2007

Criminalization of Corporate Law: The Impact on Shareholders and Other Constituents

Jill E. Fisch
University of Pennsylvania Carey Law School

JILL FISCH*

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AS I UNDERSTAND IT, THE FOCUS OF THIS PANEL IS CORPORATE criminal liability. I am going to emphasize the distinction between criminal liability of the corporation and that of individual corporate actors. We have talked a lot about the latter, and about the advantages and disadvantages of imposing criminal liability on corporate officials. I am not going to discuss that here. Rather, I am going to focus on the entity, and let me start with the perspective that was expressed earlier this morning. What exactly is the purpose of holding the corporate entity criminally liable?

In seeking to answer this question, I started by considering the purposes of criminal liability generally. This took me through the standard litany of rationales for criminal liability—deterrence, punishment, and removal from society—as well as arguments to the effect that criminal penalties establish or reinforce norms.

The distinctive tool that criminal liability uses in achieving these objectives is imprisonment. The prison sanction does a lot of the work of criminal liability in the individual context; it is probably the key factor that distinguishes criminal from civil liability. People argue that prison deters in a different way, arguably to a greater extent than large fines. In addition, prison removes convicted criminals from society. Thus, the availability of the prison sanction is one justification for using criminal prosecutions to address misconduct.

Focusing on sanctions is useful, because it may explain one of the rationales for criminally prosecuting corporations. Of course, when we move from the individual to the corporate context, imprisonment is no longer an available sanction. At the same time, criminal liability has traditionally offered additional sanctions against corporations. Donna Nagy pointed out that one reason for prosecuting corporations is that there have not been adequate civil or enforcement alternatives to ensure adequate legal compliance.[1] Indeed, when the Supreme Court upheld corporate criminal liability in 1909, it explained that adhering to "the old and exploded doctrine that a corporation cannot commit a crime would virtually take

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* T.J. Maloney Professor of Business Law, Fordham University School of Law.

1. *See* Donna Nagy, *Criminalization of Corporate Law: The Impact of Criminal Sanctions on Corporate Misconduct*, 2 J. BUS. & TECH. L. __ (2007).

away the only means of effectually controlling the subject-matter and correcting the abuses aimed at."[2] In contrast, from today's perspective, a substantial variety of non-criminal sanctions are available, particularly for violations of the federal securities laws. The Securities and Exchange Commission (SEC) can collect substantial fines (through both enforcement and administrative proceedings), issue cease and desist orders, obtain injunctions, and so forth.[3] We even have corporations operating under the supervision of court-appointed monitors.[4] Many civil sanctions and remedies are, however, relatively new.[5] Additionally, moving beyond the securities laws to other regulatory areas, there are substantial differences in the scope of remedies and the availability of civil enforcement.[6] In some areas, civil remedies may continue to provide insufficient deterrence.

So if we cannot achieve adequate deterrence through civil litigation, criminal prosecution seems like an obvious alternative. One way in which academics may be able to add value in the debate over corporate criminal liability is by identifying alternative sanctions and remedies. If there are problems—and our discussion this morning has identified several—with prosecuting corporations and corporate officials criminally, new types of civil sanctions may be the solution. David Skeel has done work on shaming as a mechanism for deterring and punishing corporate misconduct.[7] Michael Klausner was talking before about taking money away from the individual corporate decision-makers, taking away their salaries or some portion of their net worth. Sarbanes-Oxley has a provision that requires disgorgement of incentive-based compensation in the event of a restatement.[8] The Enron and

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2. N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 496 (1909).

3. *See* Matthew Scott Morris, *The Securities Enforcement Remedies and Penny Stock Reform Act of 1990: By Keeping Up With the Joneses, the SEC's Enforcement Arsenal is Modernized*, 7 ADMIN. L.J. AM. U. 151, 160–66 (1993) (describing new sanctioning powers given to the SEC by the Securities Enforcement Remedies Act of 1990).

4. *See, e.g.*, SEC v. WorldCom, Inc., No. 02 Civ. 4963, 2002 U.S. Dist. LEXIS 14201, at *2–4 (S.D.N.Y. Aug. 1, 2002) (implementing court's prior orders creating and appointing corporate monitor to oversee operations at WorldCom).

5. *See, e.g.*, Morris, *supra* note 3, at 166–67 (explaining that, prior to the adoption of the Remedies Act, the SEC's power to impose monetary penalties was extremely limited).

6. *See, e.g.*, Robert Pitofsky, *Antitrust at the Turn of the Twenty-First Century: The Matter of Remedies*, 91 GEO. L.J. 169, 171 (2002) (explaining that prior to the 1990s, the primary civil remedy in antitrust was a cease and desist order). The 1986 amendments to the Federal False Claims Act, by expanding the viability of the qui tam provision, dramatically increased civil enforcement of fraud by government contractors. For example, in 1987, the first year after the False Claims Act was amended, cases brought under the Act resulted in a total of almost $86.5 million in settlements and judgments. In 2005, the total recovery under the Act was $1.4 billion. Department of Justice False Claims Act Statistics for FY 1987-2005, Taxpayers Against Fraud Education Fund, *available at* http://www.taf.org/fcastatistics2006.pdf. *See generally*, Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167, 184–86 (1997) (describing Federal False Claims Act and 1986 amendments).

7. *See* David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001).

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 778, 116 Stat. 778 (codified as amended at 15 U.S.C. § 7243).

WorldCom settlements which require payment by individual outside directors also reflect limited efforts in this direction.[9]

Expanding upon this, we could imagine a variety of sanctions that do not depend on the traditional labels of criminal versus civil liability but instead are tailored more closely to societal goals. Removal—the equivalent of imprisonment—could be achieved in the criminal context by dissolving the corporation, taking away its charter, which is after all, a right that is granted by the State. Similarly, corporations could be disciplined by preventing them from accessing the public markets and raising capital through the sale of securities. In the government fraud context, corporations may be barred from bidding on future government contracts. All these sanctions can be imposed without the procedural complications associated with criminal prosecution. At the same time, they offer increased potential for meeting the objectives behind criminal liability, including punishment and removal as well as deterrence.

If the key distinction between criminal and civil liability is not about the choice or availability of sanctions—and I believe that, in the corporate context, it is not—then evaluating entity level liability raises a second issue: who is being sanctioned? We have discussed the fact that corporate criminal liability and large criminal fines in particular have the effect of punishing the corporation's shareholders.[10] This of course is the whole idea of derivative liability—punishing some people for the bad acts of others. In the criminal context, criminal fines punish shareholders for the bad acts of corporate managers.

One can argue that shareholders are responsible for these bad acts, that they are in a position where they should monitor their agents and where they benefit from the crime. I do not think these statements are accurate. I think the average investor, who holds an indexed mutual fund in his or her retirement account is in no position to monitor the actions of the officers running those portfolio companies. Having spent a lot of time discussing corporate misconduct with institutional investors, who are supposedly the surrogates in terms of monitoring,[11] I do not believe it is realistic to expect them to monitor effectively against criminal activity either.[12]

In terms of benefit, some commentators have argued that the risk of corporate criminal activity is simply another risk that investors bear, and that, in the context of a diversified portfolio, investors sometimes win by benefiting from misconduct

9. Bernard Black, et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057–58 (2006).

10. To the extent that criminal prosecution destroys a business, as in the case of Arthur Andersen, it may have the effect of punishing employees and other stakeholders as well.

11. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 830–49 (1992) (describing potential for institutional investors to monitor corporate officials and improve corporate decision-making).

12. *See, e.g.*, Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009, 1011 (1994) (questioning the incentives for and likely effectiveness of monitoring by institutional investors).

and sometimes lose when the corporation is caught and pays a penalty.[13] One problem with this argument is that it is not clear that the winners and losers from corporate wrongdoing are the same investors. The investors who benefit from corporate crime are the short-term traders, those who are in and out of the company's stock. The reason for this is that corporate crime is unlike other forms of risk taking. By definition, criminal activity is finite in duration; almost invariably the company will get caught. When this happens, who is going to be left holding the bag? It will be those same retirement investors who are holding the indexed mutual fund. The indexed fund is not going to get out of a company. In fact, during the fraud at Enron, as Enron's market capitalization increased, its weight in the market indices increased, so indexed investors wound up buying more and more Enron, at $90 per share, and were left holding the bag.

The in and out investors benefited from the fraud at Enron and other companies. They sold their stock before the fraud was revealed, and before the price went down. Similarly, if they are no longer shareholders in a company at the time that criminal fines are assessed, they do not pay those penalties. Systematically, the types of investors who benefit from corporate misconduct differ from those who bear the financial consequences, both in terms of the effect of the prosecution on stock price, and the civil and criminal penalties imposed on the corporation. Given the subject of this panel, that is something with which we need to be concerned.

One final point—what is the harm in imposing criminal liability upon the corporation? I have raised some questions about the value of corporate criminal liability, and I have talked about harm in terms of the corporation's shareholders, but I think the harm associated with prosecuting corporations goes beyond that. I think there is a risk associated with bringing the criminal justice process, and its tools, into corporate operations unless it can be shown that corporate criminal prosecutions are socially valuable. Anecdotal evidence suggests that it has become relatively easy for government prosecutors to use the availability of criminal sanctions to be high-handed with corporate actors who are essentially innocent—uninvolved managers, independent directors and so forth. The government's attitude is that it is dealing with a criminal. This attitude enables the government to vilify the corporation, and the attitude spills over into negotiations over a range of issues such as the waiver of attorney-client privilege, cooperation, internal investigations, and payment by the corporation of defense fees for corporate officials. It causes the government to overweigh the costs of corporate misconduct and to undervalue the social harm imposed by its prosecutions.[14]

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13. *See, e.g.*, Christopher Kennedy, *Criminal Sentences for Corporations: Alternative Fining Mechanisms*, 73 CAL. L. REV. 443, 452 (1985).

14. For the past several years, the government's policies with respect to prosecution of business organizations have been reflected in the Thompson Memorandum. *See* Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't Components U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003) (setting forth DOJ policies behind the decision to bring criminal

One consequence of relying increasingly on criminal sanctions is that it shifts the primary authority for enforcing corporate compliance with the law to the Department of Justice. We have not really focused on this development. I think, however, that there is a difference between agencies such as the SEC or Federal Trade Commission that have expertise in evaluating and understanding the impact of regulatory decisions on business operations, and the Department of Justice, which does not. The agenda of the Department of Justice is fighting crime, not evaluating the relationship of criminal liability to business operations. In our discussion today, we have debated both the effectiveness of corporate criminal liability and a variety of social costs associated with corporate criminal prosecutions. Expecting the Department of Justice to be sensitive to these concerns is really at odds with the rest of its mission and decisional structure.

charges against business entities and on evaluating corporate cooperation), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm. The Thompson Memorandum has been widely attacked. *See, e.g.*, Brief for The Securities Industry Association, et al., as Amicus Curiae, United States v. Stein, No. 05-888 (S.D.N.Y filed April 13, 2006), S1 05 Crim. 888 (2006), *available at* http://www.uschamber.com/NR/rdonlyres/ex5w7czpkhxrrtituyi2g6j5r6zyp463rc6jqzxj77a553r2qynp47kqxynvd2o5rdygaugptnhqwm/resusvsteinmotionbrief.pdf (arguing that government policies reflected in the Thompson Memorandum "violates key criminal justice principles"). In December 2006, the Department of Justice announced revisions to its policies in the McNulty Memorandum. *See* Memorandum from Paul J. McNulty, Deputy Attorney Gen., to Heads of Dep't Components U.S. Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf. The extent to which the McNulty Memorandum reflects substantial differences remains unclear.