com/2012/02/08/a-star-panel-debates-financial-crisis-prosecutions/ (summarizing the disagreement among a panel of legal experts about whether or not executives and Wall Street firms faced sufficient consequences after the financial crisis); Gretchen Morgenson & Louise Story, *In Financial Crisis, No Prosecutions of Top Figures*, N. Y. TIMES, April 14, 2011, *available at* http://www.nytimes.com/2011/04/14/business/14prosecute.html?pagewanted=all (emphasizing that there were no prosecutions of top-level executives after the financial crisis); *No Crime, No Punishment*, N. Y. TIMES, Aug. 25, 2012, (editorial), *available at* http://www.nytimes.com/2012/08/26/opinion/sunday/no-crime-no-punishment.html (commenting on the lack of accountability for top firms and top executives in light of the financial crisis). Moreover, in total federal prosecutors bring attaches with criminal liability and the severe impact that can result from criminal liability.[72] Moreover, the doctrine is over-inclusive because under respondeat superior, a corporation faces liability for the actions of a rogue employee even when it has taken all possible steps to prevent misconduct.[73] At the same time, the doctrine is under-inclusive because oftentimes prosecutors shy away from criminal prosecution to avoid punishing innocent shareholders.[74] By giving little guidance to prosecutors to determine which corporations to prosecute, we are left with arbitrary and inconsistent enforcement.[75] In addition, the doctrine is under-inclusive

criminal charges against less than a few hundred corporations in any given year. Beale, *supra* note 22, at 1487; Henning, *supra* note 30, at 1420.

72. *See* Hamdani & Klement, *supra* note 68, at 278 ("A conviction could have fatal consequences for business entities even when the criminal trial ends with a modest penalty for the defendant firm. Indeed, a variety of laws and regulations can effectively put out of business firms convicted of a crime."). For example, Arthur Andersen was found guilty and a relatively modest fine was imposed. The firm was forced out of business by this conviction, however, because SEC rules forbid a firm from serving as an auditor of a publicly traded firm if it has been convicted of a crime. Hamdani & Klement, *supra* note 68, at 278-79; *see also* Skupski, *supra* note 26, at 271-72 (contrasting the moral stigma of a criminal conviction with the less devastating effects of tort liability).

73. Kircher, *supra* note 19, at 159 (acknowledging that the respondeat superior doctrine fails to distinguish between crimes that are committed with encouragement of upper management and those perpetrated by a rogue employee). One commentator has remarked that under the doctrine of respondeat superior the test for imposing criminal liability is too easily met. Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 76 (2007) ("[T]he criminal case against a corporation, once there is evidence that even a single low-level employee engaged in criminal activity on the job, is virtually bulletproof."). Pamela H. Bucy proposes addressing this weakness by creating an affirmative defense based on the corporate ethos model discussed below. She argues that corporations should be insulated from liability if they can show that "at the time of the offense it had in place an effective corporate compliance program relevant to the crimes alleged." Bucy, *supra* note 42, at 1442; *see also* Narine, *supra* note 22, (advancing a similar argument). Arguments in favor of insulating corporations from liability if they have a policy in place to deter the action ignore the difference between formal and informal culture. The question shouldn't be as simple as whether or not the corporation had a policy in place that forbade the conduct. Rather, attention should focus on the extent to which that policy was enforced. Were employees provided mixed messages? For what type of actions were they rewarded? Were people punished for violating the express policies? These questions are part of the corporate ethos theory discussed below. Andrew Weissmann recognizes but dismisses these concerns as "unrealistic" when he talks about the unlikelihood of corporations adopting "mere show" programs to fool the courts. Weissmann, *supra* note 25, at 1336 (discussing the harms of ineffective compliance programs).

74. *See* Kelly-Kilgore & Smith, *supra* note 34, at 422 ("Although criminal prosecution of corporations is guided by recognized principles, many prosecutors still proceed against corporations with great caution, persuaded by the argument that punishing a corporation in effect punishes innocent stockholders.").

75. *See* Skupski, *supra* note 26, at 280 ("Giving the prosecution the nearly unfettered discretion to exercise their personal, variable views over whether to indict a corporation,

because a corporation can avoid liability if a single agent cannot be identified with the requisite mens rea.[76]

Finally, and most importantly, using the doctrine of respondeat superior focuses on the individual actor[77] and, as such, often fails to recognize the role that corporate culture, created by executives, can play in fostering illegal conduct by its employees.[78] In doing so, it fails to focus on the actual misconduct by the corporation.[79] In the next section, we will consider alternative theories that shift focus on this misconduct.

C. Attaching Criminal Liability to Corporations: Corporate Ethos Model

As a response to the inadequacies of the respondeat superior model, legal scholars have adopted alternative theories of criminal liability that focus on corporate culture. Doctrines such as the corporate ethos model[80] consider the role that corporate culture plays in fostering criminal conduct[81]

without any required adherence to legal standards analyzing genuine corporate culpability, opens the door to arbitrariness.").

76. Because respondeat superior applies only when a single guilty individual can be found, it ignores that role that corporate policy can play in encouraging multiple individuals to act. *See* Geraldine Szott Moohr, *Of Bad Apples and Bad Trees: Considering Fault-Based Liability for the Complicit Corporation*, 44 AM. CRIM. L. REV. 1343, 1364 (2007) (arguing that corporations should be held responsible for its "complicity in a crime" or "unlawful conduct is likely to continue, albeit with a different set of individual actors."); Vu, *supra* note 49, at 459 ("[C]riminal conviction should be more, not less, likely where evidence of multiple guilty agents exists."). Skupski describes the respondeat superior model as "fatally over - and underinclusive." Skupski, *supra* note 26, at 263. Further, George R. Skupski, argues that the standard fails "without justification, to differentiate between the nonblameworthy organizations and those which are genuinely culpable." Skupski, *supra* note 26, at 264.

77. George R. Skupski terms respondeat superior an "individualistic liability scheme" and argues that it needs to be overhauled. Skupski, *supra* note 26, at 264.

78. *See* James A. Fanto, *Recognizing the 'Bad Barrel' in Public Business Firms: Social and Organizational Factors in Misconduct by Senior Decision-makers*, 57 BUFF. L. REV. 1, 2 (2009) ("[D]irectors and executives make their decisions or perform their actions using existing practices and perspectives – in short, an organizational culture – that have been developed over time in the firm.").

79. Skupski, *supra* note 26, at 277 ("[T]he strict liability effect respondeat superior standard causes a failure to inquire into the genuine culpability of the organization."). In other words, the focus is on the behavior of the "bad apples," and the influence of the "bad tree" is ignored. *See generally* Moohr, *supra* note 76 (addressing the question of when and how to hold corporations responsible for the crimes of their individuals).

80. Abril & Olazábal, *supra* note 34, at 121-22 (referring to this model as one of "corporate character" and describe it as based on the belief that "'bad' corporations can influence individual and group criminal behavior").

81. *See, e.g.*, Kircher, *supra* note 19, at 172 ("[F]orces at work within a corporation can sometimes foster, promote or cause criminal behavior on the part of its employees.");

and posit that "organizations possess an identity that is independent of specific individuals who control or work for the organization."[82] Application of this model focuses on the "distinct human-like qualities and personalities" of corporations "that may induce their employees to act wrongfully"[83] and attaches criminal liability because of that ethos.[84] This theory recognizes that a corporation is a "complex organization" and not a person[85] and is reinforced by social psychology and organizational behavior literature that demonstrates the importance of corporate culture in contributing to misconduct within a business organization. Under this theory, rather than focusing solely on the behavior of the individual wrongdoer, attention is paid to factors that comprise corporate culture, both formal and informal.[86] Corporate criminal liability is appropriate if the

---

Lederman, *supra* note 14, at 293-97 (discussing the relationship between perpetrator and corporation). *See generally* Bucy, *supra* note 16 (exploring the notion of corporate, rather than individual, intent). George R. Skupski suggests a standard based upon an approximation of the senior management mens rea, what he terms the SMMR. Skupski, *supra* note 26, at 265. He argues that the SMMR standard relies upon both the subjective mental states of senior management and reasonable inferences of their culpability based on certain variables of organizational culpability. Skupski, *supra* note 26, at 265. Similarly, Barry J. Pollack argues that the "collective intent of a corporate entity should be measured by the actions, knowledge, and intent of senior management." Pollack, *supra* note 33, at 1394. Commentators advance other alternatives. Geraldine Szott Moohr looks at the role that corporate culture plays in encouraging individual misconduct and argues that corporations should be charged under the doctrine of accomplice theory. Moohr *supra* note 76, at 1358. Carlos Gomez-Jara Díez argues that under systems theory, corporations should only be held criminally responsible if they are capable of self-organization and self-governance. Carlos Gómez-Jara Díez, *Corporate Culpability as a Limit to the Overcriminalization of Corporate Criminal Liability: The Interplay between Self-Regulation, Corporate Compliance, and Corporate Citizenship*, 14 NEW CRIM. L. REV. 78, 85 (2011).

82. Bucy, *supra* note 16, at 1099.

83. Kircher, *supra* note 19, at 166 (quoting Abril & Olazábal, *supra* note 34, at 132).

84. Moohr, *supra* note 76, at 1347 ("Moral content can be found in the ethos of an organization."). In other words, the requisite intentionality is attributed to the corporation because of the corporate culture. *See, e.g.*, Laufer & Strudler, *supra* note 34 (discussing the importance of corporate intentionality as indicative of moral fault).

85. Skupski, *supra* note 26, at 287 ("In order to develop an effective system for identifying genuine corporate conduct and culpability, it is necessary to 'drop the analogy of the corporation as a person and analyze the behavior of the corporation in terms of what it really is: a complex organization'") (citing Clinard & Yeager, *supra* note 27, at 43).

86. *See infra* notes 106-114 and accompanying text (discussing informal and formal culture). To some extent, this entails an examination of what Peter French termed corporate internal decision structures (CID). French, *supra* note 34, at 211. Peter French argued that when a corporate act is undertaken pursuant to CID structures that "it is proper to describe it as having been done for corporate reasons, as having been caused by a corporate desire coupled with a corporate belief and so, in other words, as corporate intentional." French, *supra* note 34, at 213. Similarly, Thomas Donaldson argued that corporations were morally responsible if they embody a "process of moral decision-making." THOMAS DONALDSON,

government can prove that the corporate culture encouraged corporate employees to engage in wrongdoing.

This model has received some judicial support. Most notably, the First Circuit in *United States v. Bank of New England*, *N.A.*[87] aggregated and imputed the knowledge of individual bank employees to the corporate defendant and held that the bank could be found guilty if the requisite mens rea was "present in the sum of its parts."[88] The court acknowledged that "[c]orporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation's knowledge of a particular operation."[89] The court considered factors that it deemed relevant to impute "willfulness" to the corporation, such as the extent to which the bank as an organization consciously avoided learning about and enforcing the statutory reporting requirements and the degree to which it displayed "flagrant organizational indifference to the reporting requirements."[90]

Under the corporate ethos model, liability is imposed on a corporation when the corporate culture creates "an environment or a demonstrable personality that encouraged the violation."[91] Understanding this theory requires a brief examination of the literature considering how individuals make decisions within organizations, and the effect of organizational cultures upon individual behavior. We are not offering a comprehensive review of such a large area of scholarship; instead, we intend to briefly

---

CORPORATIONS AND MORALITY 30 (1982). Carlos Gomez-Jara Díez posits that rather than focusing on individual conduct, the focus should be on organizational knowledge. Diez, *supra* note 81, at 85 ("We ought to ask ourselves whether the corporate entity has achieved a level of internal complexity that allows it to organize itself in a meaningful way.").

87. 821 F.2d 844 (1st Cir. 1987).

88. Abril & Olazábal, *supra* note 34, at 119 (discussing *Bank of New England*, 821 F.2d 844).

89. *Bank of New England*, 821 F.2d at 856.

90. Kircher, *supra* note 19, at 161 (citing *Bank of New England*, 821 F.2d at 855-56). Under the doctrine of willful blindness, the requisite knowledge can be found from the action of actively avoiding acquiring the positive knowledge. *See, e.g.*, Abril & Olazábal, *supra* note 34, at 120-21 (discussing the concept of willful blindness in corporate criminal behavior); Skupski, *supra* note 26, at 291 (citing *Bank of New England*, 821 F.2d 844 as applying the collective knowledge doctrine and concluding that is "simply an inadequate patch over a gaping hole in the respondeat superior standard.").

91. Abril & Olazábal, *supra* note 34, at 123. Pamela Bucy calls this the "characteristic spirit" of the organization. Bucy, *supra* note 16, at 1123 (describing this characteristic spirit as "[s]uperficial things such as the manner of dress and the camaraderie of the employees as well as formal, written goals and policies . . . ."); *see also* WALLY OLINS, THE CORPORATE PERSONALITY: AN INQUIRY INTO THE NATURE OF CORPORATE IDENTITY 82 (1978) ("It is not true that all big companies are the same – they aren't. . . . [O]rganisations manage to develop an ethos . . . . a personality which is so ingrained, so much a part of them, that the corporate identity expresses itself in their every action.").

convey the importance of corporate culture. In general, we will first outline how characteristics of individuals can affect their likelihood to engage in misconduct within an organizational framework. This is explored mainly in the psychology literature. Second, we will outline how characteristics of organizations can foster a culture that encourages wrongdoing by individuals within that organization. This is explored mainly in the organizational behavior literature. We will conclude that imposition of criminal liability upon a corporation must recognize the role that corporate culture plays, and will demonstrate how the corporate ethos model focuses on corporate culture.

1. How characteristics of individuals affect individual behavior

Characteristics of individuals obviously affect their predisposition to commit wrongdoing.[92] This section will, however, go beyond a simple conclusion that bad people—bad apples—are more likely than good people to commit bad acts. Our intent is to explore what factors can influence a good person to commit bad acts. Psychology literature outlines a plethora of individual differences and cognitive biases that can influence individual decision-making.[93] For example, this literature outlines the importance of conformity in shaping individual behavior. People both consciously and unconsciously conform to the behavior they see around them.[94] In an organization, the power of "groupthink" also strongly influences individual behavior.[95] This means that if other individuals are engaging in wrongdoing, such behavior can become accepted. It can become the way things are done. The literature describes how people engage in "script processing," where they make knee-jerk decisions rather than engaging in thoughtful deliberation when faced with complex, but standard,

92. Don Mayer, Catharyn Baird & Anita Cava, Restoring the Social Contract of Capitalism Through Criminal Liability for Financial Fraud 17 (unpublished paper) (on file with the University of Miami) (citing MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 21, 30 (2011)) (positing that "despite best efforts to the contrary, unethical decisions are made not necessarily due to lack of integrity or lack of a formal ethics code, but to the intricacies of human psychology.").

93. *See, e.g.*, Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 423-26 (2003) (looking at cognitive biases as a partial explanation for the Enron scandal).

94. Solomon E. Asch, *Studies of Independence and Conformity: A Minority of One Against a Unanimous Majority*, 70 PSYCHOL. MONOGRAPHS: GEN. & APPLIED 1, 68-70 (1956).

95. *See* Fanto, *supra* note 78, at 13 (stating that "group members adhere so strongly and confidently to the group's perspective – they become almost pathologically cohesive . . . .").

dilemmas.[96] The literature outlines the fact that people are typically obedient and will do what they are told, especially in a group setting.[97] For example, if one is told to rate an issue as AAA, or to modify the model to assure that a particular issue is rated highly, we can expect that such orders would be followed. It is known that people respond to rewards and incentives, and watch how others are rewarded and punished.[98] Rewards given for achievement of goals, that ignore the way of bringing about that achievement, induce people to try to achieve goals without paying attention to the ethics or the legality of the methods used.[99] Psychology literature teaches us that most people make ethical decisions by "looking up and looking around,"[100] i.e., people watch others' behavior for cues about what is appropriate.[101] The "confirmation trap" operates in a way that

96. LINDA K. TREVIÑO & KATHERINE A. NELSON, MANAGING BUSINESS ETHICS: STRAIGHT TALK ABOUT HOW TO DO IT RIGHT 101-03 (5th ed. 2011); *see also* BAZERMAN & TENBRUNSEL, *supra* note 92, at 34-36 (describing a system of thinking in which individuals intuitively process information in a quick and efficient manner, thereby reaching decisions without engaging in much deliberation).

97. *See generally* Stanley Milgram, *Behavioral Study of Obedience*, 67 J. ABNORMAL & SOC. PSYCHOL. 371, 371-78 (1963) (describing a study that tested obedience and found that individuals tend to obey others who are viewed as legitimate authorities, especially in a public setting when there is less time for reflection).

98. Basic reinforcement theory teaches us that people will act in ways that are rewarded, and also act to avoid punishment. TREVIÑO & NELSON, *supra* note 96, at 264-69. It follows that if people are rewarded for, so called, "making the numbers" at all costs, people will act accordingly to meet that goal. TREVIÑO & NELSON, *supra* note 96, at 266 (noting that "[i]f [employees] observe that people advance by stepping on others, lying to customers, and falsifying reports, they'll be more inclined to do so because they will have learned that such behavior is rewarded."). Similarly, people will act to avoid punishment. In the corporate setting, perhaps the most threatening punishment is the potential of being fired. John C. Coffee, Jr. noted the power of the threat of dismissal. John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 229-30 (1991) (stating that "[e]xposed to the remote threat of criminal prosecution and the clear and present threat of dismissal, lower echelon employees know to which message it is more in their interest to respond."). We saw an example of this idea with Enron. As part of Enron's reward and incentive structure, those employees ranked in the bottom percentile each year were dismissed, creating incentives to commit wrongdoing. Lynne L. Dallas, *A Preliminary Inquiry Into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. 1, 45-55 (2003-2004). The idea of social learning theory extends this influence in a powerful way. Under this theory, we learn that people are influenced not only by their own rewards and punishments, but through observing the rewards and punishments that others receive. ALBERT BANDURA, SOCIAL FOUNDATIONS OF THOUGHT AND ACTION: A SOCIAL COGNITIVE THEORY 284-89 (1986).

99. *See* Dallas, *supra* note 34, at 34-35 (discussing the impact of tying compensation to profit goals).

100. Linda K. Treviño & Michael E. Brown, *Managing to be ethical: Debunking five business ethics myths*, 18 ACAD. OF MGMT. EXECUTIVE, 69, 72 (2004).

101. *See id.* (arguing that people "do what others around them do or expect them to

encourages individuals to look for evidence to confirm pre-existing conclusions, and to disregard information that does not support those conclusions.[102] Coupled with the illusion of optimism,[103] this means that employees of CRAs who were convinced that their unrealistic assumptions were true, failed to look for evidence that might have provided red flags. They were, for example, convinced that housing prices were going to continue to rise because they were rising, and any evidence that the bubble was likely to burst was ignored. Moreover, escalation of commitment makes it likely that once started down a path, even a dangerous one, people are unlikely to change course.[104] People act to diffuse responsibility, and the greater the number of people who participate in an action, the less likely people are to feel a sense of individual responsibility (so-called "bystander apathy").[105]

2. How characteristics of organizations affect individual behavior: the importance of corporate culture

Corporate culture is shaped by an organization's goals and values.[106]

---

do.") (internal footnote omitted). This concept is closely related to social processing theory. Social processing theory posits, "individuals look for signs of what are acceptable attitudes and conduct in groups." Fanto, *supra* note 78, at 11. Under this theory, if misconduct occurs in the group and is accepted by the group, it is likely to reoccur. Fanto, *supra* note 78, at 12. Merideth Ferguson refers to this as "social comparison" and hypothesizes that both direct and indirect observation of others' behavior influences behavior of others. Merideth Ferguson, From Bad to Worse: A Social Contagion Model of Organizational Misbehavior 9-10 (July 13, 2006) (unpublished manuscript, on file with the author). In other words, hearing stories of co-workers who acted improperly and were rewarded rather than punished is just as important as actually witnessing the behavior and consequences. Lastly, the pervasiveness of the behavior is also seen as an important factor. *Id.*

102. MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 39-41 (3d ed. 1994).

103. David M. Messick & Max H. Bazerman, *Ethical Leadership and the Psychology of Decision Making*, 37 Sloan Mgmt. Rev. 9, 18 (1996); *see also* Frank P. McKenna, *It won't happen to me: Unrealistic optimism or illusion of control?*, 84 Brit. J. Psychol. 39 (1993) (discussing psychology scholarship, which teaches us that people are overly optimistic about favorable outcomes); James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 Ohio St. L.J. 1333, 1344 (2001) (explaining "over-optimism" to mean that "people overestimate the probability of an outcome favorable to them . . . .").

104. Barry M. Staw & Jerry Ross, *Understanding Behavior in Escalation Situations*, 246 SCIENCE 216, 218-19 (1989).

105. John M. Darley & Bibb Latané, *Bystander Intervention in Emergencies: Diffusion of Responsibility*, 8 J. PERSONALITY & SOC. PSYCHOL. 377 (1968).

106. Fanto, *supra* note 78, at 19 ("Organizational culture is constituted of the values and goals, and the ways of thinking and behaving, that typify the organization.") (internal footnote omitted).

Culture must, however, be further broken down into formal and informal culture. The formal culture is defined by: leadership, core values, organizational hierarchy, training programs, and rewards and incentives.[107] Informal culture, on the other hand, is defined by: leadership, stories, language, and myths. [108] To some extent, formal culture can be viewed as how an organization defines itself, and the informal culture can be viewed as how an organization actually conducts itself (the "talk" versus the "walk"). Not surprisingly, informal culture plays a more important influence on individual behavior than formal culture.[109] Because individuals tend to engage in goal-oriented behavior,[110] an important aspect of corporate culture that influences individual behavior is the goals that are set, and the messages that are sent about how to achieve those goals.[111] In other words, individuals will act to achieve organizational goals, often without recognizing the ethical or legal ramifications of their actions.[112]

Leaders play a crucial role in shaping both formal and informal culture, and, as such, have the power to corrupt[113] or to foster the development of virtue in others. Robert Kennedy outlines five practical steps in which a leader can create a culture that fosters ethical behavior.[114]

107. TREVIÑO & NELSON, *supra* note 96, at 155-79 (describing various aspects of formal culture).

108. TREVIÑO & NELSON, *supra* note 96, at 180-87 (outlining what creates informal culture).

109. *See* Mayer, Baird & Cava, *supra* note 92, at 26-28 (discussing the misalignment at Goldman Sachs between their formal culture, which promised that their "clients' interests always come first" and the informal culture in which they deceived these clients for profit) (internal footnote omitted); *see also* Fanto, *supra* note 78, at 23 ("This reinforcement does not happen just because an organization has formal codes of ethics and policies stating that its members should be ethical and follow the law, but from, again, an organizational culture exemplified by its leaders and internalized by organization members that allows for this expression."). *See generally* Joseph L. Badaracco & Allen P. Webb, *Business Ethics: A View from the Trenches*, 37 CAL. MGMT. REV. 8 (1995) (discussing how corporate culture is set by the actions of high-level managers, not policies or declarations).

110. *See, e.g.*, TREVIÑO & NELSON, *supra* note 96, at 261 (discussing the value of goal setting for individuals).

111. TREVIÑO & NELSON, *supra* note 96, at 261.

112. This is closely tied to the importance of rewards and incentives. MICHAEL W. HUDSON, THE MONSTER: HOW A GANG OF PREDATORY LENDERS AND WALL STREET BANKERS FLEECED AMERICA – AND SPAWNED A GLOBAL CRISIS 1-2 (2010). For example, Michael Hudson outlines how goals and incentives worked to encourage fraudulent behavior at Ameriquest: "Up and down the line, from loan officers to regional managers and vice presidents, Ameriquest's employees scrambled at the end of each month to push through as many loans as possible, to pad their monthly production numbers, boost their commissions, and meet Roland Arnall's expectations." *Id.*

113. Fanto, *supra* note 78, at 11 ("[T]he group may become corrupt because its leader is corrupt."); *see also* Robson, *supra* note 19, at 130 (discussing the fact that the deliberate efforts of leadership shape corporate culture).

114. Robert G. Kennedy, *Virtue and Corporate Culture: The Ethical Formation of*

First, the leader must "attend to the culture of the workplace."[115] Here, Kennedy focuses on the leader's power to create a culture in which viciousness is not rewarded. Second, Kennedy tells us that leaders must act as both models and coaches of ethical behavior.[116] Conversely, if they act unethically or condone (even implicitly) unethical behavior, they are acting as role models for a corrupt culture. Third, leaders must recognize ethical behavior when it occurs.[117] Fourth, leaders must reward ethical behavior and punish unethical behavior.[118] Fifth, Kennedy recognizes the importance of education and training.[119]

3. Corporate Ethos Theory

It is clear that individuals acting within an organization can be constrained from, or encouraged by, that organization to engage in wrongdoing. An organization with a strong ethical culture, where both formal and informal cultures are aligned to address employee behavior, will be one in which it is less likely that an individual engage in wrongdoing. By contrast, an organization in which the informal culture encourages and rewards misconduct will be one in which it is more likely that employees engage in such misconduct. Theories that impose corporate criminal liability by focusing only on the individual wrongdoer's conduct (the "bad apple") ignore the effect that the organizational culture (the "bad barrel") can have.[120] Moreover, theories that focus on the actions of one individual fail to recognize that organizational wrongdoing cannot be easily traced to one individual's single action. Instead, it is often made up of many small actions by many disconnected individuals that, when aggregated, become unethical or illegal conduct.[121] Similarly, theories that call attention to the formal culture of an organization by, for example, mitigating liability if the

---

Baby Wolverines, 17 REV. BUS. 10, 14-15 (1995).

115. *Id.* at 14.

116. *Id.*

117. *Id.*

118. *Id.* at 15

119. *Id.*

120. Fanto, *supra* note 78, at 7. For example, in 2008, Siemens agreed to pay more than $540 million in corporate criminal fines, stemming from violations of the Foreign Corrupt Practices Act. Beale, *supra* note 22, at 1484. In this case, U.S. investigators concluded that "the use of bribes and kickbacks were not anomalies, but the corporation's standard operating procedure and part of its business strategy." Beale, *supra* note 22, at 1484 (internal footnote omitted).

121. Fanto, *supra* note 78, at 26 ("[O]rganizational misconduct may also not be easily traceable to one bad act; rather, it is made up of small decisions or actions that may be at first ethically or legally equivocal and that are the bases for later decisions or actions that eventually and cumulatively are clearly unethical and illegal.").

corporation has formal policies in place to deter such conduct, fail to recognize the primacy of the informal culture. The corporate ethos theory addresses those shortfalls.

As stated above, the corporate ethos model imposes criminal liability when the corporate culture has encouraged criminal behavior. Bucy identifies six factors that are relevant when analyzing the corporate ethos of a given corporation.[122] The first aspect of corporate culture that is relevant to identifying the corporate ethos is its hierarchy.[123] This aspect recognizes the role that leaders play in shaping both formal and informal culture, and focuses on how the actions of leaders might encourage misconduct. In a strong organizational culture, the leader should pay attention to the culture of the corporation. This means, among other things, that the leader should discuss unethical behavior by employees, punish such behavior, and outline a plan to minimize the likelihood that such behavior will occur again.[124]

Second, the corporate ethos is shaped by corporate goals.[125] Recall what we know about obedience and the effect of goal-driven behavior.[126] When tasked with meeting certain goals, and informed that the method of achieving them is unimportant, people are likely to reach goals by any means possible. As illustrated by considering British Petroleum (BP) prior to the Deepwater Horizon spill, one can get a sense of what a business is really about by examining its goals. Although BP's CEO Tony Hayward publicly declared his company's safety-first stance, he made cost-cutting a primary corporate goal and slashed budgets.[127] Practically speaking, BP's increased safety measures were incompatible with its cost-cutting goals.[128] Despite this example, it is possible for a corporation to set meaningful

122. *See generally* Bucy, *supra* note 16, at 1128-46 (identifying six factors).

123. Skupski, *supra* note 26, at 289; Bucy, *supra* note 16, at 1128-29; *see also* Kircher, *supra* note 19, at 172 (explaining that a corporation's policies, compensation structure, and treatment of past offenses are factors used to determine the organization's corporate ethos).

124. Bucy, *supra* note 42, at 1449-51.

125. Bucy, *supra* note 16, at 1133 (recommending examining corporate goals to determine "whether the goals set by the corporation . . . promote lawful behavior or are so unrealistic that they encourage illegal behavior.").

126. *See* Milgram, *supra* note 97, at 376-78 (discussing the "sheer strength" of obedience as demonstrated by subjects participating in a psychological study); Dallas, *supra* note 99, at 34-35 (concluding that outcome-based reward systems are less likely than behavior-based systems to be associated with ethical decision-making); *supra* note 97 and accompanying text (emphasizing the extent to which people are obedient, especially in group settings); *supra* text note 99 and accompanying text (explaining the likelihood that reward systems that ignore how goals are achieved contribute to unethical behavior).

127. STANLEY REED & ALISON FITZGERALD, IN TOO DEEP: BP AND THE DRILLING RACE THAT TOOK IT DOWN 142 (2011) (noting that "Hayward paired his stress on safety with a brutal cost-cutting drive.").

128. ABRAHM LUSTGARTEN, RUN TO FAILURE: BP AND THE MAKING OF THE DEEPWATER HORIZON DISASTER 69-81 (2012); REED & FITZGERALD, *supra* note 127, at 137-73.

compliance goals and tie executive compensation to achieving them.[129]

How corporations train their employees regarding legal requirements is a third factor relevant in assessing corporate ethos.[130] It is important to note what steps the corporation has taken in educating its employees about such requirements and ethical expectations.[131] This includes whether a company has adopted mission statements, corporate codes of conduct, or specific training initiatives, and if these policies are consistent with its informal, and formal, cultures. Are these efforts engrained in the fiber of the corporation or mere posturing?[132] Making this determination is difficult and requires attention to other factors, including a corporation's use of monitoring mechanisms and other preventative measures.[133]

A fourth factor to consider in analyzing corporate ethos is how the corporation responded to allegations of criminal behavior in the past.[134] How seriously did corporate officials investigate previous claims? Indifference or denial can be a sign that misconduct has been recklessly tolerated previously. In addition, how corporate leaders have responded to prior allegations of misconduct is telling. Returning to the BP example, the year before the Deepwater Horizon spill, the corporation faced problems in Prudhoe Bay, Alaska, and at their Texas City oil refinery.[135] Arguably, both problems were exacerbated if not caused by BP's extreme focus on cost-cutting.[136] However, even after both the Prudhoe Bay oil spill and the Texas City oil refinery explosions, no changes were made.[137] This spoke volumes about BP's corporate ethos, and communicated to employees that regardless of what leaders claimed regarding safety, cost-cutting was their priority. Similarly, it is well known that before the mismanagement that eventually forced Enron into bankruptcy, the company had faced several instances of misconduct, most notably the Valhalla affair.[138] In the wake of

129. *See, e.g.*, Bucy, *supra* note 42, at 1448 (suggesting that "directors' and officers' compensation should reflect, in part, the achievement of particular compliance goals.").

130. Bucy, *supra* note 16, at 1134-35.

131. Badarraco & Webb, *supra* note 109, at 23-25 (concluding that corporate codes and training programs are useful elements of formal culture, but insufficient if they are not complemented by actions that reflect the informal culture). *Cf.* Kennedy, *supra* note 114, at 10-11 (arguing that despite good intentions, corporate codes are often minimalist, public relations stunts, and unsuccessful but acknowledging that ethics statements have some value).

132. Kennedy, *supra* note 114, at 11.

133. Kircher, *supra* note 19, at 172-73; Skupski, *supra* note 26, at 290.

134. Bucy, *supra* 16, at 1138.

135. REED & FITZGERALD, *supra* note 127, at 114.

136. *Id.* at 123.

137. LUSTGARTEN, *supra* note 128, at 278-79; REED & FITZGERALD, *supra* note 127 at 118-25.

138. BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE

that incident, however, no one was punished or fired.[139] It is easy to imagine how employees interpreted Kenneth Lay's response to the fraud, especially to the announcement that the wrongdoers "made too much money to let them go."[140]

A fifth factor to use in examining corporate ethos is a company's compensation scheme, and especially, what the company rewards and punishes.[141] Not only do people act in ways that seek reward and avoid punishment, they watch how others' behavior is received.[142] Finally, an additional consideration in evaluating corporate ethos is the breadth of a business's indemnification policies.[143]

The corporate ethos model is not without its critics. Corporate ethos has been called imprecise because it provides a list of relevant factors, but fails to offer any guidance on how to weigh these factors in determining liability.[144] It also has been suggested that corporate ethos fails to establish at what point the corporate culture encouraged employee misconduct to a degree sufficient to impose criminal liability.[145] Finally, critics have suggested that if the corporate ethos model were adopted, the mens rea requirement would be all but eliminated.[146] A potential consequence of this change could include imposition of liability on corporations where individual actors did not realize that their seemingly innocent actions, coupled with those of other employees, contributed to the commission of a crime.[147]

Nevertheless, we believe that the corporate ethos model is preferable to respondeat superior, because it better fulfills the public policy objectives

AMAZING RISE AND SCANDALOUS FALL OF ENRON 15-17 (2003).

139. *Id.*

140. *Id.* at 21-24.

141. Bucy, *supra* note 16, at 1139.

142. TREVIÑO & NELSON, *supra* note 96, at 260-61.

143. Bucy, *supra* note 16, at 1140-46.

144. Skupski, *supra* note 26, at 300 ("[I]t fails to provide sufficiently concrete and predictable guidance as to how the variables contributing to an ethos are weighed in making the liability determination.").

145. Skupski, *supra* note 26, at 300 ("More importantly, it fails to clarify the appropriate threshold beyond which it may be said that those variables actually encourage specific criminal violations requiring various mens rea for conviction, and how this threshold correlates with the mens rea in the statute at issue.").

146. William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647, 673 (1994) (arguing that corporate ethos and similar models "are models of organizational liability, rather than culpability . . . ."). We would suggest that adopting the corporate ethos model does not eliminate the mens rea requirement, but instead shifts the focus from the mind of the individual to the mind of the corporation.

147. Kircher, *supra* note 19, at 171-72. By contrast, corporate ethos would prevent a corporation from escaping liability where its culture encourages misconduct even if no one individual can be deemed criminally responsible. Kircher, *supra* note 19, at 172.

of criminal law. Under corporate ethos, criminal liability promotes the goal of retribution, as it is based on the corporate actor's conduct and blameworthiness.[148] Liability is imposed where there is consensus that a corporate culture evidences a corporate character that deserves punishment and scorn. In addition, by distinguishing between formal and informal culture, corporate ethos provides incentives for corporations to adopt and enforce effective compliance programs, thereby serving a general deterrent function.[149]

Moreover, the corporate ethos model is not under or over-inclusive. One of the major criticisms of criminal liability under respondeat superior is that a corporation can be liable despite its reasonable efforts to deter criminal conduct by its agents.[150] As a result, under respondeat superior, there is little a corporation can do to protect itself from the consequences of a rogue employee's actions. Imposing liability in such cases fails to deter or punish. It does not inhibit similar conduct because the company was never in the position to prevent the original incident. In addition, punishing a corporation for the acts of a rogue employee cannot deter similar violations at other companies, as they are equally powerless to control such actors. Indeed, punishing a corporation that has done all it could to prevent misconduct violates the basic tenet of criminal law, of punishing the reprehensible. Respondeat superior's exclusive focus on the individual actor means corporations are punished whenever their employees commit a crime within the scope of their employment, regardless of a company's sincere efforts to prevent such actions. The corporate ethos model, in contrast, would absolve a corporation of any criminal liability for the actions of a rogue employee.

Respondeat superior has been criticized as being under-inclusive because if a specific employee who has committed an illegal act cannot be found, the corporation escapes liability.[151] By focusing on the isolated

148. Corporate ethos shifts the focus from the wrongful conduct of an individual to the culpable conduct of the organization as evidenced by its culture. Under this theory, "individual acts should only be considered relevant insofar as they express a certain kind of organizational attitude that makes it possible for us to attribute responsibility to the corporation." Diez, *supra* note 81, at 81. Imposition of criminal liability thereby "'sends the message' that people matter more than profits and reaffirms the value of those who were sacrificed to 'corporate greed.'" Kahan, *supra* note 18, at 619.

149. Vu, *supra* note 49, at 489 ("It follows, from the economic axiom that corporations seek to maximize profit, that only with monetary liability for the actions of its employees does the corporation incur any incentive to use its position to prevent employee crime."). Stacy Neumann Vu argues how, considering the marginal cost to a corporation of preventing or forgoing crime, imposition of criminal liability can serve as an effective deterrent. Vu, *supra* note 49, at 489-90.

150. *See supra* text accompanying notes 71-73.

151. *See supra* notes 74-76 and accompanying text.

wrongdoer, respondeat superior fails to recognize corporate culture's influence on individual conduct. In contrast, the corporate ethos model addresses this concern.

Finally, it should be noted that traditionally, corporate culture is considered only during sentencing.[152] Restricting evidence of corporate culture to this late stage in a proceeding, results in over-inclusive convictions. Many scholars have proposed that corporate defenders should be able to present evidence of an effective compliance program as a defense to a criminal charge.[153] For practical purposes, there might be little difference (except for burden of proof issues) between basing the *prima facie* case upon a showing of an organizational culture that encouraged illegal activity, and allowing a corporation to use a culture that fosters legal behavior as an affirmative defense.

II. CREDIT RATING AGENCIES, THE GLOBAL FINANCIAL CRISIS AND THE LIMITS OF EXISTING REGULATION[154]

CRA behavior prior to the GFC illustrates respondeat superior's inadequacies in addressing corporate criminal behavior. In Part II, we will highlight the weaknesses of the existing regulation of CRAs, including enhanced civil liability, and the important role that criminal liability can play in improving current policy. CRAs provide valuable information that can enhance investors' decision-making and redress the knowledge asymmetry inherent in investment choices. Because CRAs are charged with using their expertise to protect the public as well as investors, they have an obligation to ensure the accuracy of the ratings they assign. Unfortunately, there is substantial evidence that prior to the GFC, CRAs failed to fulfill this duty, and instead played an instrumental role in allowing the GFC to unfold.

In many ways, the GFC began with a housing boom. Low interest rates, especially interest rates that were low in the early years of adjustable rate mortgages, lead to an increased demand for housing and to an

152. *See supra* text accompanying note 64.

153. *See, e.g.*, Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save its Soul?*, 47 RUTGERS L. REV. 605, 676-78 (1995) (arguing that a corporation's comprehensive compliance program should be a defense to criminal liability as it is consistent with the principle that punishment requires proof of intent, and ultimately would benefit the corporate community and general public).

154. Part II, *supra* notes 155-204 and accompanying text, relies in large part on an an a prior article that discusses the problems associated with attaching civil liability to CRAs. *See* Ellis et al., *supra* note 12. We would like to thank both Professors D'Souza and Fairchild for their work and words.

unprecedented appreciation in home prices.[155] Most importantly, mortgages on homes were securitized.[156] This means that they were bundled, placed in special purpose vehicles (SPVs), and sold as CDOs with the mortgages as collateral.[157] More importantly, this meant that the originators who created the mortgages did not bear the risk of default. This created pressure to issue more mortgages[158] and resulted in mortgages being extended to people who otherwise would not have qualified.[159]

155. Much of this analysis has been outlined in previous work. *See generally* Ellis, Fairchild & D'Souza, *supra* note 11 (analyzing the conflicts of interest inherent in the CRA model and how those conflicts incentivized inaccurate ratings that contributed to the GFC); Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 43-44 (2009) (discussing the incentives for a "quick payday" resulting in a structure that valued the number of mortgages closed, rather than borrowers' ability to repay borrowed funds).

156. *See* Dennis, *supra* note 7, at 1118-22 (tracing the development of mortgage-backed securities and the riskier private market for these securities that evolved outside of the constraints imposed by government-sponsored enterprises); *see also* Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It,* 2009 U. ILL. L. REV. 1359, 1364-68 (2009) (describing the history and growth of the asset-backed securities market, including mortgage-backed securities). The practice of securitization became so prevalent that over two-thirds of all mortgages were securitized in 2005. Nicole B. Neuman, *A "Sarbanes-Oxley" for Credit Rating Agencies?: A Comparison of the Roles Auditors' and Credit Rating Agencies' Conflicts of Interests Played in Recent Financial Crises*, 12 U. PA. J. BUS. L. 921, 924 (2010). This contrasts with less than twenty percent of mortgages that were securitized in 1999. Neuman, *supra* at 924.

157. Moran, *supra* note 155, at 33-34; Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1022 (2007); *see also*, Lynch, *supra* note 11, at 232 (describing the assistance of mortgage-backed securities and collateralized debt obligations in slowing down the economy due to their complex structure).

158. Damon Silvers & Heather Slavkin, *The Legacy of Deregulation and the Financial Crisis—Linkages Between Deregulation in Labor Markets, Housing Finance Markets, and the Broader Financial Markets*, 4 J. BUS. & TECH. L. 301, 303 (2009). As MBSs were repackaged for more than their underlying value, there was additional pressure to both originate new mortgages, and to create and sell additional derivatives. Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585, 590 (2010) ("[W]ith someone to sell the loans to, lenders discovered a new enthusiasm for making them."); Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis*, *supra* note 4, at 5 ("These transactions, too, persisted over time, so much so that the appetite for second-level mortgage securitizations drove financial intermediaries both to originate new and increasingly risky mortgages, and to create synthetic exposure to mortgages, which then could be resecuritized through tranched special purpose entities, again at higher prices than the underlying mortgage-backed securities were trading in the market.").

159. Mortgage originators became lax with respect to credit checks of applicants, and loans were often extended without verifying an applicant's income, employment, or assets. John C. Coffee, Jr., *What Went Wrong? A Tragedy in Three Acts*, 6 U. ST. THOMAS L. J. 403, 406 (2009) ("[S]ecuritization led to lax screening by the loan originator."). The no doc

Because the purchasers of these securities lacked information about the underlying assets, their marketability was wholly dependent upon the rating assigned by CRAs.[160] For example, investors knew nothing about

loans often led to fraudulent loan applications, some of which were termed "'liar' loans." Mendales, *supra* note 156, at 1394-95 (quoting *In re* Hill, No. 07-41137, 2008 WL 2227359 at *5 (Bankr. N.D. Cal. May 23, 2008). Moreover, the numbers of such loans grew. Darcy, *supra* note 11, at 614-15 ("In 2001, 28.5% of subprime borrowers could not verify information about employment, income, or other credit-related data. This figure increased to nearly 51% in 2006.") (internal footnotes omitted). Subprime lending became the norm. Michel G. Crouhy, Robert A. Jarrow & Stuart M. Turnbull, *The Subprime Credit Crisis of 07* 4 (Working Paper, 2008), *available at* http://ssrn.com/abstract=1112467 ("By 2006, subprime mortgages represented 13% of all outstanding mortgage loans with origination of subprime mortgages representing 20% of new residential mortgages compared to the historical average of approximately 8%."). The origination-securitization frenzy sparked the classic asset price bubble, which caused credit standards to ease as lenders became "less concerned about the ability of the borrowers to repay loans and instead rely on further appreciation of the asset to shield themselves from losses." Unterman, *supra* note 8, at 54 (quoting Frederic S. Mishkin, *How should we respond to asset price bubbles*, FEDERAL RESERVE, May 15, 2008, *available at* http://www.federalreserve.gov/newsevents/speech/miskiin20080515a.htm); *see also* Matthews, *supra* note 7, at 251 ("[S]ecuritization encouraged origination volume over quality . . . ."); Mendales, *supra* note 156, at 1393 ("This led to a vicious circle like those seen in prior bubbles, in which the greater availability of mortgages increased the demand for homes, pushing up the prices at which they were sold and in turn pushing up the amounts lent to their purchasers."); Brooke A. Murphy, *Credit Rating Immunity? How the Hands-Off Approach Toward Credit Rating Agencies Led to the Subprime Credit Crisis and the Need for Greater Accountability*, 62 OKLA. L. REV. 735, 739 (2010) ("In an attempt to keep up with the high demand for RMBSs, mortgage lenders began implementing increasingly unsound lending practices, which allowed more people to qualify for home mortgages, thereby generating more mortgages and RMBSs."); David Schmudde, *Responding to the Subprime Mess: The New Regulatory Landscape*, 14 FORDHAM J. CORP. & FIN. L. 709, 712 (2009) (characterizing this as a typical bubble, like a Ponzi scheme in which "nobody gets hurt" as the bubble is forming, followed by the "necessary reckoning – the collapse of prices.").

160. *See* Coffee, *supra* note 159, at 409 ("In overview, investment banks bought unsound loans because they knew they could securitize them on a global basis if – and only if – they could obtain investment-grade ratings from major credit rating agencies. Without that rating, the debt was unmarketable."); White, *supra* note 3, at 13 ("And crucial to the ability of these packages to sell the securities was the process of obtaining favorable ratings on the securities."). Ratings are particularly important in the case of structured financial transactions such as those discussed here. Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 49 (2004)("[A] structured finance transaction will almost never go forward unless some of the securities sold in the transaction achieve a high investment grade rating."); Matthews, *supra* note 7, at 250 ("With respect to structured finance issuances, however, the CRA rating takes on a gatekeeper role akin to audits and analyses performed in connection with equity financings because informational asymmetry hampers an investor's effective evaluation of underlying mortgage pools."). Due to the importance of credit ratings to structured finance products, Frank Partnoy has concluded that "the agencies have become more like 'gate openers' than gatekeepers." Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers* 60 (U. San Diego Sch. of Law, Research Paper No. 07-46, 2006), *available at* http;//ssrn.com/abstract=900257.

the quality of the underlying assets, had no way to obtain that information and were therefore unable to evaluate the likelihood of default of the mortgages within the pool.[161] Therefore, investors' only option was to rely on the CRA's assessment of the credit risk of the investment.[162] Moreover, the complexity of the derivatives made it difficult for even sophisticated investors to properly assess their credit risk.[163]

Had CRA analysis accurately reflected the riskiness of these CDOs and rated them accordingly, this would have prevented the bubble from expanding. Instead, CRAs rated them highly, even those largely comprised of subprime mortgages.[164] Much of the criticism surrounding CRA performance has centered on the statistical models used to measure the

161. Crouhy, et al., *supra* note 159, at 9 ("Investors in complex credit products had considerably less information at their disposal to assess the underlying credit quality of the assets they held in their portfolios than the originators."); Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis*, *supra* note 4, at 6 ("Investors typically did not examine the underlying assets of a synthetic CDO or SIV in any detail or at all. One might criticize them for not doing so, except that the underlying assets were frequently not even specified when the deal was sold."). CalPers has alleged in its lawsuit that "Other than the Rating Agencies' evaluation and subsequent credit rating of an SIV, an investor had no access to any information upon which to base a judgment of a SIV's creditworthiness." CalPers Complaint, *supra* note 1, at ¶ 19. Jerome S. Fons, former Managing Director at Moody's, explains, "[i]nvestors rely on agency ratings when making purchase decisions because of the opacity . . . . Moreover, the tools to analyze credit risk, even with transparent assets, are beyond the grasp of many investors." Jerome S. Fons, WHITE PAPER ON RATING COMPETITION AND STRUCTURED FINANCE 7 (2008), *available at* http://www.fonsrisksolutions.com/Documents/Ratings%20White%20Paper.pdf.

162. *See* Coffee, *supra* note 159, at 404 ("[T]his financial technology depended very heavily on gatekeepers – that is, on professionals that investors trust to do what investors cannot do for themselves."); Lisbeth Freeman, *Who's Guarding the Gate? Credit-Rating Agency Liability as "Control Persons" in the Subprime Credit Crisis*, 33 VT. L. REV. 585, 591 (2009) ("Mortgage-backed securities, though, contain special features that distinguish them from conventional investment bonds and make accurate valuation a more difficult task for investment professionals.").

163. Andrew J. Ceresney, Gordon Eng & Sean R. Nuttall, *Regulatory Investigations and the Credit Crisis: The Search for Villains*, 46 AM. CRIM. L. REV. 225, 228 (2009) ("The financial instruments and arrangements at issue in the credit crisis investigations are highly complex."); Hill, *supra* note 158 at 590 ("[T]hese structures are highly complex and, ultimately, not well understood."); Moran, *supra* note 155, at 40 ("[A]s very complex instruments, even the most sophisticated investors sometimes fail to appreciate their risks and substitute the rating supplied by the credit rating agency for the investors' own independent risk analysis.").

164. In many ways, "[t]he essential question . . . is how loans to individuals with poor credit histories (which often originated without credit checks or down-payments) were transformed into investments that the market trusted as being as reliable as government securities." Unterman, *supra* note 8, at 58. John C. Coffee, Jr. opines that "the true mystery here is not why loan originators made unsound loans, but why investment banks bought them." Coffee, *supra* note 159, at 408. This can be attributed to the favorable ratings assigned by the CRAs to CDOs and other asset-backed securities.

likelihood of default in each tranche.[165] Unfortunately, CRAs issued these ratings relying on historical default and recovery data even when the pool consisted of newly issued mortgages with no payment history.[166] In addition, CRA models were based on optimistic assumptions regarding the continued appreciation of housing prices and borrower defaults.[167] The models were not modified as housing and credit market conditions changed

165. The SPV was typically divided into three tranches. John Crawford, *Hitting the Sweet Spot by Accident: How Recent Lower Court Cases Help Realign Incentives in the Credit Rating Industry*, 42 CONN. L. REV. 13, 16 (2009); Lynch, *supra* note 11, at 264. Arguably, the use of quantitative models is more important in the rating of structured financial products than in the case of corporate debt ratings. Crouhy, et al., *supra* note 159, at 28 ("[T]he rating of CDO tranches relies heavily on quantitative models while corporate debt ratings rely essentially on the analyst judgment.").

166. *See The Financial Crisis and the Role of Federal Regulators: Hearing before the Comm. of Gov't Oversight and Reform*, 110th Cong. 3-4 (2008) (statement of Alan Greenspan, Former Chairman, Federal Reserve) ("The whole intellectual edifice [underpinning the advances in derivatives markets] . . . collapsed in the summer of last year because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria. Instead the model has been fitted more appropriately to historic periods of stress, capital requirements would have been much higher and the financial world would be in far better shape today . . . ."); Dennis, *supra* note 7, at 1123-25 (discussing problems with relying on historical data to rate MBSs comprised of subprime mortgage pools); Lupica, *supra* note 6, at 659 ("[T]he mathematical models commonly used reflected risk based on short-term, rather than long-term historical data."); Murphy, *supra* note 159, at 747-48 ("[M]any of the risk assumptions made by the NRSROs were based on historical records rather than current data. The NRSROs' models, therefore, did not sufficiently account for the riskier form of loans that were being generated, such as adjustable rate loans and 'no income, no asset' loans.") (internal footnotes omitted); Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, *supra* note 4, at 4 ("[I]n the early 2000s, rating agency models, and assumptions about historical default, recovery, and correlation, suggested that extant mortgage-backed securities could be repackaged and resold in ways that would outperform, not only the mortgage-backed securities themselves, but other comparably rated securities."); *see also* Darcy, *supra* note 11, at 636-37 (discussing the fact that subprime mortgage loans performed strongly between 2001 and 2005.). Therefore, models that relied on historical data underestimated the risk of default. Relying on historical data resulted in a failure to differentiate between times of housing appreciation as compared with depreciation. In times of housing appreciation, borrowers who could not pay simply sold their houses rather than defaulting, making resulting default rates a bad predictor of default during a period of housing depreciation.

167. Crawford, *supra* note 165, at 16 ("In hindsight, the rating agencies fed the models unrealistically optimistic assumptions about continuing house price appreciation, the probability of borrower defaults, and correlations among defaults.") (internal footnotes omitted); Murphy, *supra* note 159 at 747 (quoting *The Role and Impact of Credit Rating Agencies on the Subprime Credit Markets: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 74, 77 (2007) (prepared statement of Michael Kanef, Group Managing Director, Moody's Investors Service) ("[T]he models used did not address basic and crucial issues related 'to the investment decision process, including the price, term, likelihood of prepayment, liquidity risk or relative valuation of particular securities.'")).

significantly.[168] In fact, even as the GFC began, CRAs failed to promptly downgrade the ratings of troubled securities.[169] Moreover, the CRAs often failed to conduct any independent due diligence, instead relying on the information provided to them by the issuers.[170] Since the complexity of the CDOs being issued made them difficult to understand, the CRAs often were unable to judge the value of the investment.[171] This meant that as the instruments' complexity increased, the financial sophistication needed to accurately rate them also increased, and some CRA analysts simply lacked the expertise needed to properly do so.[172] In addition, there is evidence that

168. Dennis, *supra* note 7, at 1123-26; Mendales, *supra* note 133, at 1380; Moran, *supra* note 155, at 48-50. In fact, as housing prices began to fall and the models used to rate the MBSs did not reflect this decline, securitization became more attractive. Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, *supra* note 4, at 7:

Paradoxically, when housing prices began to fall but ratings on first-level securitizations did not, the historical rating methodology made second-level securitizations increasingly attractive. If one could buy AAA-rated mortgage-backed securities that had fallen in price, but still use the same historical default, recovery, and correlation assumptions associated with AAA ratings in the relevant model, one could create a highly rated, high-yielding set of second-level transactions.

169. Ceresney, et al., *supra* note 163, at 265 (The CRAs "were too slow in correcting the excessively high ratings that had been placed on many cases of bonds backed by subprime mortgages during the housing boom.") (internal footnote omitted); Krebs, *supra* note 5, at 137 (noting that "in the ensuing economic downturn, the agencies failed to promptly downgrade troubled securities' ratings and companies' ratings . . . .") (internal footnote omitted).

170. Lupica, *supra* note 6, at 656 ("Rating agencies have been criticized for not conducting independent diligence in connection with their structured securities rating analysis.") (internal footnote omitted); Moran, *supra* note 155, at 49 (discussing CRA claims that they had no responsibility to evaluate the quality of the bundled mortgages). For example, CRAs failed to even check for the adequate documentation of each mortgage. There is some evidence that the issuers actually refused to provide the requested relevant data. For example, one Moody analyst reported asking for the data necessary to assess the creditworthiness of underlying mortgages and being told, "[a]ny request for loan level tapes is TOTALLY UNREASONABLE!!!" Hill, *supra* note 158 at 592 (internal footnote omitted); *see also* Ceresney, et al., *supra* note 163, at 265 ("[I]ndustry practice was to give the rating agencies only limited information, while the most detailed date concerning loan pools were not disclosed.") (internal footnote omitted); Class Action Complaint at 1, First Nat'l Bank & Trust Co. of Rochelle Ill. v. McGraw-Hill Co., Inc., No. 13CH16154 (Cir. Ct. of Cook County, Ill. July 3, 2013) [hereinafter First Nat'l Complaint], *available at* http://www.talcottfranklin.com/wordpress/wp-content/uploads/2013/07/FNB.pdf (quoting a statement by the Senior Managing Director at Moody's that it is the issuer's job to verify the accuracy of the information furnished to the CRAs).

171. Lupica, *supra* note 6, at 649 ("A central failing of the market is directly tied to the 'too-clever-by-half' structure of many of these complex transactions: few truly understood these transactions, the nature of the investments being sold, and how to evaluate the risk associated with the underlying assets." (quoting *Chain of Fools*, THE ECONOMIST, Feb. 9th-15th , 2008, at 84)); Moran, *supra* note 155, at 40 ("The complexity of CDOs often rendered them opaque even to the credit rating agencies, making the ratings suspect.").

172. *See, e.g.*, Hill, *supra* note 160, at 81 ("[T]he rating agencies' level of financial

CRAs were inadequately staffed especially given the increased business that resulted from the housing bubble[173]

It is unclear exactly why the CRAs failed to accurately rate these CDOs. Some have argued that they relied too heavily on their models and failed to take relevant subjective factors into consideration.[174] It is hard to accept the argument that CRAs exhibited "plain bad judgment"[175] in light of evidence that they actually lowered loss estimates in some instances and issued higher ratings than were justified even by their own models.[176] Some have argued that they were influenced by the fact that issuing firms in some instances were paying the CRA a separate feel to design the securities they would eventually rate.[177]

---

sophistication did not rise with the level of things about which they had to become sophisticated . . . .").

173. Mendales, *supra* note 156, at 1380 ("[I]n the increasing frenzy of the housing bubble, credit analysts at the rating agencies cut more corners as the volume of issues exceeded their capacity to examine offerings presented to them for analysis."). The SEC Summary Report concludes that ratings were issued in spite of inadequate staffing, who in many cases lacked the expertise to deal with the complexity of the structured financial instruments being rated; models that admittedly did not capture risk well. SEC, SUMMARY REPORT OF THE ISSUES IDENTIFIED IN THE COMMISSION STAFF'S EXAMINATIONS OF SELECT CREDIT RATING AGENCIES (2008) at 12, *available at* http://www.sec.gov/news/studies/2008/craexamination070808.pdf [hereinafter Summary Report].

174. Lupica, *supra* note 6, at 661 ("[R]eliance on 'math' to the exclusion of consideration of subjective factors impacting credit quality such as the issuer's management quality, competitive market position, financial policy, capital structure, cash flow protection, accounting practices, and the general economic environment led to inaccurate conclusions about levels of risk. Analysts cast aside their judgment in favor of the illusion of an objective risk numerical." (internal footnotes omitted)).

175. Ceresney, et al., *supra* note 163, at 228 ("In many of the areas being investigated, there simply may not have been intentional misconduct or criminally reckless behavior, but rather plain bad judgment on the part of market actors.").

176. Dennis, *supra* note 7, at 1138 (describing an SEC report which found "that one agency regularly lowered the loss estimates that were indicated by their statistical models and did not disclose this practice.") (internal footnote omitted)

177. Michael C. Ehrhardt & Eugene F. Brigham stated:

> Rating agencies were paid to investigate the details of each bond and to assign a rating which reflected the security's risk. The securitizing firms paid the rating agencies to do the ratings. For example, Lehman Brothers hired Moody's to rate some of their CDOs. Indeed, the investment banks would actually pay for advice from the rating agencies as they were designing the securities. The rating and consulting activities were extremely lucrative for the agencies, which ignored the obvious conflict of interest: The investment bank wanted a high rating, the rating agency got paid to help design securities that would qualify for a high rating, and high ratings led to continued business for the raters.

Given the pivotal role that CRAs play in assuring the smooth functioning of credit markets, one might expect that they would be subject to significant regulation. The opposite is, in fact, true. Historically, CRAs have been largely self-regulated. [178] Under the reputational capital theory, it is thought that an agency's interest in maintaining a reputation for issuing accurate ratings is a sufficient incentive to ensure reliable ratings.[179] Hence, regulation is unnecessary becasuse CRAs are motivated to provide accurate ratings gain the economic benefit that results from a reputation for accuracy.[180]

Largely because of this belief, CRAs continued to be unregulated until

Michael C. Ehrhardt & Eugene F. Brigham, CORPORATE FINANCE: A FOCUSED APPROACH 40 (4th ed. 2009); Coffee, *supra* note 159 at 410 ("These investment banks are repeat players, who also hire the rating agency as their consultant to teach them the rating agency's own methodology and thus help them design a product that can get an investment-grade rating."); Krebs, *supra* note 5, at 139 ("[T]he rating companies profited by advising issuers on how to squeeze the most profit out of these securities by maximizing the ratings on tranches."); Lynch, *supra* note 11, at 280 ("[I]ssuers typically consulted and worked directly with the credit rating analysts to find out how their MBSs and other asset backed securities could be structured to obtain the highest rating for the largest possible pieces of the asset pool . . . ."); Murphy, *supra* note 159 at 746 (describing how the "issuer is then given an opportunity to restructure the subordination scheme of the RMBS in order for the highest tranche to receive the most elevated rating. In restructuring the RMBS, the NRSRO actively advises the issuers regarding which structure and which credit enhancements will yield the highest rating."); *see also* Partnoy & Skeel, *supra* note 157, at 1044 ("The process of rating CDOs becomes a mathematical game that smart bankers know they win. A person who understands the details of the model can tweak the inputs, assumptions, and underlying assets to produce a CDO that appears to add value, when in reality it does not.").

178. The industry relies largely on self-regulation. Amadou N.R. Sy, *The Systemic Regulation of Credit Rating Agencies and Rated Markets* 6 (Int'l Monetary Fund, Working Paper WP/09/129, 2009) *available at* www.imf.org/external/pubs/ft/wp/2009/wp09129.pdf.

179. Dennis, *supra* note 7, at 1114 ("The dominant view concerning regulation of the rating agencies is based upon the 'reputational-capital' theory, which holds that an agency's success is primarily a result of the agency's track record in issuing accurate ratings."); Krebs, *supra* note 5, at 134 ("This is due to the thought that any resulting reputational damage from non-neutral opinions would severely damage long-term profitability, in exchange for mere short-term profits."). Rating agencies are thought to "prosper based on their ability to acquire and retain reputational capital" and trust. Frank Partnoy, *The Paradox of Credit Ratings* 4 (U. of San Diego Sch. Of Law, Research Paper No. 20, 2001) *available at* http://papers.ssrn.com/abstract=285162. According to Frank Partnoy, in order for a credit rating to be credible to third parties, the CRA must have reputational capital at stake. Partnoy, *Overdependence on Credit Ratings was a Primary Cause of the Crisis*, *supra* note 4, at 2 ("In other words, the certifying agent credibly must be able to pledge that it will suffer a loss, related either to litigation or declining reputation, if its certification is systematically biased or false.").

180. Rousseau, *supra* note 3, at 637-38 ("If a CRA has a reputation for erratic or biased analysis, investors will discount the value of the ratings assigned. If investors doubt the accuracy or independence of the ratings of a particular CRA, issuers will seek a more credible agency to signal their creditworthiness.").

the passage of the Credit Rating Agency Reform Act of 2006 (CRARA).[181] The CRARA provides limited regulation. Its primary focus was to increase competition among CRAs,[182] address potential conflicts of interest, and encourage transparency and disclosure.[183] Under the CRARA a CRA can become a Nationally Recognized Statistical Rating Organization (NRSRO). NRSROs are required to disclose the general methods they use for rating as part of the registration process, but are subject to little monitoring.[184] Moreover, the CRARA does not require that a CRA employ credible performance measurement models or methodologies.[185]

A. Statutory Liability

In instances of limited degree of nature of regulatory oversight, it is

181. 15 U.S.C.A. § 78o-7 (2006); Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1674 (2008) ("[I]n 2006 federal legislation imposed a small measure of regulatory oversight on rating agencies, which until then were essentially unregulated."); Mendales, *supra* note 156, at 1375 ("[T]he rating agencies . . . were largely unregulated until 2006 . . . .").

182. *See* Claire A. Hill, *Rating Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145, 1146 (2003) (arguing that the credit rating industry is a highly concentrated oligopoly, and that three main competitors dominate the global marketplace by controlling ninety-eight percent of total ratings assigned worldwide – Moody's, Standard & Poor's and Fitch.); *see also* Krebs, *supra* note 5, at 136 ("Moody's and S. & P. are the largest, with each respectively owning about forty percent of the credit rating markets."); Caitlin M. Mulligan, *From AAA to F: How the Credit Rating Agencies Failed America and What can be Done to Protect Investors*, 50 B.C. L. REV. 1275, 1279 (2009 asserting that the "Big Three" credit rating agencies issue ninety-eight percent of the total ratings) (citation omitted).

183. Barbara Black, *Protecting the Retail Investor in an Age of Financial Uncertainty*, 35 U. DAYTON L. REV. 61, 69 (2009) ("CRARA is a modest piece of legislation that seeks to solve these intractable problems through increased competition and disclosure."); Mendy Piekarski, *Rating Agency Accountability*, 27 REV. BANKING & FIN. L. 272, 278-80 (2008) (discussing the purpose of the then draft version of CRARA and the proposed disclosure requirements); *see also* Freeman, *supra* note 162, at 599 (2009) (maintaining that the CRARA was enacted, at least in part, in response to concerns about CRA failures in accurately rating and downgrading Enron.).

184. *See* Hill, *supra* note 160, at 44 ("Favorable treatment for securities highly rated by NRSROs is the principal feature of the regulatory regime; the NRSROs themselves are not subject to substantive monitoring."); *see also* Mendales, *supra* note 156, at 1386 ("CRARA requires an agency to discuss its general methods and procedures in its registration application, but does not require it to disclose the data underlying its statistical models or other aspects of its methodology as applied to individual securities being rated.").

185. *See* Lynch, *supra* note 11, at 268 (arguing that CRAs are not required to disclose the data underlying the statistical models employed or other facts relevant to the methodology adopted to rate the CDOs, and noting that the CRARA actually prohibits the SEC from regulating any aspect of the rating process including the methods used by CRAs to rate securities); *see also*, 15 U.S.C.A. §78o-7(c)(2)(2006) (explaining that neither the Commission or state may regulate procedures and methodologies of credit ratings).

possible for the threat of civil liability to act as an adequate deterrent.[186] Such liability can be premised on statute or on common law liability. In the case of CRAs, however, the threat of civil suit has proven to be equally ineffective in regulating CRAs.[187] In fact, CRAs have been largely protected from liability under securities laws. They were expressly insulated from liability based on Sections 7 and 11 of the 1933 Securities Act because their statements were not considered a part of the registration statement.[188] Therefore, liability can only be imposed on CRAS under securities laws where plaintiffs can prove fraud.[189] Unfortunately, the scienter requirement in a securities fraud case has made it difficult to impose liability in such cases.

Recognizing that CRAs perform essential gatekeeper functions that are "fundamentally commercial in character and should be subject to the same standards of liability and oversight that apply to auditors, securities analysts, and investment bankers,"[190] the newly adopted Dodd-Frank Act made a few significant changes with respect to CRA liability. First, Dodd-Frank provided that CRAs are no longer exempt from Section 11 liability

186. *See* Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 426 (2007) (arguing that the threat of civil liability can incentivize firms to act as effective gatekeepers by "raising the costs of complicity."). *See generally* Maas, *supra* note 35 at 1023 (arguing for the application of targeted criminal law).

187. Dennis, *supra* note 7 at 1140-44 (noting and discussing CRA's ability to "avoid[] liability for inaccurate ratings."); *see also* Kettering, *supra* note 181, at 1688 (indicating one commentator has remarked that in the few cases brought against CRAs, "the only common element . . . is that the rating agencies win."(quoting Partnoy, *supra* note 179, at 19)). *See generally* Gregory Husisian, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*? 75 CORNELL L. REV. 411, 459 (1990) (explaining that the courts rely on the market to fix cases of negligence and potential liability with CRAs, not their own judicial system).

188. Rule 436(g)(1) of the Securities Act of 1933 (repealed 2010), 17 C.F.R. §230.436(g)(1)(2003) ("[T]he security rating assigned to a class of debt securities, a class of convertible debt securities, or a class of preferred stock by a nationally recognized statistical rating organization . . . shall not be considered a part of the registration statement prepared or certified by a person within the meaning of sections 7 and 11 of the Act.").

189. Kettering, *supra* note 181, at 1689. *See also* John Patrick Hunt, *Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement,* 2009 COLUM. BUS. L. REV. 109, 190-95 (2009) (discussing liability for security fraud including various suits stemming from the GFC.)

190. Dodd-Frank, § 931 (3) (2010). This basic premise is clearly set forth in the Statute:

> (1) IN GENERAL. – The enforcement and penalty provisions of this chapter shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws . . . .

Dodd-Frank Act, 15 U.S.C. § 78o-7(m)(1) (2010).

for misstatements in the registration statements. Instead, CRAs would be treated like other experts and face liability for misstatements or omissions in the registration statement. They can overcome this liability by showing that they met their due diligence requirement. An expert can meet its due diligence defense by showing that it "had, after reasonable investigation, reasonable ground to believe and did believe" that there were no misstatements or omissions of material facts in the portions of the registration statement he expertized.[191] Thus, under Dodd-Frank a CRA can avoid liability under Section 11 only by demonstrating that it made a reasonable investigation and that based on that investigation, it had reasonable grounds to believe that its ratings were accurate. [192]

Second, Section 933 of Dodd-Frank specifically addresses CRA liability in its amendment of the state of mind requirement of Section 21D of the Securities Exchange Act of 1934. In securities fraud cases, liability can only be imposed if the plaintiff can prove that the defendant acted with a "particular state of mind."[193] Subsection (2) provides that this state of mind requirement is met when a CRA recklessly or knowingly failed to conduct a reasonable investigation or failed to obtain a reasonable verification of facts provided by third parties.[194]

In spite of the changes imposed by the language of Dodd-Frank, it is unlikely that a CRA will face liabilitly under the securities laws. Section 11 provides that experts have liability only if they consent to have their expert opinions be part of the registration statement.[195] After Dodd-Frank

191. *Id.* § 77k(b)(3)(B)(i).

192. *See generally* William K. Sjostrom, *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 BRANDEIS L. J. 459 (2006) (discussing the reasonable investigation standard, as established by case law and the SEC's adoption of 17 C.F.R. §230.176 (2006)).

193. *See* Dodd Frank Act, 15 U.S.C. § 78u-4(b)(2)(A) (2010)

194. *Id.* § 78u-4(b)(2)(B):

> (B) EXCEPTION. – In the case of an action for money damages brought against a credit rating agency or a controlling person under this title, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity the facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed –
>
> > (i) to conduct a reasonable investigation of the rated security with respect to the faculty elements relied upon by its own methodology for evaluating credit risk; or
> >
> > (ii) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter.

195. Sjostrom, *supra* note 192 at 566.

was enacted, CRAs withheld this permission.[196] The SEC then issued a no-action letter making it clear that CRAs would not be held liable for Section 11 misstatements.[197]

B. Common Law Liability

A number of cases based on common law have been brought against CRAs. As might be expected, some issuers have alleged that CRA ratings were too low and some investors have alleged that the ratings were too high. CRAs have prevailed in most cases for a number of reasons. First, it has been difficult for the plaintiffs to prove the elements necessary for a prima facie case. For example, it is difficult to prove the scienter needed to bring a fraud action, the requisite duty of care to bring a negligence action, privity of contract to bring a contract action,[198] and the reliance necessary to be successful in a fraud or negligent representation case.[199]

196. *See* Benjamin H. Brownlow, *Rating Agency Reform: Preserving the Registered Market for Asset-Backed Securities*, 15 N.C. BANKING INST. 111, 111 (2011) (recounting how Ford Motor Company LLC was unable to find a single NRSRO to provide credit ratings for inclusion in their registration statement); Gretchen Morgenson, *Hey, S.E.C., The Escape Hatch is Still Open*, N.Y. TIMES, Mar. 5, 2001, *available at* http://www.nytimes.com/2011/03/06/business/06gret.html (noting that the CRAs responded to the legislation by not allowing their ratings to be disclosed in asset-backed deals.).

197. *See* Ford Motor Credit Co., SEC No-Action Letter, 2010 WL 2882538, at *1 (Nov. 23, 2010) ("Pending further notice, the Division will not recommend enforcement action to the Commission if an asset-backed issuer . . . omits the ratings disclosure . . . from a prospectus.").

198. A problem facing investors bringing claims against CRAs for negligence involves the extent to which the CRA owed investors a duty of care. Similarly, investors suing based on breach of contract have faced lack of privity defenses. In other words, CRAs have successfully argued that investors are not in privity of contract with the CRA and that they are not intended third-party beneficiaries entitled to sue for breach of any contract. *See, e.g.*, Quinn v. McGraw-Hill, 168 F.3d 331 (7th Cir. 1999) (contract between issuer and CRA not intended to benefit investor); First Equity Corp. v. Standard & Poor's Corp., 869 F.2d 175, 179 (2d Cir. 1989) (denying recovery for lack of privity, citing that the court did not want to expose the organization to claims by the entire general public); Jaillet v. Cashman, 189 N.Y.S. 743, 744 (Sup. Ct. 1921) ("There is no privity between this plaintiff and the defendant. He is but one of a public to whom all news is liable to be disseminated."). Moreover, courts have denied liability based on negligent misrepresentation finding the absence of the requisite "special relationship." *See generally* Murphy, *supra* note 159, at 777-79 (discussing the issue of privity).

199. *See* Ellis et al., *supra* note 12, at 183-84 (discussing the problems associated with attaching civil liability to CRAs); *see also* Quinn v. McGraw-Hill, 168 F.3d 331 (7th Cir. 1999) (demonstrating that plaintiffs have found it difficult to prove justifiable reliance). The court in *Quinn* held that investor reliance on the rating was unreasonable, absolving the CRA from liability, and relied on boilerplate language warning the investor that the rating was not a recommendation to buy or sell. *Id.* at 334. Hence, the court found that these statements "should have alerted Quinn to the fact that he was responsible for doing his own homework about the risks he was assuming . . . ." *Id.* at 336. Arguably, this is at least in

Second, even when plaintiffs are able to prove the prima facie case, CRAs have been able to avoid liability by asserting a First Amendment privilege.[200] CRAs have compared themselves to members of the financial press and argued that their function is essentially journalistic in nature. Terming their ratings "the shortest editorial ever written,"[201] they have argued that ratings opinions on matters of public concern and entitled to the First Amendment protection afforded to members of the press.[202] This First Amendment immunity can be overcome only by a showing of actual malice.[203] A number of courts have upheld this argument and the general

part, based on the court's view that ratings are mere opinions. *See* Caleb Deats, *Talk that Isn't Cheap: Does the First Amendment Protect Credit Rating Agencies' Faulty Methodologies from Regulation?*, 110 COLUM. L. REV. 1818, 1834 (2010) ("If the Court expects readers to approach opinions skeptically . . . those who seek to rely on predictive opinions likely must demonstrate a similar skepticism."). *But see* Murphy, *supra* note 159, at 780-82 (arguing that ratings impact the market and, thus, meet the reliance standard).

200. *See* Jefferson Cnty. Sch. Dist. v. Moody's Investor's Servs., Inc., 988 F.Supp. 1341, 1348 (D. Colo. 1997), *aff'd* 175 F.3d 848 (10th Cir. 1999) (discerning that certain claims were not provably false and thus immunized by the First Amendemnt.); *see also* Crawford, *supra* note 164; Freeman, *supra* note 161; Thomas J. Pate, *Triple-A Ratings Stench: May the Credit Rating Agencies be Held Accountable?*, 14 BARRY L. REV. 25, 44 (2010) ("Most of the cases brought against CRAs have failed on the basis of the argument that they are members of the press and that their ratings are protected under the heightened actual malice standard.").

201. The phrase "world's shortest editorial" was coined in a law review note. Husisian, *supra* note 187, at 446

202. *See, e.g.*, Nagy, *supra* note 4, at 141-42 ("Despite harboring enormous influence in all areas of the financial markets, rating agencies have deflected liability for their inaccurate ratings by claiming that their core function is journalism – that they serve to gather and analyze newsworthy financial information and then disseminate opinions about this information to the public."). The Court in *Dun & Bradstreet, Inc., v. Greenmoss Builders, Inc.*, 472 U.S. 749, 784 (1985), explained that the First Amendment creates a privilege applicable to "expression on matters not of public concern." Whether something is deemed to be a matter of public concern "must be determined by the content, form, and context of a given statement . . . " Connick v. Myers, 461 U.S. 138, 147-48 (1983).

203. Under the *New York Times* test, journalists are liable for such false statements only if the statements were made with knowledge of falsity or reckless disregard of the truth (i.e., actual malice). New York Times v. Sullivan, 376 U.S. 254, 279-80 (1964) (defining actual malice as a statement made "with knowledge that it was false or with reckless disregard of whether it was false or not."). The court justified this protection by stating that "erroneous statement is inevitable in free debate, and . . . must be protected if the freedoms of expression are to have the 'breathing' space that they 'need to survive.'" *Id.*, at 271-72; *see also* Murphy, *supra* note 159, at 776-77 (noting that the *New York Times* test was designed to immunize reporters from defamation claims not claims based on negligence, fraud or negligent misrepresentation, i.e., the claims typically asserted against CRAs). *See generally* Crawford, *supra* note 165, at 19 (noting that lawsuits against CRAs are often stymied by the First Amendemnt); Jonathan W. Heggen, *Not Always the World's Shortest Editorial: Why Credit-Rating-Agency Speech is Sometimes Professional Speech*, 96 IOWA L. REV. 1745, 1755 (2011) (observing that CRAs have used the First Amendment as a tool to protect against regulation).

expectation is that immunity will be granted.[204] Therefore, plaintiffs have rarely, if ever, been successful in attaching civil liability to CRAs for faulty credit ratings.

Recent case law indicates, however, that CRAs might face some civil liability stemming from their actions leading up to the GFC.[205] The court in *Abu Dhabi Commercial Bank v. Morgan Stanley & Co. Int'l Ltd.*[206] rejected the First Amendment defense for CRAs. The case of *Cal. Pub. Employees' Ret. Sys. v. Moody's Investors Serv. Inc.*[207] further illustrates the proposition that CRAs might face liability for rating CDOs in the time leading up to the GFC. In that case, Judge Richard Kramer of the Superior Court of the State of California concluded that the ratings were not entitled to First Amendment protection.[208] The court quickly concluded that the CRAs were "not akin to members of the financial press;"[209] instead the court found the rating activity to be an "economic activity designed for a limited target for the purpose of making money."[210]

The likelihood of CRAs facing civil liability is unclear. Moreover, as has been outlined above, civil liability differs significantly from criminal liability in terms of fulfilling the public policy goals of retribution, deterrence, and rehabilitation. Therefore, the question arises: to what extent might criminal liability serve as an effective alternative?

III. ATTACHING CRIMINAL LIABILITY TO CRAS: THE CORPORATE ETHOS MODEL

Any discussion of imposing criminal liability upon CRAs necessitates some consideration of what crimes, if any, have been violated. A criminal action would likely be based upon either federal mail or wire fraud, federal

204. *See, e.g.*, Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 758 (1985) (indicating that ratings are opinions and that the first amendment immunity for ratings can only be broken by a showing of malice); Compuware Corp. v. Moody's Inv. Servs., Inc., 499 F.3d 520 (6th Cir. 2007); Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & "ERISA" Litig.), 511 F. Supp. 2d 742 (S.D. Tex. 2005); Cnty. of Orange v. McGraw Hill Co., 245 B.R. 151 (C.D. Cal. 1999); *see also*, Arthur R. Pinto, *Control and Responsibility of Credit Rating Agencies in the United States*, 54 AM. J. COMP. L. 341, 353 (2006) (stating that immunity will be granted where there is no proof of malice).

205. *See* Ellis, Fairchild & D'Souza, *supra* note 12, at 203-07 (noting that civil liability might be imposed on CRAs based on common law).

206. 651 F. Supp. 2d 155 (S.D.N.Y. 2009).

207. 226 Cal. App. 4th 643 (2014).

208. Order Overruling in Part and Sustaining in Part Defendants' Demurrers to Complaint, Cal. Pub. Employees' Ret. Sys. v. Moody's Investors Serv., Inc., (Cal. Super. Ct. June 1, 2010) (No. CGC-09-490241), *available at* http://ratingagencylawblog.files.wordpress.com/2010/06/calpers-v-moodys.pdf) [Hereinafter CalPers Order].

209. *Id.* at 8.

210. *Id.*

securities law, or general fraud under state law.[211] Regardless of which criminal statutes are employed, a prerequisite to finding criminal liability is clearing the mens rea hurdle. In this section, we illustrate application of the corporate ethos model to determine whether or not the mens rea requirement has been met and compare it to application of the traditional respondeat superior model.

A. Corporate Ethos Model

Under the corporate ethos model, liability is imposed upon a corporation where the corporate culture encouraged the criminal activity. Under this model, the corporate culture is defined by its hierarchy (the role of the leaders), goals, education and training programs, monitoring mechanisms, response to the allegations of criminal behavior, compensation incentives, and the breadth of indemnification policies.[212] In this section, we will examine the culture of CRAs, using facts from the time period leading up to the GFC as an illustration, and apply the corporate ethos model.

1. Corporate Goals

A good starting point for examining culture is to look at corporate goals. Each CRA has a statement of corporate goals. The formal statements can be found online. For example, Moody's declares that they seek "to protect the integrity of the rating process, to ensure that investors and issuers are treated fairly, and to safeguard confidential information provided to us by issuers."[213] More specifically, their Code of Professional Conduct states that Moody's (MIS):

> [M]aintains independence in its relationships with Issuers, investors, and other interested entities. MIS does not have a fiduciary relationship with the Issuer whose security is being rated (or any other party). Nor does MIS act as an advisor to the Issuers it rates. MIS may comment on the potential credit implications of proposed structural elements of a security, but

211. Maas, *supra* note 35, at 1023 ("Prosecutors could try to bring a wire fraud case, a case for fraudulent violation of SEC regulations, or a more general criminal fraud case at the state level.").

212. *See infra* notes 123-143 and accompanying text.

213. MOODY'S INVESTORS SERV., CODE OF PROFESSIONAL CONDUCT 2 (June 2011) *available at* http://www.moodys.com/uploadpage/Mco%20Documents/Documents_professional_conduct.pdf).

> MIS does not participate in the actual structuring of any security under consideration for a Credit Rating [and, that they] will invest resources sufficient to carry out high-quality credit assessments of Issuers or obligations. When deciding whether to rate or continue rating an obligation or Issuer, MIS will assess whether it is able to devote sufficient personnel with appropriate skills to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order to make such an assessment.[214]

Moreover, the Code decrees that "[t]he Credit Rating MIS assigns to an Issuer or obligation will not be affected by the existence of, or potential for, a business relationship between MIS (or its affiliates) and the Issuer (or its affiliates), or any other party, or the non-existence of any such relationship."[215] Standard & Poor's and Fitch make similar statements.[216]

Unfortunately, there is ample evidence that the informal culture was, instead, dictated by a drive for revenue.[217] This became an overriding goal of increasing market share.[218] For example, in 2000 Moody's head of the Structured Finance Group in Paris acknowledged corporate strategy based on maximizing "market share and the gross margin with insufficient resources."[219] A default matrix employed at Standard & Poor's explicitly

214. *Id.* at 6-8.

215. *Id.* at 10.

216. Complaint at ¶¶ 143-89, Varga & Longbottom v. McGraw Hill Fin., Inc., (N.Y. Sup. Ct. Nov. 11, 2013) (No. 652410/2013), [hereinafter Bear Stearns Complaint] *available at* http://s3.documentcloud.org/documents/817719/credit-ratings-lawsuit.pdf; *see also* Complaint for Civil Money Penalties at ¶¶ 110-21, United States v. McGraw Hill Companies, Inc., (N.D. Cal. Feb. 4, 2013) (No. CV 13-00779), [hereinafter DOJ complaint] (relying on Standard & Poor's policy against conflicts of interest).

217. William J. Harrington, former analyst with Moody's Derivatives Group identifies what he terms the "unchanging corporate credo of maximizing earnings. . . ." William J. Harrington, *Comment on SEC Proposed Rules for Nationally Recognized Statistical Rating Organization* 8, *available at* http://www.sec.gov (2011) [hereinafter Harrington Comment].

218. In a complaint brought by the First National Bank and Trust Company of Rochelle, Illinois against the CRAs, this tradeoff is described as a "Faustian bargain with Wall Street to prostitute their ratings, independence[,] and reputations in return for unprecedented profits." First Nat'l Complaint, *supra* note 170, at 4. The Senate Subcommittee on Investigations describes what they term a "major cultural shift" in the corporate culture of Moody's, as Moody's changed from being conservative in the issuance of ratings to a desire to "increas[e] market share and 'servic[e] the client.'" *Wall Street and The Financial Crisis: Anatomy of a Financial Collapse*, *U.S. Senate*, *Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs*, 112th Cong., 1st Sess. 273 (2011) [hereinafter Investigations].

219. Investigations, *supra* note 218, at 274 (citing a 3/19/2000 email from Catherine Gerst to Debra Perry, Moody's Chief Administrative Officer). An email from Brian

listed the dual goals of market share and profit.[220] An internal memo at Standard & Poor's spoke of "an increase in internal management pressures to maintain or grow market share while also growing margins."[221] An analyst at Moody's related that "[j]ob 1 is to keep the earnings machine working."[222] Several CRA executives reported "enormous pressure from their superiors when their market share dipped."[223]

Moreover, the formal culture is described as a culture of independence, without conflict of interest, and one in which ratings are objectively calculated. Unfortunately, there is ample evidence that the informal culture was, instead, driven by the issuer-pays model, which creates an inherent conflict of interest.[224] Because ninety-five percent of annual CRA revenue is from issuer fees, "[t]he result is a system that creates strong incentives for the rating agencies to inflate their ratings to attract business, and for the issuers and arrangers of the securities to engage in 'ratings shopping' to obtain the highest ratings for their financial products."[225] Fees were contingent on the issue of achieving the target rating and actually being offered to the public.[226] These incentives

---

Clarkson, a senior manager of the Moody's Structured Finance Real Estate and Derivatives Group, further illustrates the focus on market share. Brian Clarkson's email states:

> The Derivatives team has achieved a year to date 96% market share compared to a target share of 95%. This is down approximately 2% from 2002 primarily due to not rating Insurance TRUP CDO's and rating less subordinated tranches. Noel's team is considering whether we need to refine our approach to these securities. The CMBS team was able to meet their target share of 75%. However, this was down from 84% market share in 2002 primarily due to competitor's [sic] easing their standards to capture market share.

Id. As the Senate Report points out, this email demonstrates a focus on achieving market share and "appears silent with regard to issuing accurate ratings." *Id.*; *see also* Bear Stearns Complaint, *supra* note 216, at ¶ 195 (referencing an employee email stating "that aspects of the firms' ratings methodology would have to be revisited to recapture market share from the competing rating agency.").

220. DOJ Complaint, *supra* note 216, at ¶ 168.

221. Bear Stearns Complaint, *supra* note 216, at ¶ 204.

222. Harrington Comment, *supra* note 217, at 27.

223. Investigations, *supra* note 218, at 276 (quoting Eric Kolchinsky, senior manager at Moody's).

224. In 2003, the SEC voiced concerns about the impact of the conflict of interest. SEC. & EXCH. COMM'N, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS 40 n.109 (January 2003) ("[C]oncerns had been expressed that a rating agency might be tempted to give a more favorable rating to a large issue because of the large fee, and to encourage the issuer to submit future large issues to the rating agency.").

225. Investigations, *supra* note 218, at 273.

226. DOJ Complaint, *supra* note 216, at ¶ 65.

encouraged CRAs to rate the issues highly and to assist in marketing the product.[227] Instead of the independence that is touted as a part of the formal culture, CRAs worked with the issuers to create derivatives so that they could rate issues as high as possible.[228]

A 2002 Moody's survey of the Structured Finance Group provides a revealing glance into employee perception of the corporate goals and, perhaps, into its informal culture. Those responding to the survey described the business objectives as including "generating increased revenues; increasing market share; fostering good relationships with issuers and investors; and delivering high quality ratings and research."[229] More telling, "[w]hen asked about how business objectives were translated into day-to-day work, most agreed that writing deals was paramount, while writing research and developing new products and services received less emphasis."[230] Moreover, many cited the importance of building relationships with issuers and investment bankers.[231] The focus on client relationships was problematic because clients were pressuring CRAs to ease rating standards and at the same time shopping their ratings among CRAs to obtain the rating desired.[232]

There is evidence that employees responded to this pressure in the way we might expect. Recall, psychology literature informs us that individuals are basically obedient and will engage in goal-driven behavior, e.g., will work to achieve goals by whatever means.[233] Therefore, it is not surprising to hear a Standard & Poor's Managing Director state, "I knew it was wrong at the time . . . . It was either that or skip the business. That wasn't my mandate. My mandate was to find a way. Find the way."[234] Hence, it is clear that while the formal statement of corporate goals

227. CalPers Complaint, *supra* note 1, at ¶ 48.

228. *See e.g.*, Bear Stearns Complaint, *supra* note 216, at ¶ 298 (noting how a S & P analyst described the process by which he manipulated the data to improve the rating); Investigations, *supra* note 218, at 250-54 (describing the rating process including the role that CRAs had in structuring the produce and credit enhancements required for the AAA rating). Brian Clarkson, former Chief Operating Officer at Moody's has been quoted as describing this process as one where "[y]ou start with a rating and build a deal around a rating." CalPers Complaint, *supra* note 1, at ¶ 47.

229. Investigations, *supra* note 218, at 274.

230. Investigations, *supra* note 218, at 274.

231. Investigations, *supra* note 218, at 274.

232. Investigations, *supra* note 218, at 278 (reporting that investment banks were pressuring CRA analysts to "ease rating standards."). Further, there is evidence that ratings shopping was a common occurrence. Investigations, *supra* note 218, at 287 ("Moody's Chief Credit Officer told the Subcommittee staff that ratings shopping, the practice in which investment banks chose the credit rating agency offering the highest rating for a proposed transaction, was commonplace prior to 2008.").

233. *See supra* note 99 and accompanying text.

234. Bear Stearns Complaint, *supra* note 216, at ¶ 199.

emphasized accuracy and integrity of ratings, the informal culture was driven by a need to obtain larger market share and increased revenues for the firms. There is evidence that the overriding goal of growing market share lead CRAs to issue favorable ratings and to adjust the models used to guarantee favorable ratings and attract business.[235] In spite of the fact that CRAs knew that the assumptions and facts used in their models were flawed and that the ratings assigned to CDOs were likely inaccurate, overrating securities and underestimating risk,[236] the pressures to grow market share induced them to continue unchanged. In fact, there is evidence that the failure to update or revise these models was based on a desire to maintain market share.[237] CRA management made clear that when accuracy of ratings conflicted with obtaining business, the choice was

235. Bear Stearns Complaint, *supra* note 216, at ¶ 208 (quoting an email from Richard Gugliada, Managing Director at Standard & Poor's, in which he discussed scheduling a meeting to explore "adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals."). Richard Gugliada admitted that Standard & Poor's repeatedly eased its rating standards in "a market-share war where criteria were relaxed." Bear Stearns Complaint, *supra* note 216, at ¶ 208; *see also* DOJ Complaint, *supra* note 216, at ¶ 176 (quoting senior analyst at Standard & Poor's, acknowledging the tradeoffs between market share and accurate ratings: "So how do we balance these risks and rewards to achieve our business objectives? For example, if our objectives were solely based on market share, then one solution might be to create a different, more 'favourable' [sic] model for each type of transaction.").

236. Investigations, *supra* note 218, at 276 ("Despite the internal recognition at Moody's that previously rated CDOs were at substantial risk for downgrades, the email shows management pressing the CDO Managing Directors about losing a few points of market share in the middle of an accelerating ratings disaster."); *see also* DOJ complaint, *supra* note 216, at ¶¶ 123-24 (outlining how Standard & Poor's failed repeatedly to account for known credit risks consciously deciding to favor issuers and grow market share and profits); Bear Stearns Complaint, *supra* note 216, at ¶ 314 (quoting Standard and Poor's Director Frank Parisi, acknowledging that their rating models were only "marginally more accurate than 'if you just simply flipped a coin.'").

237. *See* Bear Stearns Complaint, *supra* note 216, at ¶ 205 (discussing a document circulated at Standard & Poor's requiring any new ratings proposals to include an explanation of "market perception and reaction."); DOJ Complaint, *supra* note 216, at ¶¶ 138-57 (discussing Standard & Poor's refusal to adopt the LEVELS 6.0 model because it would result in higher loss coverage levels); DOJ Complaint, *supra* note 216, at ¶ 296 ("Put simply, it was not profitable to update these models, so S&P purposely refrained from doing so."); DOJ Complaint, *supra* note 216, at ¶ 306 (quoting the statement of Richard Gugliada in a deposition in which he acknowledged that the decision to delay implementation of a new model was due to "concerns to be competitive and preserve market penetration."); *see also* DOJ Complaint, *supra* note 216, at ¶ 277 (in which a Standard and Poor's employee admits that the ratings model is insufficient but used anyway); DOJ Complaint, *supra* note 216, at ¶ 288 ("Version 6.0 could've been released months ago and resources assigned elsewhere if we didn't have to massage the sub-prime and Alt-A numbers to preserve market share . . . ."); DOJ Complaint, *supra* note 216, at ¶¶ 160-80 (discussing Standard & Poor's failure to update the CDO Evaluator).

to sacrifice ratings in response to the "ongoing threat of losing deals."[238] In fact, the Report by the Senate's Permanent Subcommittee on Investigations concluded that "[i]t was not in the short term economic self interest of either Moody's or S&P to provide accurate credit ratings for high risk RMBS and CDO securities, because doing so would have hurt their own revenues."[239] A Moody's managing director acknowledged the lure of profits when he outlined the errors made and concluded that, "[c]ombined, these errors make us look either incompetent at credit analysis, or like we sold our soul to the devil for revenue, or a little bit of both."[240]

Meeting these goals was very lucrative for the CRA firm. In fact, the earnings for structured finance instruments were estimated at three times the fees assessed for rating corporate bonds.[241] Fees of up to $150,000 for each non-prime MBS rated were not uncommon, with fees of $500,000 for cash CDOs and for up to $750,000 for each synthetic CDO rated.[242] In some cases, the fees could be as high as $1 million for rating a derivative (on top of what earned for rating underlying assets).[243] Moody's and Standard & Poor's received a record amount of revenues for rating structured finance products from 2004 to 2007.[244] For example, in 2007, 53% of Moody's revenue was from structured finance.[245]

2. Attention to hierarchy (the role of the leaders)

Social science supports the conclusion that behavior by upper

238. Investigations, *supra* note 218, at 276 (citing an email from S & P management; the email continued, "We are meeting with your group this week to discuss adjusting criteria for rating CDOs of real estate assets this week because of the ongoing threat of losing deals.").

239. Investigations, *supra* note 218, at 244. In fact, "[m]ultiple former Moody's and S&P employees told the Subcommittee that, in the years leading up to the financial crisis, gaining market share, increasing revenues, and pleasing investment bankers bringing business to the firm assumed a higher priority than issuing accurate . . . ratings." Investigations, *supra* note 218, at 273.

240. Investigations, *supra* note 218, at 245; Bear Stearns Complaint, *supra* note 216, at ¶ 1.

241. CalPers Complaint, *supra* note 1, at ¶ 41.

242. DOJ Complaint, *supra* note 216, at ¶¶ 62-63.

243. CalPers Complaint, *supra* note 1, at ¶ 42. The $250,000 charged to rate a $350 million mortgage pool can be contrasted with the $50,000 in fees garnered for rating an equivalent-size bond. CalPers Complaint, *supra* note 1, at ¶ 43.

244. Investigations, *supra* note 218, at 30. For example, over the five year period preceding the GFC, the gross revenues Moody's received from rating CDOs more than tripled, going from $61 million in 2002 to over $260 million in 2006. Investigations, *supra* note 218, at 30-31. S&P reports similar jumps in revenue. Investigations, *supra* note 218, at 30. In total, the revenues received by the three leading CRAs more than doubled during this period. Investigations, *supra* note 218, at 31.

245. CalPers Complaint, *supra* note 1, at ¶ 43.

management is a powerful force in creating corporate culture. As such, the leader has the capacity to foster virtue in firm employees and, by doing so, encourage ethical and legal behavior. The leader can work to establish a culture in which individuals are respected and nurtured, thereby fostering virtue, or one in which individuals are treated badly.[246] There is evidence that CRA leaders fostered a culture of harassment and intimidation. William J. Harrington, former analyst with Moody's Derivatives Group, described how Moody's leadership "maneuvered for a prescribed result through intimidation of other voting members. Intimidation could be blatant, with managers belittling opposing views, interrupting while others speak . . . ."[247] There is evidence that CRA upper management routinely pressured analysts to issue pre-determined ratings influenced by management's desire to increase revenues and stock price. For example, there are reports that Brian Clarkson, a former senior executive at Moody's, "used fear and intimidation tactics" to encourage analysts to spend less time rating securities and more time working with investment bankers.[248] This pressure translated into a "radical change in Moody's analytical culture that not only changed the rating process, but also profoundly changed Moody's ratings."[249] Leaders can foster virtue by acting as role models and coaches of virtuous behavior; the leader can foster virtue by recognizing and rewarding virtuous behavior and by punishing unethical and illegal behavior.[250] Unfortunately, CRA leadership, at best, ignored unethical behavior and, at worse, encouraged illegal behavior. When CRA leaders were informed of concerns about rating accuracy as the housing market deteriorated, they did nothing. For example, in February 2007, Frank Parisi, Standard & Poor's director, informed senior management that losses in 2006 could be as much as two times the losses for 2000.[251] However, no action was taken to revise loss estimates.[252] This lack of

246. *See* Kennedy, *supra* note 114, at 14 (discussing the importance of "attend[ing] to the culture of the workplace" as an important factor in fostering the development of virtue in firm employees).

247. Harrington Comment, *supra* note 217, at 14-15.

248. Investigations, *supra* note 218, at 274 (relying on a statement by Mark Froeba, Moody's former Senior Vice President).

249. Bear Stearns Complaint, *supra* note 216, at ¶ 235.

250. Kennedy, *supra* note 114, at 14.

251. Bear Stearns Complaint, *supra* note 216, at ¶ 273.

252. Bear Stearns Complaint, *supra* note 216, at ¶ 273. When a Standard & Poor's executive objected to new criteria procedures, his concerns were ignored. DOJ Complaint, *supra* note 216, at ¶ 126 (quoting an executive who asked, "Does this mean we are to review our proposed criteria changes with investors, issuers and investment bankers?"). Jerome Fons tells a similar story at Moody's. Bear Stearns Complaint, *supra* note 216, at ¶ 362 ("The deterioration in standards was probable . . . . [E]vidence first arose at least in 2006 that things were slipping, and the analysts or the managers for whatever reason turned a

action was an important factor in creating an informal culture that focused on achieving the goal of market share and increased revenue at all costs.[253] When an employee questions unethical or illegal behavior and senior management turns a blind eye, this tells employees that such behavior is sanctioned.

3. Compensation incentives

An examination of the rewards and incentives of an organization is crucial to defining the informal culture. Psychology research teaches us that people will act in ways that are rewarded and will act to avoid punishment. Moreover, people will watch how others are rewarded and punished and that will guide individual behavior. At the CRAs, compliance with pressures to increase market share was rewarded; non-compliance was punished.[254] Top CRA executives were rewarded handsomely for performance. For example, Moody's CEO Raymond W. McDaniel Jr., earned more than $8 million in compensation in 2006; in the same year the head of the structured finance group earned $3.8 million.[255] Upper and middle management also received massive compensation packages. For example, Moody's managing directors made from almost $700,000 to over $930,000 including stock options.[256] There is evidence that lower level employees were also driven to act by the potential for rewards. One employee is quoted as saying, "[l]et's hope we are all wealthy and retired by the time this house of cards falters."[257] In Moody's 2006 Business Effectiveness Survey, a Moody employee noted, "[i]ndividuals are being promoted/rewarded who do not read the documents

blind eye to this, did not update their models or their thinking[,] and allowed this to go on.").

253. One analyst questioned the loosening of assumptions in a model and asked, "who was the genius who came up with this[?]" The reply was, "I am interested to see if any career consequences occur. Does the company care about deal volume or sound credit standards?" DOJ Complaint, *supra* note 216, at ¶ 187. The non-action by leadership and the lack of punishment answered that question. Mark Froeba, Moody's former Senior Vice President revealed, "Moody's managers deliberately engineered a change to its culture to ensure that rating analysis never jeopardized market share and revenue. They accomplished this both by rewarding those who collaborated and punishing those who resisted." Bear Stearns Complaint, *supra* note 216, at ¶ 236.

254. *See generally* Harrington Comment, *supra* note 217 (noting that analysts were given harsh reviews for challenging management while those in compliance were rewarded).

255. Investigations, *supra* note 218, at 258.

256. Investigations, *supra* note 218, at 258-59. William J. Harrington opines that awarding stock options exacerbated the conflicts of interest and "seduced" employees at all levels. Harrington Comment, *supra* note 217, at 12.

257. Bear Stearns Complaint, *supra* note 216, at ¶ 1.

and do not truly analyze the documents. They simply convey what the bankers tell them."[258]

By contrast, not meeting corporate performance goals could be fatal. Several Moody's employees have testified about these pressures. Senior analyst Richard Michalek describes a meeting with his boss as follows:

> The conversation was quite uncomfortable, and it didn't improve when he described how he had previously had to fire [another analyst], a former leader of the Asset-Backed group who he otherwise considered a 'good guy.' He described how, because of the numerous complaints he had received about [that analyst's] extreme conservatism, rigidity and insensitivity to client perspective, he was left with no choice. . . . He then asked me to convince him why he shouldn't fire me. . . . [T]he primary message of the conversation was plain: further complaints from the 'customers' would very likely abruptly end my career at Moody's.[259]

Another analyst testified that, "the fear was real, not rare and not at all healthy. You began to hear of analysts, even whole groups of analysts, at Moody's who had lost their jobs because they were doing their jobs, identifying risks and describing them accurately." [260]

4. Education and training programs

There is little evidence of the existence of education and training programs in CRAs. What is apparent, however, is that CRAs failed to

258. Bear Stearns Complaint, *supra* note 216, at ¶ 223.

259. Investigations, *supra* note 218, at 275. Another example in the Senate Report includes a statement by Eric Kolchinsky from Moody's who said that, "[m]anagers of rating groups were expected by their supervisors and ultimately the Board of Directors of Moody's to build, or at least maintain, market share. It was an unspoken understanding that loss of market share would cause a manager to lose his or her job." Investigations, *supra* note 218, at 275.

260. Investigations, *supra* note 218, at 275 (quoting Mark Froeba). Mark Froeba explained that Moody's former President and COO "used fear and threats of termination to encourage analysts to work more cooperatively with investment bankers at the expense of ratings quality." Bear Stearns Complaint, *supra* note 216, at ¶ 226. Mark Froeba also testified, "When I left Moody's [in 2007], an analyst's worst fear was that he would do something that would allow him to be singled out for jeopardizing Moody's market share, for impairing Moody's revenue, or for damaging Moody's relationships with its clients, and lose his job as a result." Bear Stearns Complaint, *supra* note 216, at ¶ 236; *see also* Harrington Comment, *supra* note 217, at 17 ("Management also explicitly threatened the job security of analysts who 'impeded deals' . . . .").

maintain enough trained personnel to conduct quality ratings assessments. The lack of a sufficient number of trained analysts affected ratings quality and CRA leadership was aware of this issue.[261] Moreover, as the housing market began deteriorating, it became clear that some modification to existing models should be adopted and CRA personnel should conduct surveillance of mortgage performance.[262] Unfortunately, CRAs were insufficiently staffed to conduct adequate surveillance, and no changes were made.[263] Moody's employees noted that "[t]his is not a recipe for ethical behavior,"[264] yet nothing changed. Again, this is an important aspect of informal culture. At a time where the formal culture touted accuracy of ratings as paramount, CRA staff was so inadequate that accurate ratings were impossible. The fact that management was aware of this and refused to address it because it would impact revenue speaks to the primacy of the revenue goal.

The last three factors that are relevant under the corporate ethos model are 5) the monitoring mechanisms in place, 6) how the corporation responded to the allegations of criminal behavior, and 7) the breadth of their indemnification policies.

Collectively, these require a consideration of the extent to which the corporation tacitly encouraged the illegal behavior at issue. In other words, was the behavior recklessly tolerated? One important factor in creating corporate culture is how the organization, in particular its leaders, responds to allegations of misconduct. There is evidence that the manipulation of ratings was condoned if not actively encouraged. For example, one Standard and Poor's employee describes how he manipulated the payment dates inputted into the ratings model in an attempt to justify high ratings.[265] Rather than being punished or warned against such behavior, he reports the response of a senior director as, "I don't think this is enough to satisfy them. What's the next step?"[266]

One vehicle for insuring proper behavior within a corporation is a

261. Moody's Structured Finance Group Survey in 2002 revealed that, "[t]here [was] some concern about workload and its impact on operating effectiveness . . . . Most acknowledge that Moody's intends to run lean, but there is some question of whether effectiveness is compromised by the current deployment of the staff." Bear Stearns Complaint, *supra* note 216, at ¶ 239.

262. *See* Bear Stearns Complaint, *supra* note 216, at ¶ 325.

263. *See* Bear Stearns Complaint, *supra* note 216, at ¶ 325 ("Despite this clear concern, S&P did not take action to bolster its surveillance capabilities – making its ratings increasingly inaccurate."). In fact, Moody's had only twenty-six surveillance analysts responsible for tracking over 13,000 rated CDOs. Bear Stearns Complaint, *supra* note 216, at ¶ 357.

264. Bear Stearns Complaint, *supra* note 216, at ¶ 359.

265. Bear Stearns Complaint, *supra* note 216, at ¶ 298.

266. Bear Stearns Complaint, *supra* note 216, at ¶ 298.

compliance department. Unfortunately, there is evidence that CRA compliance departments were more concerned with insuring behavior that was consistent with the overriding goal of increasing market share than with accurate ratings. For example, in an August 8, 2011 letter to the SEC, William J. Harrington, an analyst at Moody's Derivatives Group wrote, "[t]he Compliance Department is also an enforcer that actively harasses analysts viewed as 'troublesome,'i.e. independent, and is well-experienced in doing so."[267]

Under the corporate ethos model, corporate criminal liability is appropriate if the government can prove that the corporate ethos or corporate culture encouraged corporate employees to engage in wrongdoing. In this section, we have outlined facts that tell the story of a misaligned corporate culture. The formal culture is described as one that values the importance of reputational capital, public trust and accurate ratings. The informal culture, however, is one in which the overriding goals of revenue and market share rule. We see examples of individuals conforming to the revenue mantra, operating under confirmation bias as they rely on unreasonable assumptions without question.[268] We see examples of individuals driven by a culture that rewards only actions that increase revenue and market share and punishes any behavior that negatively impacts revenue. We see a culture defined by leadership that favorably acknowledges only behavior that leads to revenue growth and actively seeks to punish honest analysts who question inaccurate models and ratings that are based on unrealistic assumptions.[269]

B. Respondeat Superior Model

As we have demonstrated, prosecutors would be able to overcome the mens rea hurdle using the corporate ethos model proposed. By contrast, it seems unlikely that they would be able to establish the requisite mens rea using the traditional model of respondeat superior. Recall that under respondeat superior, the prosecutor must demonstrate that an employee

267. Harrington Comment, *supra* note 217, at 9.

268. *See, e.g.*, Bear Stearns Complaint, *supra* note 216, at ¶ 351 (explaining that Moody's employed a model that assumed that housing prices would increase four percent each year for forty-five years). How could this happen? A member of Moody's senior management suggests the answer might be confirmation bias, opining, "it seems to me that we had blinders on and never questioned the information we were given." Bear Stearns Complaint, *supra* note 216, at ¶ 365.

269. *See, e.g.*, Bear Stearns Complaint, *supra* note 216, at ¶ 236 ("Moody's senior managers never set out to make sure that Moody's rating answers were always wrong. Instead, they put in place a new culture that would not tolerate for long any answer that hurt Moody's bottom line.").

committed a crime within the scope of his or her employment and intended to at least, in part, benefit the corporation. The problem is that a single individual who committed a criminal act with the requisite intent must be identified.[270] Applying the doctrine of respondeat superior to the facts outlined above illustrates a major criticism of this model: under-inclusiveness. While we have demonstrated that the corporate culture created the situation that led individuals within that organization to engage in conduct to benefit the corporation, it is unlikely that any single individual could be identified. Moreover, it seems unlikely that the actions of any single individual were criminal. It is only when those actions are aggregated that we see a criminal act. In other words, if a single analyst responds to pressures created by the culture (e.g., he attempts to achieve organizational goals without question and does so in part to earn a favorable evaluation and rewards), that alone is not criminal. It is only when coupled with every other analyst engaging in similar behavior that we have a pattern of inaccurate ratings and criminal conduct by the corporation.

CONCLUSION

There are many arguments against imposing corporate criminal liability from a public policy standpoint. Arguably, the philosophies underlying criminal law are inapplicable to the corporation. To the extent that criminal sanctions are imposed against people who have committed morally reprehensible acts, imposing similar sanctions on a corporation makes no sense. Moreover, it has been argued that, "no matter what fiction we employ, a corporation has no intent."[271] We believe, however, that the imposition of criminal sanctions upon a corporation can serve valid public policy objectives. Any other conclusion ignores the important role that corporations play in today's economy.[272] Importantly, in many cases the threat of criminal sanctions is necessary to induce needed changes and to

270. *See* Maas, *supra* note 35, at 1023 (arguing that it would be difficult to identify any one analyst whose behavior would meet the scienter requirement).

271. Bucy, *supra* note 22, at 1288.

272. *See* Beale, *supra* note 22, at 1482 ("[I]mposing criminal liability on corporations makes sense, because corporations . . . are very real and enormously powerful actors whose conduct often causes very significant harm both to individuals and to society as a whole."); Bucy, *supra* note 22, at 1288 ("The major argument in favor of prosecuting corporations is as follows: corporations are major actors in today's world; the criminal law is the most effective method of influencing behavior by rational actors; therefore, criminal prosecution is the most effective way to influence corporate actors."); Bucy, *supra* note 42, at 1437 ("Any societal actor that engages in such wide-ranging and potentially harmful activities should be subject to criminal prosecution since it is the most potent regulatory mechanism society possesses.").

protect the public. The actions of CRAs in the years leading up to the GFC serve as useful examples.

There is no doubt that CRA behavior was an important contributing factor to the GFC. Had CRAs properly rated the complex derivatives, they could have stopped the bubble. Instead, motivated in large part by the huge commissions they received, they mis-rated the CDOs, provided incentives for mortgage originators to offer increasingly risky mortgages and fueled the bubble. At the time, they were subject to minimal regulation, and the threat of civil liability was almost non-existent. Little has changed since the GFC. Dodd-Frank imposed civil liability, but the SEC suspended that section. It is possible that CRAs could still avoid any civil liability using the First Amendment as a shield. In other words, civil liability and administrative regulation have proven to be ineffective in regulating CRA behavior.

We believe that the threat of criminal sanctions is needed to provide sufficient incentives to modify CRA behavior.[273] We recognize that imposition of criminal sanctions can have severe consequences for corporations. Arthur Andersen was forced out of business as a result of their conviction; British Petroleum has faced debarment because of their guilty plea. To some extent, that is the point. Sanctions for engaging in criminal behavior should have severe consequences. Imposition of criminal sanctions can carry severe consequences for individuals also, but that does not lead us to conclude that such sanctions are ill advised. In the case of CRAs, the very minimal threat of civil liability is ineffective in controlling corporate behavior, especially when the potential rewards are so great. We have seen CRA profits rise astronomically since the adoption of the issuer-pays model; we have seen the percentage of those profits attributed to creating and rating complex derivatives rise dramatically. The potential rewards are too great; the danger of civil liability is too small.

By contrast, there is reason to believe that the threat of criminal sanctions will operate as an effective deterrent. There is evidence that such threats can be highly effective.[274] As part of a standard cost-benefit analysis, corporate executives will assess the inherent risks in allowing corporate crime and take actions to avoid such behavior.[275]

Moreover, we believe that such criminal sanctions can and should be

273. *See* Mayer, Baird & Cava, *supra* note 92, at 2 (arguing that imposition of criminal liability would act not only to deter fraudulent activities in the financial sector but also "would help to reestablish the basic social contract between business and society.").

274. *See* Bucy, *supra* note 42, at 1438 (positing that "corporate actors are highly deterable.") (footnote omitted).

275. *See* Bucy, *supra* note 42, at 1438 ("Most corporate leaders make decisions based, in part, upon their best assessment of whether they (or their company) might be prosecuted if their company undertakes certain actions.").

imposed under a corporate ethos model only where the corporate culture encouraged and rewarded the criminal behavior. By using a corporate ethos theory of liability against the corporation rather than against a single individual, the focus would switch to the organization and away from the individual. Thus, the advantage of using the corporate ethos model is that it focuses on the corporate culture in its entirety (the bad barrel), rather than singling out a specific individual engaged in wrongdoing (the bad apple), even if the actions of that individual are imputed to the corporation. We believe that imposition of criminal sanctions on CRAs under the corporate ethos model will best meet the rehabilitative function of criminal law and provide important deterrent incentives that will encourage attention to corporate culture.