

# Insuring Corporate Crime

MIRIAM HECHLER BAER\*

*Corporate criminal liability has become an important and much-talked about topic. This Article argues that entity-based liability—particularly the manner in which it is currently applied by the federal government—creates social costs in excess of its benefits. To help companies better deter employee crime, the Article suggests the abolition of entity-wide criminal liability, and in its place, the adoption of an insurance system, whereby carriers would examine corporate compliance programs, estimate the risk that a corporation’s employees would commit crimes, and then charge companies for insuring those risks. The insurance would cover civil penalties associated with the entity’s employee-related criminal conduct. Part I begins with a discussion of corporate criminal liability and the costs that accrue from the manner in which it has been implemented by the Department of Justice. Part II examines several proposals to change corporate criminal liability, and explains why most of these proposals would barely alter the current structure. Part III lays out the proposal for an insurance system in lieu of entity-based criminal liability and explains, in rough form, how corporate entities might contract for insurance, how claims might be filed, and how damages might be measured. Part III also addresses a number of arguments that others might raise against the proposal.*

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\* Acting Assistant Professor of Lawyering, New York University; J.D. 1996, Harvard Law School; A.B. 1993, Princeton University; Assistant United States Attorney, Southern District of New York 1999–2004. The author gratefully thanks for helpful comments and suggestions Jennifer Arlen, Rachel Barkow, Stephanos Bibas, Matthew Bodie, Peggy Davis, Harry First, Brandon Garrett, Rebecca Hollander-Blumoff, Jim Jacobs, Marcel Kahan, Orin Kerr, Dan Richman, Stephen Schulhofer, Christine Hurt, Sean Griffith, Kimberly Krawiec, Michael Guttentag, Brian Galle and the Conglomerate Junior Scholars Workshop 2007 ([www.theconglomerate.org](http://www.theconglomerate.org)) and the NYU Lawyering Scholarship Colloquium. Excellent research assistance was provided by Jesse Jensen.

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## INTRODUCTION

Since 1909, federal courts have widely accepted the maxim that corporate organizations may be held vicariously liable for their employees' crimes.<sup>1</sup> There is far less consensus, however, that corporate liability deters crime.<sup>2</sup> This Article suggests that corporate criminal liability inherently encourages entities to overpay for their employees' actual and feared criminal conduct. Because the current corporate criminal liability standard is so broad and the collateral consequences of a criminal indictment are so devastating, entities will attempt to avoid formal charges *ex ante* by investing in "compliance" products intended to impress prosecutors in the future, even if these programs are more costly than effective.<sup>3</sup> Risk averse corporate managers may further attempt to avoid entity-based criminal liability by declining otherwise beneficial investments simply because they seem too risky.<sup>4</sup>

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1. N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481, 493–94 (1909) (explaining that it is "well established" that in actions for tort, corporations are responsible for the actions of their agents).

2. See, e.g., Mary Kreiner Ramirez, *The Science Fiction of Corporate Criminal Liability: Containing the Machine Through the Corporate Death Penalty*, 47 ARIZ. L. REV. 933 (2005) (embracing deterrence rationale and proposing a "three strikes" death penalty approach towards corporations whose employees violate the law); Michael L. Seigel, *Corporate America Fights Back: The Battle over Waiver of the Attorney-Client Privilege*, 49 B.C. L. REV. 1, 10–11 (2008) ("corporate culpability achieves significant additional deterrence, specific and general, beyond that achieved solely by the prosecution of individuals"). *But see* Preet Bharara, *Corporations Cry Uncle and their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 113 (2007) (accepting general premise that corporate criminal liability deters wrongdoing but arguing for narrower standard of liability); Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319 (1996) (questioning theoretical necessity of criminal liability as means of achieving deterrence); Gilbert Geis & Joseph F. C. DiMento, *Empirical Evidence and the Legal Doctrine of Corporate Criminal Liability*, 29 AM J. CRIM. L. 341 (2002) (calling for empirical testing of efficacy of corporate criminal liability); Vikamaditya S. Khanna, *Corporate Criminal Liability: What Purpose Does it Serve?*, 109 HARV. L. REV. 1477, 1478 & n.2 (1996) (criticizing analysis of corporate criminal liability and citing earlier critiques and defenses).

3. See Julie O'Sullivan, *The Federal Criminal "Code" Is a Disgrace: Obstruction Statutes as a Case Study*, 96 J. CRIM. L. AND CRIMINOLOGY 643, 668 (2006) ("it is difficult to find a case in which a corporation cannot be tagged for the activities of its agents"); Andrew Weissman, *A New Approach to Corporate Criminal Liability*, 44 AM. CRIM. L. REV. 1319, 1320–21 (2007) (observing that even minimal employee conduct will trigger corporate-level liability). For a discussion of the collateral consequences of corporate indictment, see discussion *infra* at 28–29 n.144–49, and Erik Paulsen, Note, *Imposing Limits on Prosecutorial Discretion in Corporate Prosecution Agreements*, 82 NYU L. REV. 1434, 1453–54 (2007). For a discussion of costs and inefficiencies encountered in compliance programs, see *infra* at 23–26.

4. Cf. Seigel, *supra* note 2, at 12–13 (observing—without apparent criticism—that uncertainty inherent in corporate criminal law "undoubtedly makes corporate officers much

Once the government learns that a corporation's employee has violated the law, companies will "pay" far more than investing in showy compliance products to avoid a corporate indictment.<sup>5</sup> This is so because the costs of a criminal indictment to a corporate entity are so great and because the corporation's legal liability for its employees' crimes is so broad.<sup>6</sup> Indeed, as a legal matter, the government may convict the entity for nearly any employee crime, provided the employee was acting within the "scope of his authority" and acted with "an" intention to help the company, even if the employee was violating express directions or corporate policies.<sup>7</sup> As a result, the company whose employee (or even some unidentified group of employees) commits a crime will have few *legal* defenses to protect it from an indictment, much less a conviction.<sup>8</sup>

This reality creates a massive bargaining imbalance between corporations and prosecutors, which in turn generates numerous inefficiencies. On one hand, depending on the industry in which the corporation operates, the return of an indictment from a grand jury will wreak serious havoc on the organization, and cause massive dislocations up to and including its death.<sup>9</sup> Therefore, any corporation who comes within the purview of a federal investigation will do just about anything to avoid a criminal indictment.

On the other hand, the federal prosecutors who administer the corporate criminal justice system have lots of leverage, but little incentive to reach an efficient arrangement with corporate entities. Instead, prosecutors who lack the information and expertise to efficiently identify and correct compliance risks within corporations will nevertheless demand monitoring and reporting regimes (and sometimes ancillary payments that have little or no connection<sup>10</sup> to the underlying crime) without critically evaluating the costs and benefits of those regimes or their effect on the integrity of the corporation.<sup>11</sup>

Prosecutors will extract even greater concessions when they consider the corporation's *ex post* cooperation in identifying and assisting in the prosecution of its current and former employees. Because the prosecutor operates in a culture that pushes for maximum indictments and penalties, she will demand that the entity become a surrogate policeman for the government in exchange for leniency.<sup>12</sup> As a result,

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more risk averse"). For a more negative view of liability-fueled risk aversion, see Assaf Hamdani, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677, 1679 (2007) (arguing that liability imposed on lawyers, accountants, and directors for failing to prevent misconduct may cause risk aversion "particularly since they act on behalf of third parties and therefore do not bear the full costs of taking precautionary measures or making conservative decisions").

5. See discussion *infra* at 33–34 (discussing costs of corporate cooperation).

6. See *supra* note 4.

7. See discussion *infra* at 15 and notes 81–85.

8. *Id.* See also Weissman, *supra* note 3, at 1320 (observing that "minimal" employee conduct will trigger entity liability).

9. "[A]n indictment—especially of a financial services firm—threatens to destroy the business regardless of whether the firm ultimately is convicted or acquitted." United States v. Stein, 440 F. Supp. 2d 315, 337 (S.D.N.Y. 2006); see also Weissman, *supra* note 3, at 1321.

10. See Brandon L. Garrett, *Structural Reform Prosecutions*, 93 VA. L. REV. 853, 916 (2007) (describing four recent agreements that required the corporate defendant to make payments to entities that were unconnected to the underlying harm).

11. For a discussion of monitoring regimes, see *infra* at 35–38.

12. See Garrett, *supra* note 10, at 899.

corporations—both those suspected of wrongdoing and those who adopt measures ostensibly to avoid similar wrongdoing—are likely to adopt measures that undermine employee trust and loyalty.

The end result of this process (assuming the corporation successfully avoids indictment) is the government's provision of either a deferred or non-prosecution agreement (collectively referred to as DPAs in this Article) that will likely require it to pay fines, provide extensive assistance in the prosecution of individual employees, and agree to costly monitoring and reporting provisions.<sup>13</sup>

DPAs (and the process that precedes their implementation) affect not only individual corporate signatories, but also those *other* corporations in similar industries or otherwise similar circumstances to adopt programs that they think will please prosecutors should they ever become the subject of a criminal investigation.<sup>14</sup> The actual number of corporate prosecutions and DPAs may appear small (and the number of indictments even smaller), but their corresponding effect on onlooker corporations is far more significant.<sup>15</sup>

Despite the government's increasingly aggressive threats of corporate prosecution over the last decade, along with its extraction of numerous concessions through DPAs, there is little evidence that employee compliance across firms has increased.<sup>16</sup> Although DPAs may soften the most visible costs of indictment, they may in fact exact many other costs on corporate shareholders, yet in a far less visible manner.<sup>17</sup>

Although complaints about the corporate criminal justice system have been building over the last decade<sup>18</sup> (particularly, the government's practice<sup>19</sup> of requiring corporate

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13. *See infra* at 29-38.

14. As of July 31, 2006, the Department of Justice had announced twelve deferred prosecution agreements for the year. Sue Reisinger, *Deal-Making by DOJ Is on the Rise*, NAT'L L.J., July 31, 2006, at 8. Since 1992, over forty pre-trial agreements have been documented and reported by either the Department of Justice or individual United States Attorneys' Offices. Lawrence D. Finder & Ryan D. McConnell, *Devolution of Authority: The Department of Justice's Corporate Charging Policies*, 51 ST. LOUIS U. L.J. 1, 2 fig.1 (2006). Whereas DPAs prior to 1999 were fairly simple settlements that called for fines and limited corporate reforms, today's DPAs require, among other things: outside monitors and extensive reporting; the corporate defendant's promise to prohibit its employees from contradicting factual statements contained in the DPA; and waiver of the attorney-client privilege. *See* Garrett, *supra* note 10, at 853 (discussing increase in corporate prosecutions that seek far-reaching "structural reforms" in lieu of indictments); Finder & McConnell, *supra*, at 5-7, 17-19.

15. *See infra* at 31-32.

16. Despite the federal government's increased prosecution of corporate entities and defendants, corporate crime (particularly, corporate fraud, which is one of the key forms of criminal conduct in the white collar context) remains a significant problem across thousands of organizations. *See* KPMG FORENSIC, KPMG FORENSIC FRAUD SURVEY 2003 at 2, *available at* [http://www.us.kpmg.com/RutUS\\_prod/Documents/9/FINALFraudSur.pdf](http://www.us.kpmg.com/RutUS_prod/Documents/9/FINALFraudSur.pdf) (reports of employee fraud increasing even though organizations are "responding with anti-fraud" measures); PRICEWATERHOUSECOOPERS, 2005 GLOBAL ECONOMIC CRIME STUDY: US AND NORTH AMERICA 4, *available at* <http://www.pwc.com> (follow "publications" hyperlink) [hereinafter PWC 2005 REPORT] (economic crime is "pervasive" throughout North American companies despite increased reliance on internal controls and audits).

17. *See infra* at 35.

18. *See, e.g.*, JOHN HASNAS, TRAPPED: WHEN ACTING ETHICALLY IS AGAINST THE LAW (2006) (corporate criminal liability results in unethical conduct); Elizabeth K. Ainslie, *Indicting*

entities to waive the attorney-client privilege over communications between employees and corporate counsel in exchange for leniency), the frustration with the corporate criminal process appeared to reach a boiling point in 2006. This occurred when the Honorable Lewis Kaplan, a district judge in the Southern District of New York, concluded in *United States v. Stein* that the United States Attorney's Office in Manhattan had violated the Fifth and Sixth Amendment rights of several KPMG employees. The government did this by threatening KPMG, the huge accounting firm, with indictment unless it reversed its former policy of advancing attorneys fees to current and former employee-targets of the government's criminal investigation of abusive tax shelters<sup>20</sup> that KPMG had widely implemented and marketed.<sup>21</sup> By forcing

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*Corporations Revisited: Lessons of the Arthur Andersen Prosecution*, 43 AM. CRIM. L. REV. 107 (2006) (arguing that costs of corporate prosecutions often outweigh benefits); Fischel & Sykes, *supra* note 2, at 319 (arguing that civil liability more efficiently deters corporate conduct than criminal liability); Khanna, *supra* note 2, at 1477 (same); William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343 (1999) (criticizing liability scheme's emphasis on compliance programs); Shayne Kennedy, Note, *Probation and the Failure to Optimally Deter Corporate Misconduct*, 71 S. CAL. L. REV. 1075 (1998) (arguing that civil fines would more effectively deter misconduct than probationary sentences envisioned by the Organizational Sentencing Guidelines).

19. For criticism of the waiver issue generally, see AMERICAN BAR ASSOCIATION, REPORT OF ABA TASK FORCE ON ATTORNEY-CLIENT PRIVILEGE 1 (2006), available at [http://www.abanet.org/buslaw/attorneyclient/materials/hod/emprights\\_report\\_adopted.pdf](http://www.abanet.org/buslaw/attorneyclient/materials/hod/emprights_report_adopted.pdf) [hereinafter ABA TASK FORCE REPORT] (emphasizing unanimous support for Resolution 111 opposing further erosion of attorney-client privilege); Elkan Abramowitz & Barry A. Bohrer, *Waiver of Corporate Attorney-Client and Work Product Protection*, N.Y. L.J. Nov. 1, 2005, at 3 (pointing out efforts by the ABA and SEC to prevent the erosion of corporate attorney-client privilege); Lynnley Browning, *Ex-Officials of Justice Dept. Oppose Prosecutors' Tactic in Corporate Criminal Cases*, N.Y. TIMES, Sept. 7, 2006, at C1 (describing letter from Kenneth Starr and Richard Thornburgh to the Justice Department criticizing government's request for privilege waivers in corporate prosecutions). On December 11, 2006, in response to threatened legislation and criticism of prosecutorial practices, the Department of Justice promulgated new guidelines for prosecutors. Memorandum from Paul J. McNulty, Deputy Attorney General, to United States Attorneys, Principles of Federal Prosecution of Business Organizations, available at [http://www.usdoj.gov/dag/speeches/2006/mcnulty\\_memo.pdf](http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf) [hereinafter McNulty Memo]. The McNulty Memo requires prosecutors to classify potentially privileged material into two categories and then seek approval from the Department of Justice prior to seeking the material. For a defense of the government's procedure of obtaining waivers, see George M. Cohen, *Of Coerced Waiver, Government Leverage, and Corporate Loyalty: The Holder, Thompson and McNulty Memos and Their Critics*, 93 VA. L. REV. (IN BRIEF) 137 (2007) (contending that unwillingness to waive privilege is simply a manifestation of corporate management's attempt at "saving their own necks").

20. As described by the court, the scheme:

allegedly involved at least four separate tax shelter vehicles, called FLIP, OPIS, BLIPS, and SOS, designed to generate phony tax losses through a series of sham transactions. The conspirators allegedly sought to protect their clients from potential IRS penalties by paying co-defendant Raymond Ruble, a New York tax attorney, to issue opinion letters falsely representing that the tax shelters were likely to survive IRS review.

*United States v. Stein*, 488 F. Supp. 2d 350, 354 (S.D.N.Y. 2007).

21. *United States v. Stein (Stein I)*, 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006). Pursuant to revised prosecutorial guidelines contained in the memorandum issued in the McNulty Memo of

KPMG to withdraw financial support for its employees' defenses, the government effectively reduced the individual defendants' ability to defend what had been characterized as the largest tax prosecution in history.

In a separate opinion, Judge Kaplan found that the prosecution also had pressured KPMG to coerce its employees to speak with government agents during the course of their investigation.<sup>22</sup> Under a policy that KPMG drafted (and the government approved), employees who cooperated with government agents and provided adequate assistance would have the benefit of private attorneys representing them, paid for by KPMG.<sup>23</sup> Those who declined to speak by exercising their Fifth Amendment right against self-incrimination or who provided less than complete information, however, would risk termination and be solely responsible for their legal representation.<sup>24</sup> In July of 2006, Judge Kaplan found that this agreement violated the individual employees' constitutional rights and suppressed several employee statements.<sup>25</sup> One year later, on July 17, 2007, the court dismissed the indictment against thirteen of the sixteen individual KPMG defendants, concluding that the government had used its overall leverage over KPMG to interfere not only with the individual defendants' constitutional privilege against self-incrimination, but also their rights to be defended by the counsel of their choice.<sup>26</sup>

Many will wonder if the KPMG episode is a singular example of one court punishing what it perceived as prosecutorial overreaching, or in fact is the harbinger of a sea change in the way prosecutors and corporate defendants do business. The former option seems more likely. Since Judge Kaplan laid out his initial criticisms in *Stein I* and *II*, the Department of Justice (DOJ) has revised its internal prosecutorial guidelines in a manner that is marginally more pro-defendant.<sup>27</sup> However, neither Judge Kaplan's

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December 2006, prosecutors may no longer consider the payment of an employee's attorney fees as reason for an indictment except in extraordinary circumstances. See McNulty Memo, *supra* note 19, at 11 (stating that "[p]rosecutors generally should not take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation and indictment").

22. Kaplan suppressed several of the KPMG employees' statements. *United States v. Stein (Stein II)*, 440 F. Supp. 2d 315, 319 (S.D.N.Y. 2006).

23. *Stein I*, 435 F. Supp. at 345–47.

24. "In other words, KPMG told its personnel that it would cut off payment of legal expenses of any employee who refused to talk to the government or who invoked the Fifth Amendment." *Stein II*, 440 F. Supp. at 318.

25. *Stein II*, 440 F. Supp. at 319.

26. *United States v. Stein (Stein III)*, 495 F. Supp. 2d 390, 414 (S.D.N.Y. 2007) (criticizing the government's "willingness . . . to use their life and death power over KPMG to induce KPMG to coerce its personnel to bend to the government's wishes notwithstanding the fact that the Constitution barred the government from doing directly what it forced KPMG to do for it"). Previously, the court had attempted to remedy the situation by suppressing the coerced employee statements and by authorizing and taking ancillary jurisdiction over a civil suit between the former employees and KPMG over the attorney fee payments. *United States v. Stein*, 452 F. Supp. 2d 230, 242–43 (2006), *vacated*, *Stein v. KPMG*, 486 F.3d 753 (2d Cir. 2007) (holding that the district court had no jurisdiction).

27. See McNulty Memo, *supra* note 19. The McNulty Memo in part arose in response to proposed legislation authored by Arlen Specter that would make it illegal for prosecutors to request a waiver of the attorney-client privilege. Attorney-Client Privilege Protection Act of 2006, S. 30, 109th Cong. (2006), *available at* [http://online.wsj.com/public/resources/documents/WSJ\\_thompsonmemoleg.pdf](http://online.wsj.com/public/resources/documents/WSJ_thompsonmemoleg.pdf).

decision nor the revised Department policy significantly changes the status quo.<sup>28</sup> The revised policy increases the administrative hurdle of requesting privileged material from corporate targets and discourages prosecutors from blatantly punishing corporations for advancing attorneys fees to employee-targets.<sup>29</sup> The new internal policy does not, however, alter the *respondeat superior* rule that has thrived in the organizational criminal context. Nor does it eliminate the collateral consequences of indictment. Accordingly, corporate entities will continue to enact compliance programs of questionable value and cut agreements with prosecutors that threaten to impose unnecessary costs on shareholders and society.<sup>30</sup> Federal prosecutors, meanwhile, will continue to use their power to regulate and rely on corporate entities to leverage their prosecutions of individual employees.

Instead of tweaking the current system of corporate criminal liability, this Article sets forth a more far-reaching proposal. In place of entity-based criminal liability, I propose a system of civil liability paired with “compliance insurance.” In place of prosecutors, insurance carriers would encourage organizations to monitor and police their employees through privately negotiated insurance policies. Carriers would set yearly premiums that would reflect the carriers’ assessment of the risk that a given company’s employees would violate the law in the course of their employment, and corporations would pay and disclose these premiums to their shareholders. Prosecutors would continue to prosecute individual employees aggressively for criminal conduct. On the entity level, however, employee crime would ordinarily trigger a civil pay-out to either private or government victims.<sup>31</sup> This system would maintain incentives for businesses to monitor and deter employee misconduct; preserve funds for restitution; remove uncertainty and waste from corporate monitoring efforts; and reduce inefficiencies caused by excess prosecutorial discretion.<sup>32</sup> This Article argues that even if it is politically impossible to achieve, its benefit—and its stark contrast to the system currently in place—suggests that scholars and policymakers may be unnecessarily overlooking the value of insurance-based incentives in deterring corporate crime.

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28. Judge Kaplan’s attempts at reform were made moot when the Second Circuit found a lack of ancillary jurisdiction over the KPMG attorneys’ fees dispute. The Second Circuit took no position on Kaplan’s previous conclusion that the DOJ had violated the employees’ rights to counsel by placing pressure on KPMG to withhold payments for attorneys fees. *See KPMG*, 486 F.3d at 753. Another court criticized the attorneys fees policy as “unquestionably obnoxious.” *United States v. Rosen*, 487 F. Supp. 2d 721, 737 (E.D. Va. 2007).

29. *See McNulty Memo*, *supra* note 19, at 11.

30. According to several studies, corporate crime has increased in the last five years. PWC 2005 REPORT, *supra* note 16, at 4 (explaining that “[e]conomic crime is a pervasive and growing threat to US and North American businesses of all types”). According to the PWC Report, internal controls fail to detect economic crime approximately sixty percent of the time. *Id.* at 16.

31. To the extent entities were already the subject of civil lawsuits, the system simply would ensure that the entity’s insurance paid for the costs of its employees’ wrongdoing, regardless of whether that wrongdoing was labeled “criminal.”

32. This Article focuses primarily on federal criminal prosecutions. I intend the term “corporate criminal liability” to encompass prosecutions of all legitimate business entities (corporations, partnerships, associations, and other unincorporated organizations). The concerns discussed in this Article do not apply to entities created solely for the purpose of masking criminal conduct.

Part I of this Article explains how the practice of corporate criminal liability causes corporate entities to overpay for leniency and compliance. Entity-based criminal liability is administered by federal prosecutors empowered by their investigatory authority, their charging discretion, and the broad standard of corporate criminal liability.<sup>33</sup> Corporate liability is often described as a composite system because it combines elements of strict and negligence-based liability.<sup>34</sup> On one hand, virtually all business organizations can be held vicariously liable for crimes committed by their employees in the course of their employment.<sup>35</sup> Organizations, however, can avoid liability or reduce their punishment significantly by demonstrating to prosecutors that they meet certain compliance and cooperation standards set forth by the DOJ.<sup>36</sup> Because the “cost” of indictment is so high, most corporate defendants will seek mitigation. Moreover, corporations who have yet to be accused of any type of wrongdoing will adopt methods and programs believed to be useful in avoiding corporate crime and favored by DOJ prosecutors, in the event criminal conduct is later detected.<sup>37</sup>

The problem with the composite system is that its mitigation rules are too vague and are administered and drafted by persons who lack the requisite information and incentives to set compliance and cooperation at efficient levels. As Part I explains, corporate organizations adopt internal policies that may or may not justify their costs.<sup>38</sup> To the extent organizations spend money on programs whose costs exceed their productivity, society is harmed.

Part II explores and analyzes several groups of reforms, including proposals to alter the liability standard,<sup>39</sup> place greater evidentiary burdens on prosecutors during the

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33. *Stolt-Nielsen S.A. v. United States*, 442 F.3d 177, 183 (3d Cir. 2006) (“[T]he executive branch ‘has exclusive authority and absolute discretion to decide whether to prosecute a case . . . .’” (quoting *United States v. Nixon*, 418 U.S. 683, 693 (1974))); *see also* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 688 (1997) (explaining that the corporate liability standard is “far reaching”).

34. *See, e.g.*, Arlen & Kraakman, *supra* note 33, at 688; Vikamaditya S. Khanna, *Corporate Liability Standards: When Should Corporations Be Held Criminally Liable?*, 37 AM. CRIM. L. REV. 1239 (2000); Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571, 581–83 (2005).

35. *See* discussion *infra* at 15.

36. *See* discussion *infra* at 22–27.

37. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with the Law*, 2002 COLUM. BUS. L. REV. 71, 72 (2002).

38. *See* Howard W. Goldstein, *When the Government Ends a Deferred Prosecution Pact*, N.Y. L. J., May 4, 2006, at 5 (explaining that from the point of view of “the corporate target, a deferred prosecution agreement—no matter how harsh and intrusive the terms—is frequently an offer the company simply cannot refuse when the alternative is possibly death or less drastic, but nonetheless severe, consequences”); Langevoort, *supra* note 37, at 74 (concluding that overestimates of the reliability of in-house monitoring combined with underestimates of the costs of third-party audits “biases the legal response towards insisting on too much auditing, forcing unnecessarily costly compliance initiatives”).

39. *See* Ainslie, *supra* note 18, at 110 (listing four suggested reforms); Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 530–32 (2006) (suggesting that the criminal prosecution of corporations should be limited to situations where the agent’s



investigation stage,<sup>40</sup> monitor prosecutors,<sup>41</sup> and eliminate corporate criminal liability altogether.<sup>42</sup> With the exception of the final category, none of these reforms are likely to achieve significant gains in efficiency.

Part III therefore proposes a different type of solution to the overpayment problem. In place of corporate criminal liability, I propose “compliance insurance,” a new insurance product that would return much of entity-based liability to the realm of tort, where it belongs.<sup>43</sup> This idea also builds on a growing body of literature that has begun to explore the link between insurance and corporate governance.<sup>44</sup>

As set forth in this Article, this would be an opt-in program whereby the private insurance market would sell “compliance insurance” to business organizations wishing to escape the current corporate criminal rules of *respondeat superior*. Insurance would cover losses stemming from employees’ violations of federal and state laws and regulations. Although current state laws prohibit insurance policies from covering intentional misconduct, compliance insurance would cover the entity’s *vicarious* risk, subject to certain exceptions discussed *infra*.

Compliance insurance would not replace Director and Officer (D&O) insurance. Nor would it replace or alter individual criminal prosecutions. Officers, directors, and employees would remain civilly and criminally liable for monetary penalties arising from their criminal misconduct. Organizations, however, would not be subject to criminal liability, so long as they obtained a minimum level of insurance, paid their premiums, and complied with their policies.

In this idealized world, insurance carriers would play a role similar to auditors, analysts, and lawyers and other corporate “gatekeepers.”<sup>45</sup> However, rather than

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action is the result of institutional influence).

40. Richard A. Bierschbach & Alex Stein, *Overenforcement*, 93 GEO. L. J. 1743, 1758 (2005).

41. Benjamin M. Greenblum, Note, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863, 1896–1904 (2005).

42. Fischel & Sykes, *supra* note 2, at 319.

43. Even in the tort context, the wisdom of corporate vicarious liability has been questioned. See, e.g., Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1749–1754 (1996) (criticizing fairness-based explanations for vicarious liability).

44. Professors Ronen and Cunningham have proposed and elaborated on an insurance scheme that would replace auditor liability for misstatements or omissions later found in public companies’ financial statements. See Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 413 (2004); Joshua Ronen, *Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited*, 8 STAN. J.L. BUS. & FIN. 39 (2002). Professor Griffith has also argued for mandatory disclosure of directors’ and officers’ policies as a market signal. Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies*, 154 U. PA. L. REV. 1147 (2006) (calling for mandatory disclosure of officers’ and directors’ policies because policies can signal market on strength of corporation’s internal governance mechanisms).

45. Gatekeepers have been described as persons who use their reputation capital to bridge the gap between investors and corporate managers. See John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308 (2004) [hereinafter Coffee, *Gatekeeper Reform*]; John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid,”* 57 BUS. LAW. 1403, 1405 (2002) (describing gatekeepers as

placing their reputations at risk, carriers would place their *actual* capital at risk and would be less susceptible to capture.

### I. HOW BUSINESSES OVERPAY FOR CORPORATE CRIME

The following Part examines how public corporations have come to occupy a position whereby they overpay, in terms of compliance costs and over-deterrence, for the prosecutorial leniency necessary for smoothing the potentially huge disruptions caused by entity-based criminal liability.

Entities were not always subject to criminal liability. Until the 1800s, courts agreed that corporate criminal liability could not exist because corporations lacked the requisite intent to be held morally culpable for their employees' conduct.<sup>46</sup> The watershed case that established criminal *respondeat superior* liability for intent-based crimes was *New York Central*.<sup>47</sup> In *New York Central*, the Supreme Court upheld the provision of the Elkins Act that held that corporations could be prosecuted for their employees' failure to comply with the tariffs set by the Interstate Commerce Commission (ICC).<sup>48</sup> Although the Supreme Court acknowledged that common law did not recognize corporate criminal liability, it nevertheless reasoned that, "we go only a step farther," by extending vicarious tort liability to criminal violations.<sup>49</sup> Otherwise, the Court reasoned, "many offenses might go unpunished and acts be committed in violation of law . . . ."<sup>50</sup>

The fear that offenses "might go unpunished" absent criminal liability is obsolete.<sup>51</sup> State and federal governments now possess tremendous regulatory and purchasing power over much of the business world.<sup>52</sup> Nevertheless, over the years, most

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"reputational intermediates"). Sean J. Griffith has referred to insurance carriers as "accidental gatekeepers," since their primary intent is to assess risk and not to provide information to investors. Griffith, *supra* note 44, at 1150.

46. By the mid-1800s, some courts permitted criminal prosecution of municipal corporations for failing to maintain public bridges or highways. See Ainslie, *supra* note 18, at 110–11; Laufer, *supra* note 18, at 1361. Under English common law:

well into the 1800s—the corporation could not be indicted at all unless it created a nuisance by failing to perform a public duty. "Prosecution" in such instances was not viewed as a criminal proceeding, but as a means of ensuring that duties imposed by charter or statute were carried out. Most cases involved a failure to repair highways or bridges, or to keep navigable waterways clear. Not until the 1840s—just as the corporation was becoming intertwined in the daily lives of ordinary men and women—was it held that corporations could be prosecuted criminally for malfeasance, at least when nonviolent misdemeanors were charged.

Lawrence Mitchell Rothman, *Life After Doe? Self-Incrimination and Business Documents*, 56 U. CIN. L. REV. 387, 403 n.82 (1987) (citations omitted).

47. *N.Y. Cent. & Hudson River R.R. v. United States*, 212 U.S. 481 (1909).

48. *Id.* at 494. The railroad company was charged with payment of an illegal rebate. *Id.* at 489.

49. *Id.* at 494.

50. *Id.* at 495.

51. See Pamela H. Bucy, *Organizational Sentencing Guidelines: The Cart Before the Horse*, 71 WASH. U. L.Q. 329, 340 (1993) (describing the Court's reasoning as "flawed and outdated").

52. See Greenblum, *supra* note 41, at 1885–89 (explaining that the government may seek civil fines or forfeiture; freeze the offender's assets; obtain cease and desist orders; withdraw

legislators have reacted to well-publicized instances of corporate fraud (e.g. Enron and Worldcom) and inadequate monitoring (e.g. Arthur Andersen) by increasing criminal sanctions in the wake of each new wave of scandals.<sup>53</sup> Over the last hundred years, individual federal criminal liability for individuals<sup>54</sup> and corporate criminal liability in general have significantly expanded to include misconduct that previously had fallen either within the realm of tort law or under state or local control.<sup>55</sup> Accordingly, as the field of criminal law expands, all organizations must contend with the consequences of criminal liability.

In addition to expanded federal criminal liability, the last three decades have produced a systemic proliferation in corporate compliance programs tasked with monitoring organizational compliance in an expanding regulatory field.<sup>56</sup> Compliance programs in turn, have generated and sustained an entire new industry of so-called experts: lawyers, accountants, and other consultants who draft corporate codes, staff corporate ethics offices and whistleblower hotlines, create corporate-wide training programs, and assist corporate security officers in increasingly complex internal investigations.<sup>57</sup> At their best, corporate compliance programs can reduce and identify, but not necessarily eliminate, employee crime.

#### A. *The Powers of the Federal Prosecutor*

As a result of the trend in federal criminalization of previously civil and regulatory misconduct, business entities are particularly prone to prosecution by federal prosecutors.<sup>58</sup> Federal prosecutors, in turn, possess significantly broader powers than

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necessary licenses or permits; and/or cancel government contracts and debar or disqualify the offender from contracting to supply future business to government agencies).

53. Vikamaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L. Q. 95, 95 (2004) (“[M]ost corporate crime legislation arises when there is a large public outcry over a series of corporate scandals during or around a downturn in the economy.”).

54. See Robert A. Creamer, *Criminal Law Concerns for Civil Lawyers*, FED. LAW., May 2005, at 34, 35 (citing the thirteen federal criminal statutes that are most often invoked against individuals in white-collar cases). Unlike common law fraud, which required a showing of loss caused by a particular false statement, the federal mail and wire fraud statutes require only the use of the mails or interstate wires and a scheme to defraud a person of property or the intangible right to another person’s honest services. HASNAS, *supra* note 18, at 12 (concluding that the federal fraud statutes “authorize the punishment of almost any kind of dishonest or deceptive behavior, even when no other party has suffered any harm”).

55. See John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal”?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 202 (1991).

56. See generally Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 280 (2004) (noting the recent increase in corporate compliance programs).

57. See Tanina Rostain, *The Emergence of “Law Consultants,”* 75 FORD. L. REV. 1397 (2006). Compliance programs first surfaced in response to the Federal Corrupt Practices Act (FCPA), which required compliance officers to educate corporate employees on the illegality of bribing foreign officers. Rebecca Walker, *The Evolution of the Law of Corporate Compliance in the United States: A Brief Overview*, 1561 PLI/CORP 13 (2006). Later scandals in the defense contracting, health care, and securities industries prompted further rounds of internal controls. *Id.*

58. See John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law*

their civil and local counterparts.<sup>59</sup> They may serve grand jury subpoenas on any entity within the United States for documents.<sup>60</sup> The “grand jury’s” document requests (which in reality are guided substantially by the prosecutor) are restrained by few rules of relevancy or evidence.<sup>61</sup>

Prosecutors also may compel witnesses to testify at trial or before a grand jury.<sup>62</sup> If those witnesses refuse to speak, prosecutors may immunize those witnesses and seek contempt orders and imprisonment if the witnesses persist in their silence.<sup>63</sup> If the prosecutor fears that a business entity will destroy evidence of criminal wrongdoing, she may obtain a search warrant, instruct federal agents to seize that evidence, and, if necessary, investigate and prosecute the entity and its employees for obstruction of justice.<sup>64</sup>

While federal prosecutors have great powers to compel others to produce evidence, they have relatively few disclosure obligations of their own.<sup>65</sup> The grand jury need not identify the purpose for which the document or testimony is sought.<sup>66</sup> The affidavit

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*Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1880 (1992) (explaining the vulnerability of corporations to be a result of “the common statutory pattern in the United States for a statute establishing an administrative agency to provide that any willful violation of the rules adopted by the agency constitutes a federal felony”). For a more general discussion of over-criminalization and legislators’ political incentives to err on the side of greater criminal liability than necessary, see William J. Stuntz, *The Political Constitution of Criminal Justice*, 119 HARV. L. REV. 780, 802–07 (2006).

59. See Pamela H. Bucy, *Moral Messengers: Delegating Prosecutorial Power*, 59 SMUL. REV. 321, 327 (2006) (noting that states have lagged behind the federal government in passing aggressive laws).

60. *Id.* at 321 (discussing broad prosecutorial subpoena power). Unless protected by the attorney-client privilege or work product doctrines, entities must produce the documents specified in the grand jury subpoena. See *id.* They may not rely on the Fifth Amendment privilege against self-incrimination. See *Hale v. Henkel*, 201 U.S. 43, 74 (1906); HASNAS, *supra* note 18, at 27.

61. *United States v. R. Enters.*, 498 U.S. 292, 298 (1991) (emphasizing that rules and restrictions that apply at trial do not apply to grand jury proceedings); see also Niki Kuckes, *The Useful, Dangerous Fiction of Grand Jury Independence*, 41 AM. CRIM. L. REV. 1, 3 (2004) (criticizing pretense that grand jury is independent from federal prosecutor).

62. *Chavez v. Martinez*, 538 U.S. 760, 767–68 (2003) (“It is well established that the government may compel witnesses to testify at trial or before a grand jury, on pain of contempt, so long as the witness is not the target of the criminal case in which he testifies.”).

63. See *id.* at 768 (“Even for persons who have a legitimate fear that their statements may subject them to criminal prosecution, we have long permitted the compulsion of incriminating testimony so long as those statements (or evidence derived from those statements) cannot be used against the speaker in any criminal case.”); Bucy, *supra* note 51, at 341 (discussing broad prosecutorial power to grant immunity).

64. See Fed. R. Crim. P. 41 (authorizing search warrants); 18 U.S.C. § 1505 (2000) (criminalizing obstruction of justice in federal investigations); 18 U.S.C. § 1511 (2000) (criminalizing obstruction of state or local investigations); 18 U.S.C. § 1519 (Supp. V 2005) (criminalizing destruction or alteration of records with the intent to impede or obstruct federal investigations).

65. See Susan R. Klein, *Enhancing the Judicial Role in Criminal Plea and Sentence Bargaining*, 84 TEX. L. REV. 2043–45 (2006). Compare FED. R. CRIM. P. 16, with FED. R. CRIM. P. 26.

66. *R. Enters.*, 498 U.S. at 301 (limiting quashing of grand jury subpoenas to situations in which there is no reasonable possibility of uncovering relevant information).

supporting the search warrant may be sealed by a district judge and remain under seal while the government completes its investigation.<sup>67</sup> Discovery, which is significantly more limited in criminal than in civil cases, will not be ordered until after the prosecutor has obtained an indictment from the grand jury.<sup>68</sup> Even then, the prosecutor need not produce every page of her file; rather, she need only produce the defendant's own statements and any evidence she intends to offer at trial.<sup>69</sup> As a result, in any corporate prosecution, informational asymmetries will abound. In some instances, the prosecutor may have a better sense of the company's (and its individual employees') liability than the company's independent board members or general counsel.

Although the disclosure rules favor the prosecutor, her greatest source of power is her unfettered charging discretion. Absent some showing of post-trial "vindictiveness" or racially motivated behavior, the prosecutor's charging decision is sacrosanct.<sup>70</sup> No court can overturn a prosecutor's decision *not* to prosecute someone.<sup>71</sup> Nor can any court throw out an otherwise factually sufficient indictment simply because the court disagrees with the prosecutor's exercise of discretion.<sup>72</sup>

The plea bargaining process, which includes deferred prosecution agreements<sup>73</sup> (DPAs)—is largely immune from judicial review. The federal prosecutor who pursues a corporate defendant is subject neither to the administrative constraints of a regulator

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67. *Matter of Sealed Affidavits to Search Warrants Executed on February 14, 1977*, 600 F.2d 1256, 1257 (9th Cir. 1979) ("courts have inherent power, as an incident of their constitutional function, to control papers filed within the courts within constitutional and other limitations"); *United States v. Napier*, 436 F.3d 1133, 1139 (9th Cir. 2006) (affirming lower court's refusal to unseal portions of affidavit that related to confidential informant); *Times Mirror Co. v. U.S. District Court*, 873 F.2d 1210, 1219 (9th Cir. 1999) (sealing of affidavit appropriate to protect pre-indictment investigation). *See also* David Horan, *Breaking the Seal on White Collar Search Warrant Materials*, 28 PEP. L. REV. 317, 324 (2001) (observing that sealing of federal search warrants has become common).

68. *See* FED. R. CRIM. P. 16.

69. *Id.*

70. "In our system, so long as the prosecutor has probable cause to believe that the accused committed an offense defined by statute, the decision whether or not to prosecute, and what charge to file or bring before a grand jury, generally rests entirely in his discretion." *Bordenkircher v. Hayes*, 434 U.S. 357, 364 (1978); *see also* U.S. CONST. art. II, § 3 (granting Executive power to "take Care that the Laws be faithfully executed").

71. *See generally* *Linda R.S. v. Richard D.*, 410 U.S. 614, 619 (1973) (holding that private individuals lack "judicially cognizable interest" in prosecution of another person).

72. *United States v. Williams*, 504 U.S. 36, 48 (1992) (holding that prosecutor not required to seek court's approval for indictment).

73. DPAs fall within two broad categories. Some are drafted and entered into before the prosecutor has filed any charges whatsoever. In those instances, the DPA is purely "private" and the courts have no interest in these agreements *ex ante*. In a second group, the Government files an information or complaint, but the parties agree that it will be deferred for the length of time agreed upon in the DPA. A court then must sign off on the DPA insofar as it implicates the Speedy Trial Act. Other than the Speedy Trial Act concern, however, the court does not review the agreement's substance. *See* Wilson Meeks, Note, *Corporate and White-Collar Crime Enforcement: Should Regulation and Rehabilitation Spell an End to Corporate Criminal Liability?*, 40 COLUM. J.L. & SOC. PROBS. 77, 107 (2006).

nor the litigation restraints of a civil attorney. Her word is final and her mistakes are largely unknowable and uncorrectable.<sup>74</sup>

*B. The Prosecutor's Burden*

Where prosecutions of individuals are concerned, the prosecutor's broad powers might be justified as necessary to meet the burden of proving guilt beyond a reasonable doubt.

Prosecutors have often claimed that these powers are necessary because: (a) violations within the corporate context are more complex and therefore more difficult to detect and explain to a jury; (b) suspects are well-funded and have access to good legal representation; and (c) the crimes are often committed by groups of people who can use their collective powers (and their positions within the firm itself) to obstruct the government's investigation and thwart legitimate law enforcement aims.<sup>75</sup>

If the government is unable to identify the person or persons who are responsible for wrongdoing, employees and managers will be undeterred from committing corporate crimes. Potential investors, in turn, may question the integrity of public (and private) markets and may either leave the market altogether or invest inefficiently in their own protection. Accordingly, prosecutors argue, there is good reason for the government to have broad power to demand information and access from corporate firms. From this perspective, the corporate managers who complain about corporate liability are not so worried about protecting the entity as they are with protecting their own skin.<sup>76</sup>

Courts and legislatures, however, have alleviated the prosecutor's burden in white collar prosecutions in number of ways.<sup>77</sup> They have made it relatively easy for the government to request and obtain information from corporate entities.<sup>78</sup> They have expanded the prosecutor's reach by enacting a proliferating number of (often overlapping) criminal statutes.<sup>79</sup> They have increased sentences<sup>80</sup> for individual

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74. For similar criticisms of the judiciary, see Richard A. Epstein, *The Unintended Revolution in Products Liability Law*, 10 CARDOZO L. REV. 2193, 2202–03 (1980) (“Today all doctrinal innovation has to come from the courts, where the technical lags and information deficits are at their highest. Yet there is no alternative forum, save legislation, in which to override judgments when they have proved mistaken; indeed, there is no way to find out whether they are mistaken at all.”).

75. See Bharara, *supra* note 2, at 72 (citing the “widespread—and largely legitimate—view that white collar crime is singularly difficult to detect, investigate, and prosecute”); Peter J. Henning, *Testing the Limits of Investigating and Prosecuting White-Collar Crime: How Far Will the Courts Allow Prosecutors to Go?*, 54 U. PITT. L. REV. 405 (1993) (analyzing current trends in white collar cases that courts are struggling to resolve).

76. Cohen, *supra* note 19, at 146–47.

77. See generally HASNAS, *supra* note 18, at 23–55 (describing solutions to enforcement of corporate criminal liability).

78. *Hale v. Henkel*, 201 U.S. 43 (1906).

79. HASNAS, *supra* note 18, at 31–32.

80. See Frank O. Bowman, Pour Encourager Les Autres? *The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments that Followed*, 1 OHIO ST. J. CRIM. L. 373 (2004) (tracking the increase of penalties for economic crime offenders under United States Sentencing

offenses (including white collar crimes) and simultaneously have offered attractive cooperation agreements for defendants who help the government, thereby increasing the likelihood that some employee-defendants will turn on others. Finally, they have enacted an incredibly broad liability standard for corporate entities. It is this last “innovation” that is discussed in the next Section.

### *C. The Need for Composite Liability*

The contemporary criminal liability standard for organizations is incredibly broad.<sup>81</sup> Business entities may be held criminally liable for any act by any employee acting within the scope of his apparent authority provided the employee acted with at least a partial intent of benefiting the corporation.<sup>82</sup> The organization may be prosecuted for an employee’s conduct regardless of whether it violated corporate policy or specific instructions.<sup>83</sup> Even where criminal conduct cannot be attributed to a single employee, the corporation still may be prosecuted under a collective knowledge theory.<sup>84</sup>

Under this broad enunciation of liability, hundreds of thousands of entities are potentially eligible for prosecution every year.<sup>85</sup> Federal prosecutors, however, lack both the physical and political resources to prosecute every guilty entity. Moreover, prosecutions and convictions of organizations have far-reaching collateral effects. Were the government to systematically indict each plausibly guilty organizational defendant, the visible, harmful fall-out of these indictments might spur the public to contract the liability standard or re-examine its consequences. Instead—either with an intent to preserving resources or maintaining power—the federal criminal justice system has adopted what is often referred to as a “composite” standard of liability. Although the organization technically operates in a strict liability regime, prosecutors (and, pursuant to the Organizational Sentencing Guidelines, judges) may soften that liability when the organization demonstrates sufficient compliance efforts prior to detection, and cooperation efforts after detection.

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Guidelines in 2001, and additional increases that occurred following passage of Sarbanes-Oxley Act of 2002); Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 954 (2003) (describing significant increases in statutory maximum penalties for economic crimes pursuant to Sarbanes-Oxley).

81. In a 2005 speech, Mary Jo White, a former United States Attorney of the Southern District of New York, soberly warned an audience of defense attorneys:

[T]he sweep of corporate criminal liability could hardly be broader. All of you in this audience probably know the law well, but its breathtaking scope always bears repeating: If a single employee, however low down in the corporate hierarchy, commits a crime in the course of his or her employment, even in part to benefit the corporation, the corporate employer is criminally liable for that employee’s crime. It is essentially absolute liability.

Mary Jo White, *Corporate Criminal Liability: What Has Gone Wrong?*, 1517 PLI/CORP 815 (2005).

82. See, e.g., *United States v. Automated Med. Labs*, 770 F.2d 399 (4th Cir. 1985).

83. *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972).

84. See *United States v. Bank of New Eng.*, 821 F.2d 844 (1st Cir. 1987).

85. See HASNAS, *supra* note 18, at 12 (federal criminal law statutes such as mail fraud statute “authorize the punishment of almost any kind of dishonest or deceptive behavior, even when no other party has suffered harm”).

Compliance and cooperation help the government and the organization, albeit in different ways. For the organization, compliance and cooperation lessen the possibility that the government will charge the organization at all and, if all else fails, reduce its likely sentence under the Organizational Sentencing Guidelines (OSG). At the same time, the composite system provides the government with a method of screening potential defendants, maintaining control over business entities, and leveraging its prosecution of individuals. Moreover, because it leaves the specific details of internal compliance largely to the private sector, the system creates an impression of flexibility and private initiative.<sup>86</sup>

Theoretically, society ought to prefer the composite system of liability to its two logical alternatives, negligence and strict liability.<sup>87</sup>

Under a negligence regime, organizations are criminally liable only if the government proves that they failed to monitor employees adequately and prevent and report their crimes. This definition of “due care” creates strong incentives for firms to monitor their employees and credibly deters the firm’s employees, who fear both internal detection and external prosecution.<sup>88</sup> However, there may be some activities that, regardless of an organization’s due care, create substantial costs. Under a negligence system, these costs are borne solely by the firm’s victims. If victims are unable to shift these costs back onto producers, then producers will engage in the same level of activity without regard to the activity’s true costs. Negligence fails to secure optimal activity levels.<sup>89</sup> Moreover, because a negligence regime requires a determination of due care by a finder of fact, it is administratively expensive and prone to error.<sup>90</sup> Accordingly, strict liability is preferable when externalities are prevalent and due care determinations are likely to be difficult.

Strict liability—which holds the organization strictly liable for all of its employees’ work-related torts and crimes—is preferable to negligence insofar as it forces firms to set activity levels at optimal levels. It also avoids the error and cost problems that plague negligence systems. On the other hand, as Professors Arlen and Kraakman explain, strict liability perversely discourages firms from monitoring, detecting, and reporting their employees’ wrongdoing because firms receive no credit for monitoring and reporting employee crime.<sup>91</sup> To the contrary, monitoring *increases* the likelihood

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86. “Legislative and regulatory responses to private sector crises using internal controls enable the state to reach into the private sector to exert power, while preserving the essentially private character of its organizations and their operation.” Cunningham, *supra* note 56, at 281.

87. Arlen & Kraakman, *supra* note 33, at 718. Arlen and Kraakman further distinguish between “adjusted strict liability” regimes that hold firms strictly liable for their employees’ crimes, but insulate their monitoring results (through an evidentiary privilege, for example); and “composite regimes,” which hold firms liable for “all detected wrongs but impos[e] an additional sanction on firms with suboptimal policing measures.” *Id.* at 726. As used in this Article, the term “composite liability” refers to this second category of mixed liability regimes.

88. *Id.* at 715–16.

89. *Id.*

90. *Id.*

91. *Id.* at 707–09; see also Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994) (presenting an economic analysis of the impact of strict liability on corporate expenditures on enforcement costs). Even under a strict liability regime, some corporate managers will employ monitoring as a form of self-defense, which in turn may disclose crimes that “help” the organization. For example, a CFO who is



of liability for residual crimes that the company can only detect but not prevent. If the combined costs of monitoring and increased liability for detection outweigh the benefits of prevention, then rational firms will divert resources from monitoring or instead erect “cosmetic” monitoring programs.<sup>92</sup> Moreover, since employees know that their employer does not want to detect crime, employees in a strict liability regime do not take their employers’ monitoring threats seriously.<sup>93</sup>

Under a composite liability rule, the entity is strictly liable for its employees’ wrongdoing, but may mitigate its sentence by demonstrating a defined level of care (i.e. monitoring and reporting). The composite system is often deemed superior to a pure strict liability system because it preserves the firm’s incentives to monitor and report wrongdoing, yet bypasses the administrative costs of the negligence system. In this ideal world, firms self-monitor, detect, and report crime (for which they are rewarded with lesser penalties), and yet they also strive to set activity levels at optimal levels.<sup>94</sup>

Unfortunately, the composite system’s theoretical advantages are eclipsed by the drawbacks of its real-world application. These drawbacks include: (1) the use of vaguely worded performance standards in lieu of specific rules that lay out the terms of mitigation;<sup>95</sup> (2) a lack of transparency in the manner in which these performance standards are applied to individual cases; and (3) the dearth of opportunities to challenge the government’s decision-making process. All of these drawbacks taken together effectively distort much of the composite system’s theoretical benefits.<sup>96</sup>

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cooking the books might also be siphoning money from corporate accounts into his own bank account. If organizations employ controls to deter the second type of conduct, they may simultaneously detect the first type. See James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1, 14–15 (1997). Self-defensive monitoring, however, may be insufficient if the employee of the organization is effectively insulated from the effects of the employee’s criminal conduct (e.g., dumping toxic chemicals into a river that is located far away). Nor does it ensure that corporations will report to authorities the misconduct that they detect. Cf. Richard A. Epstein, *Imperfect Liability Regimes: Individual and Corporate Issues*, 53 S.C. L. REV. 1153, 1156–57 (2001) (in the context of automobile accidents, observing that self-bonding is an incomplete deterrent when injurer can insulate himself from harm).

92. See Arlen & Kraakman, *supra* note 33, at 707, and Arlen, *supra* note 91, at 836, for discussions of diversion of resources. For “cosmetic compliance,” see Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1231 (2003) (describing “window dressing” measures); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003).

93. Arlen & Kraakman, *supra* note 33, at 714–15. If the probability of detection were already very high, firms subject to strict liability might still adopt monitoring regimes since they would not increase the probability of detection substantially. See Khanna, *supra* note 92, at 1232.

94. See Khanna, *supra* note 92, at 1268–69.

95. I am referring to the tri-partite discussion of regulation (command-and-control rules, performance based standards, and incentives) set out by Susan Rose-Ackerman and amplified by Jon Hanson and Kyle Logue. Jon D. Hanson & Kyle D. Logue, *The Costs of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 107 YALE L.J. 1163, 1173–74, 1264 (1998) (citing SUSAN ROSE-ACKERMAN, *RETHINKING THE PROGRESSIVE AGENDA: THE REFORM OF THE AMERICAN REGULATORY STATE* (1992)).

96. “The most profound problem with [the composite regime] is the likely indeterminacy of the undertaking to engage in ‘optimal’ compliance efforts. Such a finding will be made *ex post*

*D. The DOJ's Execution of the Composite System*

The Department of Justice's (DOJ's) nonbinding internal policies for prosecutors lay out the standards of conduct that prosecutors must consider when they decide whether an organization has earned mitigation under the composite system.<sup>97</sup> Over the last decade, these policies have been circulated in memoranda form by the presiding Deputy Attorney General.<sup>98</sup>

1. The McNulty Memo: An Overview

The McNulty Memo, implemented by Paul McNulty on December 12, 2006, is the latest iteration of the DOJ's internal policy for charging business entities.<sup>99</sup> The McNulty Memo came about in part because the ABA and numerous scholars and practitioners had repeatedly criticized its predecessor policy, the Thompson Memo (named for then Deputy Attorney General Larry Thompson) for encouraging prosecutors to consider the organization's willingness to waive its attorney-client privilege in exchange for lenience.<sup>100</sup> Judge Kaplan's opinion in *Stein I* (which addressed a related issue, the government's pressure on companies to deny attorneys fees to indicted employees), followed by Senator Arlen Specter's threats to enact legislation protecting the corporate attorney-client privilege, precipitated the DOJ's revision of its internal charging policies.<sup>101</sup>

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and there likely will be little guidance *ex ante* as to what constitutes optimal compliance efforts." Cox, *supra* note 91, at 16 (emphasis in original).

97. It is unclear how the DOJ would respond to instances in which prosecutors failed to adhere to these policies, which expressly deny the creation of any substantive or procedural rights for business entities. See, e.g., McNulty Memo, *supra* note 19, at 19. The Department of Justice historically has exercised uneven levels of authority over the United States Attorneys' offices. See Daniel C. Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 805 (1999) (discussing dispersed authority of U.S. Attorneys' offices).

98. The SEC maintains a separate Framework for Cooperation by which its Enforcement Division evaluates whether corporations should be fined or criminally prosecuted for their employee's violations of the security laws. Like the DOJ's internal policies, the SEC's framework urges its regulators to examine the organization's compliance program and its subsequent cooperation with SEC staff. Criminal charging decisions, however, are ultimately made by the prosecutors within the United States Attorneys' Offices and the Department of Justice. The relationship between federal prosecutors and regulators and the costs and benefits of parallel civil and criminal litigation is beyond the scope of this Article.

99. See McNulty Memo, *supra* note 19.

100. E.g., ABA Task Force on the Attorney-Client Privilege, *Report of the American Bar Association's Task Force on the Attorney-Client Privilege*, 60 BUS. LAW. 1029, 1043-46 (2005); Earl J. Silbert & Demme Doufekias Joannou, *Under Pressure to Catch the Crooks: The Impact of Corporate Privilege Waiver on the Adversarial System*, 43 AM. CRIM. L. REV. 1225, 1238 (2006).

101. On September 13, 2006, Paul McNulty, then Deputy Attorney General, announced during testimony before the Judiciary Committee (then headed by Specter) that the Department of Justice was reviewing its internal charging memorandum in light of the criticism of the KPMG case. See Lynnley Browning, *Justice Department is Reviewing Corporate Prosecution Guidelines*, N.Y. TIMES, Sept. 13, 2006, at C3.

Breaking from its predecessor policies, the McNulty Memo arguably protects attorney-client privileged documents by requiring prosecutors to seek advance DOJ approval and follow certain procedures prior to seeking a corporate waiver.<sup>102</sup> Apart from the new waiver procedure and a provision advising that organizations ordinarily will not be penalized for paying attorneys fees for employees who have been targeted by the prosecution,<sup>103</sup> the McNulty Memo's substantive provisions are nearly identical to the Thompson Memo, which was released to the public on January 20, 2003, and governed prosecutorial charging decisions from that date through December 10, 2006.<sup>104</sup> Both the McNulty and Thompson Memos affirmatively require<sup>105</sup> prosecutors to assess entity-based charges in "any matter" of business crime and to include an analysis of each of nine factors.<sup>106</sup>

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102. McNulty Memo, *supra* note 19, at 8. In order to obtain such approval, the individual prosecutor must demonstrate a "legitimate need" for such documents, which in turn depends on: (a) the likelihood the privileged information will assist the government's investigation; (b) whether alternate means of obtaining the information exist; (c) the completeness of the organization's voluntary disclosure; and (d) the collateral consequences of waiver to the corporation. *Id.* at 9.

103. "Prosecutors generally should not take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation and indictment." *Id.* at 11. A footnote suggests, however, that such payments *may* be taken into account if it appears that the corporation is behaving in such a manner as to obstruct the investigation. *Id.* at 11 n.3. It is unclear what the DOJ means by this footnote since any payment of fees is "obstructive" insofar as it assists a target in leveraging his defense.

104. The first DOJ memo to set forth the government's position on charging corporations for their employees' crimes was released by Deputy Attorney General Eric Holder in 1999. The Holder Memo, which originally was not released to the public, was intended only as a summary of "best" practices that different United States Attorneys' Offices had adopted, partly in response to the Organizational Sentencing Guidelines, which also employed a similar "carrot and stick" approach. Finder & McConnell, *supra* note 14, at 3, 6-9.

105. Memorandum from Larry D. Thompson, Deputy Attorney General, to United States Attorneys, *Principles of Federal Prosecution of Business Organizations* (Jan. 20, 2003), available at [http://www.usdoj.gov/dag/cftf/business\\_organizations.pdf](http://www.usdoj.gov/dag/cftf/business_organizations.pdf) [hereinafter Thompson Memo]; McNulty Memo, *supra* note 19, at 2; see also Christopher J. Christie & Robert M. Hanna, *A Push Down the Road of Good Corporate Citizenship: The Deferred Prosecution Agreement Between the U.S. Attorney for the District of New Jersey and Bristol-Meyers Squibb Co.*, 43 AM. CRIM. L. REV. 1043, 1045 (2006) (noting that the Thompson Memo's "analytical framework applies in all corporate fraud investigations").

106. McNulty Memo, *supra* note 19, at 4; Thompson Memo, *supra* note 105, at 3-4. Those nine factors are: (1) the nature and seriousness of the offense; (2) the "pervasiveness of wrongdoing within the organization; (3) the organization's history of similar conduct; (4) the organization's "timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents" including willingness to waive the attorney-client privilege; (5) the "existence and adequacy of the corporation's compliance program"; (6) remedial actions, including any efforts to implement an "effective" corporate compliance program or to improve an existing one or to replace, discipline, or terminate "wrongdoers"; (7) collateral consequences and impact on the public arising from the prosecution; (8) the adequacy of the prosecution of individuals responsible for the corporation's malfeasance; and (9) the adequacy of civil or regulatory enforcement actions. *Id.*

Both Memos rest on the assumption that entity-based prosecutions improve corporate business. Without attempting to separate out entity-based prosecutions from prosecutions of individual defendants, the McNulty Memo lauds prosecutors for their “unprecedented success in prosecuting corporate fraud” during the preceding four years. As a result of these prosecutions, “the information used by our nation’s financial markets is more reliable, our retirement plans are more secure, and the investing public is better protected as a result of our efforts.”<sup>107</sup>

The McNulty Memo does not consider whether the alleged increase in the reliability of markets and pension plans is traceable solely to entity-based prosecutions, or whether such increase in liability stems from structural improvements brought about by the Sarbanes-Oxley Act of 2002,<sup>108</sup> the government’s increased prosecution of individual criminals, and the public’s and media’s increased attention to the veracity of financial reporting. Moreover, the Memo fails to consider the point at which social costs of corporate “self-regulation” outweigh the benefits of fraud reduction. Instead, the Memo implies that *any* reduction in fraud redounds to the benefit of shareholders.

## 2. McNulty, Morality, and the Nature of the Firm

Like its predecessor, the McNulty Memo defends corporate criminal liability as a means “to address and be a force for positive change of corporate culture [and] alter corporate behavior.”<sup>109</sup> This statement is important because it belies a presumption that corporate entities are singular moral actors and therefore amenable to blame and punishment. This presumption, however, is hardly a foregone notion.

Although some scholars have proposed (and the McNulty Memo presumes) that an identifiable “corporate ethos” or culture causes individual criminal conduct and therefore subjects the corporate entity to moral condemnation and criminal liability,<sup>110</sup> nowhere else in criminal law does such a broad theory of vicarious liability exist.<sup>111</sup> Moreover, the culture-based argument for entity liability ignores the modern understanding of the corporation as an organizational form that brings together a mass of uninformed and fairly weak owners (shareholders) who must depend in large part on directors to monitor the strong executives who run the firm.<sup>112</sup>

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107. McNulty Memo, *supra* note 19, at 1.

108. See Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

109. McNulty Memo, *supra* note 19, at 2; Thompson Memo, *supra* note 105, at 1.

110. E.g., Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1099 (1991); Buell, *supra* note 39.

111. According to Professor Brown:

Criminal law has well established ways to address conduct that wrongly compels others to commit crimes—for example, liability for coercion and duress defenses—or wrongly encourages or aids others in crime commission—for example, complicity and accomplice liability. And when another’s influence on an actor’s conduct falls short of complicity . . . no liability follows, even though it may be a real influence.

Darryl K. Brown, *Street Crime, Corporate Crime and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1318 (2001).

112. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

To the extent that one subscribes to the view that a public corporation is a form of ownership that permits a diffuse group of investors (shareholders) to efficiently do business with a much smaller, coordinated group of professionals (managers), with the oversight of agents (directors), corporate crime is not a separate moral wrong, but rather yet another agency cost that investors must figure out how to control.<sup>113</sup> These costs are further complicated by the complex organization into which the modern corporation has evolved.<sup>114</sup> Corporate criminal liability, under this view, is not only inefficient, but it is also highly unfair: it effectively punishes shareholders for the very agency costs they already were attempting to reduce and control.<sup>115</sup>

### 3. McNulty and Compliance

In addition to treating the corporation as a moral actor, the Memo also lauds the prosecutor's opportunity to create "deterrence on a massive scale" by indicting one corporate actor in an industry suffering "pervasive" criminal conduct, as well as the

113. Agency costs are the costs that arise when managers' interests diverge from those of the principals (shareholders) on whose behalf they act. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Agency costs have often been described as "one of the central problems organizing the field of corporate law." Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705, 1715 (1996).

114. As explained by Dean Oakes:

The truth is that organizational failure is caused by more than a failure in coordination, planning or information processing. There are micro-economic rewards and punishments within the organization and varying levels of leadership and employee motivation. The corporate setting is even more complicated by concepts and practices such as team production, work groups, independent departmental profit and loss calculations, etc.

Richard T. Oakes, *Anthropomorphic Projection and Chapter Eight of the Federal Sentencing Guidelines: Punishing the Good Organization When It Does Evil*, 22 HAMLINE L. REV. 749, 759 (1999); see also Croley, *supra* note 113, at 1706 ("[R]eal firms are not monolithic actors . . . [rather,] they are networks of many semi-autonomous actors whose behavior is related in many complicated and contingent ways.").

115. For a similar criticism of enterprise liability for fraud on the market, see Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Security Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 693 (1992):

[S]hareholders face collective action problems because they are too numerous to manage the firm . . . They therefore hire agents (directors) to manage it for them. These directors, not the firm's owners, decide how the firm will deter wrongful acts by its agents. . . . [But] [t]hese directors may not impose optimal sanctions on the firm's agents. This possibility introduces an additional level of agency costs [and] . . . is particularly important in Fraud on the Market cases, because Fraud on the Market is generally committed by some of the very directors and senior officers hired to manage the firm and to deter fraud.

*Id.* (citation omitted); see also John C. Coffee, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1537 (2006) ("To punish the corporation and its shareholders in such a case is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary.").

opportunity to create “specific deterrence” by altering the indicted entity’s culture.<sup>116</sup> Absent from the Memo is any analysis of why prosecutors are the proper actors (even among government actors) for improving corporate governance within firms and why criminal law is the appropriate vehicle for altering corporate behavior.<sup>117</sup>

Although the McNulty Memo dispenses with some of the Thompson Memo’s emphasis on detecting “false cooperation” by corporate defendants, it has retained the essential nine-factor framework through which prosecutors decide how to treat potential corporate defendants. Despite the presence of nine factors, most government charging decisions boil down to two key questions: the steps the organization took to prevent the given situation (i.e., the organization’s compliance program) and the steps the organization took to rectify the situation through cooperation and other “assistance.”<sup>118</sup>

Neither the McNulty nor Thompson Memos provide formal guidelines for assessing compliance programs. Instead, both Memos proclaim:

The fundamental questions any prosecutor should ask are: “Is the corporation’s compliance program well designed?” and “Does the corporation’s compliance program work?”<sup>119</sup>

In case prosecutors are unsure how to decide if a program is “well-designed” or whether it “works,” the Memo offers further guidance:

In answering these questions, the prosecutor should consider the comprehensiveness of the compliance program; the extent and pervasiveness of the criminal conduct; the number and level of the corporate employees involved; the serious duration and frequency of the misconduct; and any remedial actions

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116. McNulty Memo, *supra* note 19, at 2. This deterrence argument nevertheless rests in part on a belief that government can improve the moral fiber of individuals who run corporate firms. SEC officials, for example, have claimed an obligation to improve the “moral DNA” of corporate executives. See Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 773 (2005) (quoting then-SEC Chairman William Donaldson’s 2004 speech to the Practising Law Institute).

117. Indeed, the DOJ’s attempt to define good corporate governance is in stark contrast to the business judgment rule, which ordinarily leaves the internal affairs of the corporation to its board of directors. See Del. Code Ann. tit. 8, § 141(a) (2007); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). The corollary to this rule is that shareholders are best served when board members are not unduly risk averse (i.e., when they are free to make decisions that later on turn out to be wrong). See, e.g., *Gagliardi v. Trifoods Int’l*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

118. “In many of the cases we have seen in the past couple of years, two of the most important factors we’ve focused on are the corporation’s culture, and the authenticity of the company’s cooperation. Those two factors are, in some sense, two sides of the same coin.” Christopher Wray, Assistant Attorney General, Criminal Division, Department of Justice, Remarks at the 22nd Annual Corporate Counsel Institute (Dec. 12, 2003) 5, available at [http://www.usdoj.gov/criminal/pr/speeches/2003/12/2003\\_2986\\_rmrk121203Corprconsinst.pdf](http://www.usdoj.gov/criminal/pr/speeches/2003/12/2003_2986_rmrk121203Corprconsinst.pdf).

119. McNulty Memo, *supra* note 19, at 14; Thompson Memo, *supra* note 105, at 7.

taken by the corporation, including restitution, disciplinary action, and revisions to corporate compliance programs.<sup>120</sup>

This inquiry suffers on a number of levels. First, it is difficult to perceive how a prosecutor, even one who has some expertise in corporate governance, will decide whether a program is “well-designed” or whether it “works” without expending considerable time and resources examining the organization, its industrial context and the relative benefits and drawbacks of numerous compliance-related decisions.<sup>121</sup> Even if government prosecutors were inclined and properly situated to undertake this task, they might well come up with the wrong answer.<sup>122</sup>

Moreover, the DOJ’s policy presumes that “effective” compliance programs reduce crime. However, deterrence theory strongly suggests that “effective” programs—for example, those designed and funded in such a manner as to deter crime—may create perverse outcomes as a result of substitution effects.<sup>123</sup>

For example, imagine that a well-funded compliance program enacted in good faith deters or apprehends seventy-five percent of the employees who otherwise would have violated the law. The remaining twenty-five percent, however, respond to the compliance program either by continuing their crimes *or* by investing resources in detection avoidance and committing crimes that are less easily detected but more serious (and therefore whose projected payoff exceeds the projected sanction if caught).<sup>124</sup> As Professor Katyal observed in his 1997 article on deterrence, when sanctions are implemented, the criminal’s choice is not as simple as “crime” or “no crime.”<sup>125</sup> Instead, the criminal may substitute his activity with *other* criminal conduct, or he may supplement the same criminal conduct with measures designed to reduce the probability of detection.<sup>126</sup>

Corporate criminals may be particularly likely to choose detection avoidance over cessation of crime when corporations adopt or enhance compliance programs after crimes have already been committed or are already under way. (This obviously would be the case for any company that attempts to increase compliance efforts after it has already become a going concern). For example, imagine an employee who has already

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120. McNulty Memo, *supra* note 19, at 14; Thompson Memo, *supra* note 105, at 7.

121. In contrast, the Delaware Chancery Court’s decision in *In re Caremark International, Inc.*, 698 A.2d 959 (Del. Ch. 1996), which both Memos cite, simply held that directors should ensure that some method of measuring compliance or internal controls *existed* within the firm. In fact, the *Caremark* court stressed that “the level of detail that is appropriate for [a legal compliance] system is a question of business judgment” and that, at least as Delaware law was concerned, board members should not be held civilly liable for trusting their employees “absent grounds to suspect deception.” *Id.* at 970. Many of the compliance programs that are the source of federal scrutiny would meet the standard laid out by Chancellor Allen in *Caremark*.

122. See Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 908 (“A review of recent finance literature suggests that a number of the governance metrics selected [by rating agencies] do not reliably predict firm performance.”).

123. See generally Neal Kumar Katyal, *Deterrence’s Difficulty*, 95 MICH. L. REV. 2385, 2387 (1997); Chris W. Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331, 1352–60 (2006) (discussing detection avoidance costs).

124. See Sanchirico, *supra* note 123, at 1368–69.

125. See Katyal, *supra* note 123, at 2387.

126. *Id.* at 2387; Sanchirico, *supra* note 123, at 1337.

committed, or is in the midst of committing, a crime, such as creating a fraudulent financial statement for a company's first quarter disclosure. If, after the first fraudulent statement, the company visibly enlarges its compliance program (and therefore increases the probability of the employee's apprehension), his consideration of whether to file a fraudulent second quarter statement will depend not only on the benefit he can achieve with the new crime (which is reduced by the increased probability of detection), but also the benefit he gets from covering up the prior crime. In other words, the second fraudulent statement not only increases his yearlong bonus, but it also covers up the prior fraudulent statement and permits him to avoid the sanction that would surely accrue if he put out a truthful second statement and triggered an investigation into the discrepancy between the first and second quarter statements.<sup>127</sup>

Accordingly, because of the periodic, ongoing nature of crime (which one could argue is particularly the case with fraud and financial crimes), compliance programs may encourage avoidance detection expenditures. These expenditures, in turn, may result not only in the commission of additional crimes (both to cover up the original crime, and perhaps to compensate for the resources expended on detection avoidance), but also the commission of more serious crimes. For example, if the employee is unable to discern how much his avoidance measures have lowered the probability of detection, he might compensate by increasing the magnitude of his future crime. Finally, as Katyal notes in the street crime context, while the compliance program drives the more risk averse criminals out of the market, the criminals who remain can exercise monopoly power over the remaining goods.<sup>128</sup>

In sum, a "good" compliance program (as opposed to one that is merely cosmetic in character) may encourage the worst employee-criminals to expend greater corporate resources covering up the worst crimes.<sup>129</sup> To counteract this phenomenon (assuming the company is even aware of it), the company either must: (a) increase its detection efforts even more, or (b) increase its sanctions.

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127. Imagine at a given time  $T$ , a crime produces a Benefit,  $B$ , of 10, with a 1% Probability of Detection,  $p$ , and Sanction,  $s$ , of 100. Under such conditions,  $B$  is greater than the expected value of the penalty ( $p$  multiplied by  $s$ ) and the rational criminal will commit the crime. If, sometime during or following the commission of the crime, at  $T_1$ , Company X increases its enforcement efforts such that expected penalty increases to 20 (either by increasing sanctions or probability of detection), then the costs of the conduct outweigh the benefits since 20 obviously exceeds 10.

Criminals who have not yet committed the crime will be deterred. Criminals who have committed prior crimes and who are committed to engaging in future crimes in order to cover up the initial crimes (such as fraudulent financial reports for public companies) are much less likely to be deterred, however, because the benefit now includes the foregone sanction from the prior crime assuming cessation of criminal conduct increases the probability of detection to 100%. Or,

$$10 + 100 \text{ [the benefit plus the foregone sanction]} > 20 \text{ [the expected value of the new penalty]}$$

For a more in depth discussion of this timing problem, see Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. (2008) (forthcoming).

128. Katyal, *supra* note 123, at 2415.

129. *Id.* at 2414 (pointing out that equal detection rates may bring down the overall crime rate but encourage the proliferation of "particularly heinous" crimes).



Option A (increase probability of detection) is effectively capped by law. Companies might place video monitors in every office and read every employee's work email, which of course has its own drawbacks. Companies cannot, however, wiretap employees' personal phones, search their homes, or subpoena their personal bank accounts. Would-be criminals who know they are being watched will simply conduct their activities beyond the scope of the company's legal eyes and ears.

Option B (increase sanctions) also has inherent limitations. In most instances, the worst sanction a company can level on an employee is termination. Unfortunately, the DOJ's emphasis on "corporate culture" undermines Option B's usefulness. Swift termination of even slightly wayward employees is the company's way of demonstrating that it does not tolerate crime. This option, however, may eliminate marginal deterrence.<sup>130</sup> If stealing a pencil from the supply closet is sufficient to get fired, then the employee might as well steal the contents of the petty cash drawer too.<sup>131</sup> It may also undermine more subtle attempts at communitarian control. Instead of giving wayward employees a chance to reform, the company will feel compelled to terminate them the minute any wrongdoing, however minor, is detected.

My point is not that compliance is hopeless, but that compliance programs, even those instituted in "good faith," may very well fail in their efforts to prevent wrongdoing. Some employee-criminals will react to increased detection and sanctions by expending private and corporate resources on detection avoidance or on other criminal conduct.<sup>132</sup>

This is not the only problem with the McNulty Memo. The prosecutor's role as arbiter of compliance is equally problematic. Cognitive biases and heuristics, such as hindsight bias and accessibility, may also affect the prosecutor's decision.<sup>133</sup> In other words, the government will be more likely to conclude that criminal conduct was foreseeable to the organization because it in fact occurred. And prosecutors, who regularly come into contact with defendants who lie and cheat, will more likely

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130. See Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1245–46 (1985) (explaining that uniformly high sanctions eliminate marginal deterrence for varying crimes).

131. See Katyal, *supra* note 123, at 2414–15 (discussing problems when range of sanctions is limited).

132. "Cleave another violation with a sanction and you discourage it. Cleave detection avoidance, and like the hydra, it grows another head." Sanchirico, *supra* note 123, at 1367.

133. See generally Christine Jolls, Cass R. Sunstein & Richard H. Thaler, *A Behavioral Approach to Law and Economics*, in BEHAVIORAL LAW AND ECONOMICS 38–39 (Cass R. Sunstein ed., 2000) (discussing hindsight bias in the context of negligence determinations by juries). These biases and heuristics apply informatively to prosecutors. See Alafair S. Burke, *Improving Prosecutorial Decision Making: Some Lessons of Cognitive Science*, 47 WM. & MARY L. REV. 1587, 1590–91 (2006); Keith A. Findley & Michael S. Scott, *The Multiple Dimensions of Tunnel Vision in Criminal Cases*, 2006 WIS. L. REV. 291 (2006) (discussing hindsight bias as it applies to criminal prosecutions); Rachel E. Barkow & Kathleen M. O'Neill, *Delegating Punitive Power: The Political Economy of Sentencing Commission and Guideline Formation*, 84 TEX. L. REV. 1973, 1981–82 & n.35 (2006); Sara Sun Beale, *What's Law Got to Do With It? The Political, Social, Psychological and Other Non-Legal Factors Influencing the Development of (Federal) Criminal Law*, 1 BUFF. CRIM. L. REV. 23 (1997) (discussing accessibility).

criticize those companies that accepted their employees' non-criminal explanations too easily.

#### 4. McNulty and Cooperation

In addition to judging the organization's compliance efforts, prosecutors must also assess the organization's cooperative efforts during the course of an investigation.<sup>134</sup> Presumably, cooperation is a relevant factor because it helps the government distinguish "good" corporate citizens from "bad" ones. If the corporation did not intend for the crime to occur, then the firm theoretically should be more than willing to extend its "full cooperation" to the government.

Nevertheless, the cooperation-based inquiry substantially undermines the deterrence goals of corporate criminal liability. Because the cooperation factor is aggregated with all other factors under the McNulty analysis, the factor obscures the government's compliance determination. A company could employ a state-of-the-art compliance program (or agree to enact such a program), but if it fails to "cooperate" with the government's investigation, it still may be indicted.

The aggregation problem is of particular importance because prosecutors have institutional reasons for overemphasizing the cooperation prong at the expense of all other factors. Contrary to the government's claims, the prosecutor is not some objective arbiter, measuring the corporation's post-detection conduct against some defined amount of "help." Instead, the prosecutor is a hired gun who will invariably ask whether the entity has provided the government everything it *needs* to identify and prosecute high-level employees. As the McNulty Memo implicitly recognizes, the more pressure the prosecutor places on the organization, the more assistance he or she will obtain from the organization in identifying additional criminal acts by corporate employees. Additional evidence leads to additional indictments. If the corporation cooperates, individual targets are easily isolated and less likely to have the resources to fight. Isolated targets plead guilty more quickly and accept longer sentences and larger fines.<sup>135</sup>

Given these interests, as well as the individual United States Attorneys' Office's institutional interest in competing for the public's good will and limited resources,<sup>136</sup> even the most principled prosecutor will have difficulty—as he wades through muddy

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134. McNulty Memo, *supra* note 19, at 7–12; Thompson Memo, *supra* note 105, at 5–6.

135. Cf. William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 535–37 (2001) (describing local prosecutors' incentives to preserve resources through plea bargaining procedures).

136. See generally Michael A. Simons, *Prosecutorial Discretion and Prosecution Guidelines: A Case Study in Controlling Federalization*, 75 N.Y.U. L. REV. 893, 932–33 (2000) ("[I]t is at least the perception in United States Attorney's Offices that those offices that bring increasing numbers of prosecutions will be 'rewarded' with increasing allocations of resources (i.e., more positions for prosecutors, investigators, and support staff) and that those offices that bring decreasing numbers of prosecutions will be 'penalized' by the Department of Justice through corresponding reductions in resources."). Simons concludes that this perception leads prosecutors to prosecute crimes that could otherwise be prosecuted in state courts. *Id.* at 933. The perception, however, just as easily supports the hypothesis that prosecutors will extract maximum convictions and maximum terms from corporate defendants.

facts and complex considerations— separating his personal and bureaucratic interests in maximizing individual convictions from his independent obligation to sort “good” corporate citizens from “bad” ones.<sup>137</sup>

Some might argue, as Professor Richman has, that prosecutorial excess can and will be reigned in by the law enforcement agents (such as employees of the FBI, IRS, or SEC) with whom prosecutors partner to investigate and prosecute cases.<sup>138</sup> Law enforcement agents, however, do not have final say on whether the company will be indicted or the specific terms of a firm’s DPA. Moreover, law enforcement agents, many of whom come from the enforcement division of a given agency, are also likely to harbor many of the same cognitive biases as their counterparts within the United States Attorneys’ Offices.

### 5. Opacity and Uncertainty

Even if one were to assume that government prosecutors can efficiently discern “good” corporate defendants from “bad” ones, the DOJ’s internal policy fails to provide either transparency or consistency.<sup>139</sup> Because the McNulty and Thompson Memos’ factors are broad and subjective, it is costly and difficult for companies to predict how they will be applied.<sup>140</sup> The DOJ’s internal guidelines do not require prosecutors to publicly explain in writing the process by which they made factual findings, or to quantify individual factors *ex post* (much less in advance). As a result, companies face uncertainty when they try to decide whether a given compliance product will later be viewed as excessive or necessary by a prosecutor. Uncertainty, in turn, can breed overdeterrence and risk aversion, both of which increase the company’s (and society’s) costs.<sup>141</sup>

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137. Additionally, prosecutors may be unduly influenced by personal interests such as self promotion or ego. See generally Kenneth Bresler, “I Never Lost a Trial:” *When Prosecutors Keep Score of Criminal Convictions*, 9 GEO. J. LEGAL ETHICS 537, 541 (1996) (criticizing prosecutors who maintain win-loss tallies).

138. Daniel Richman, *Institutional Competence and Organizational Prosecutions*, 93 VA. L. REV. IN BRIEF 115, 116 (2007), <http://www.virginialawreview.org/inbrief/2007/06/18/richman.pdf> (“[P]rosecutors rarely act alone, and are unlikely to do so in a sustained white collar investigation.”).

139. Plea bargaining in general reduces transparency in the enforcement of criminal law, with negative effects on public legitimacy. See Stephanos Bibas, *Transparency and Participation in Criminal Procedure*, 81 N.Y.U. L. REV. 911 (2006).

140. “If the legal standard is uncertain, even actors who behave ‘optimally’ in terms of overall social welfare will face some chance of being held liable because of the unpredictability of the legal rule. More important, these actors can usually reduce that chance by ‘overcomplying,’ that is, modifying their behavior beyond the point that would be socially optimal.” John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966 (1984).

141. This is a common problem that can render standards (which are defined *ex post*) more costly than rules (which are defined *ex ante*) for regulated entities. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1919 (1998) (concluding that indeterminate laws increase costs of obtaining legal advice and risk of litigation); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 569 (1992).

One might reasonably ask why well-funded organizations with access to excellent representation do not take their chances more often by going to trial or by refusing non-binding government requests that they view as excessive or inefficient. The far-reaching collateral consequences of indictment, however, further explain why overdeterrence and risk aversion are the likely outcomes of vague and inconsistently applied standards.

Whereas individual defendants can tame overreaching prosecutors by taking their case to trial (or, in the civil context, by testing regulatory decisions before administrative judges and federal judges), corporate prosecutions offer far fewer opportunities to test prosecutorial decision-making.<sup>142</sup> The DOJ's internal policies are non-binding and not subject to legal review. Negotiations as to how those standards apply occur outside the judicial system before any charges have been filed.<sup>143</sup> Prosecutors need not justify their decisions to courts until after they have indicted entities and individuals.

As has been noted by many others, however, corporate indictments often trigger collateral consequences that threaten many entities' viability.<sup>144</sup> Federal law, for example, requires all federal agencies to debar or suspend any contract with any indicted contractor or its affiliate, regardless of whether the indictment is in any way related to the agency's contract.<sup>145</sup> Similarly, indicted organizations may become ineligible to receive federal aid.<sup>146</sup> Apart from debarment, a corporate indictment may also result in the corporation's loss of licenses, permits, or ability to participate in entire areas of regulated commerce, including accounting, banking, health care, law, and other industries.<sup>147</sup> Corporate indictments also trigger reputation losses, including downturns in the stock market, a reduction in potential employees and customers, and the exodus of current customers and employees.<sup>148</sup> These effects often are

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142. An exception to this rule is the government's prosecution of KPMG, which resulted in a DPA and the government's indictment of former KPMG employees. Jonathan D. Glater, *8 Former Partners of KPMG Are Indicted*, N.Y. TIMES, Aug. 30, 2005, at C1. It should be noted, however, that the entity itself did not challenge the government's behavior in court; rather, the individual defendants who were the subject of the government's prosecution brought the government's conduct to the attention of the court.

143. Because these negotiations occur before charges are filed and outside the judicial system, they too lack transparency and, in many instances, accountability for the negotiating parties. See Stephanos Bibas, *Transparency and Participation in Criminal Procedure*, 81 N.Y.U. L. REV. 911, 938 (2006).

144. See generally Bierschbach & Stein, *supra* note 40, at 1749–51 (discussing collateral consequences in terms of “market spillovers”); Creamer, *supra* note 54, at 35–37 (describing effects).

145. Federal Acquisition Regulation (FAR), 48 C.F.R. §§ 9.406-2, -5(a) (2006). For a more in-depth discussion of debarment, see H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post-Caremark Era*, 26 DEL. J. CORP. L. 1, 93–102 (2001).

146. Creamer, *supra* note 54, at 35.

147. See Greenblum, *supra* note 41, at 1885–86 (cataloguing consequences of criminal convictions).

148. For a recent empirical study of losses suffered by managers upon the disclosure of corporate financial misconduct, see Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Consequences to Managers for Financial Misrepresentation* (April 16, 2007), available at <http://ssrn.com/abstract=972607> at 30–34 (describing combination of job losses and civil and

irreversible.<sup>149</sup> Although the Supreme Court eventually reversed and remanded Arthur Andersen LLP's conviction for faulty jury instructions, Andersen remained effectively defunct.<sup>150</sup>

In sum, the combination of vague standards, applied by a branch of government that is subject to little oversight and not likely to be held accountable for mistakes in application, backed up by a legal system whose mere initiation creates a drastic and often irreversible sanction, leads organizations to overpay for the crimes that their employees have committed and for the crimes that their employees may one day commit.<sup>151</sup>

#### *E. When and Where Organizations Overpay*

The government's aggressive enforcement of a broad criminal liability standard, combined with the significant extralegal consequences that accompany a criminal indictment, creates an atmosphere wherein *all* organizations—not just the relative few who come under the government's charging power—are likely to “overpay” for actual and potential employee crimes. That is, they pay in excess of the penalties that ordinarily would be necessary to deter criminal conduct, make victims whole, and internalize the social costs of their employees' misconduct.<sup>152</sup> A penalty in excess of that necessary to encourage optimal behavior is undesirable because it forces organizations to misallocate resources and underproduce otherwise socially beneficial goods.

Some will no doubt demand empirical evidence of overpayment. Because “overpayment” includes both reduced risk-taking and overinvestment in ineffective compliance, it is difficult to quantify the total amount by which corporate organizations

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criminal penalties). Reputation losses are also discussed at length in Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J.L. & ECON. 489 (1999); Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988–1990*, 71 B.U. L. REV. 247, 266–67 (1991); Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993); Dennis Recca, Note, *Reputational Penalties For Corporations and the Federal Sentencing Guidelines*, 2004 COLUM. BUS. L. REV. 879.

149. “[A] wrongful indictment . . . works a grievous, irreparable injury to the person indicted’ resulting in damage to the person’s reputation which, because the public remembers the accusation and suspects guilt, can not be simply cured by a subsequent finding of not guilty.” *Stolt-Nielsen, S.A. v. United States*, 352 F. Supp. 2d 553, 560 n.8 (E.D. Pa. 2005) (quoting *In re Fried*, 161 F.2d 453, 458–59 (2d Cir. 1947)), *rev’d*, 442 F.3d 177 (3rd Cir. 2006).

150. *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005). The government declined to retry Andersen.

151. Although the following comments on overdeterrence were not made in regard to corporate criminal liability, they are nevertheless particularly apt: “If there is a risk either of accidental violation of the criminal law or of legal error, an expected penalty will induce innocent people to forgo socially desirable activities at the borderline of criminal activity. The effect is magnified if people are risk averse and penalties are severe.” Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1206 (1985).

152. It is also possible that some organizations underpay for corporate crime by creating cosmetic compliance programs and/or designating certain employees as corporate scapegoats for criminal conduct that was sanctioned more broadly. Because the facts supporting these agreements (and indeed, many of the agreements themselves) are not public, it is difficult to test these theories. Nevertheless, recent reports regarding the negotiation of agreements with KPMG and Bristol Myers Squibb suggest an overpayment rather than an underpayment scenario.

overpay for criminal liability.<sup>153</sup> Nevertheless, the sections below discuss potential and actual instances of overpayment both before and after a corporation becomes the subject of a criminal investigation.

### 1. Prior to Detection: “Regulation by Prosecution”

Prior to detection, organizations are likely to adopt monitoring and compliance programs that please law enforcement actors but either are ineffective or overly deter risky decisions.<sup>154</sup>

The DOJ purposely has not prescribed the content of a corporate compliance program.<sup>155</sup> DOJ officials contend that by leaving content undefined, the government has created a flexible environment for private organizations to determine which compliance tools work best for them.<sup>156</sup> This open-ended form of regulation, however, is illusory.<sup>157</sup> Although the DOJ would have us believe that it has promulgated flexible standards, the flexibility lies solely on the side of prosecutors. Since the McNulty Memo declines to define “effective compliance” or “sufficient cooperation” *ex ante*, the only safe standard is 100 percent compliance. Anything less may result in criminal

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153. See Gilbert Geis & Joseph F.C. DiMento, *Empirical Evidence and the Legal Doctrine of Corporate Criminal Liability*, 29 AM. J. CRIM. L. 341 (2002) (observing dearth of proof of corporate criminal liability’s effectiveness and suggesting topics for further empirical inquiry).

154. Professor Krawiec has questioned whether compliance programs are effective at all. Krawiec, *supra* note 34, at 591–596. Krawiec hypothesizes that compliance programs remain popular because of political influence exerted by the business lobby and compliance professionals. *Id.* at 610–12. Krawiec further develops her public choice theory in another recent article. *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) (concluding that business professionals would rather pay for “cosmetic” compliance programs than affect real organizational change).

155. See McNulty Memo, *supra* note 19, at 14. Some agencies have filled in this gap. See, e.g., *OIG Compliance Program Guidance for Pharmaceutical Manufacturers*, Department of Health and Human Services, 68 Fed. Reg. 23,731 (May 5, 2003).

156. The McNulty and Thompson Memos include both rules and standards as those terms have been defined by Louis Kaplow. Because key terms such as “effective compliance program” and “sufficient cooperation” are only partially defined *ex ante*, they are best viewed as “standards.” See Kaplow, *supra* note 141, at 559–60 & n.2. Kaplow theorizes that when activity is infrequent or affects few individuals, standards are preferable to rules because the promulgation costs of defining a rule *ex ante* are high. *Id.* at 573. By contrast, “the greater the frequency with which a legal command will apply, the more desirable rules tend to be relative to standards. This result arises because promulgation costs are borne only once, whereas efforts to comply with and action to enforce the law may occur rarely or often. Rules cost more to promulgate; standards cost more to enforce.” *Id.* at 577.

Corporate crime and entity-based liability questions are neither infrequent nor so heterogeneous to render *ex ante* rules infeasible. Moreover, if one considers corporate criminal liability to affect all shareholders and stakeholders (employees, customers, etc.), corporate criminal liability affects potentially millions of people. Given the foregoing, we should expect the government to promulgate rules instead of standards. Kaplow nevertheless concedes the possibility that political motivations may cause a governing authority to prefer standards even though rules appear more efficient. *Id.* at 609.

157. Cunningham, *supra* note 56, at 286 n.74 (suggesting that regulation in this context may in fact be involuntary).

liability. If the SEC or some other rule-making agency promulgated a formal rule that expressly required firms to achieve 100 percent compliance, that rule would be met by substantial public (and perhaps judicial) resistance. Instead, by purposely leaving the definition blank in a nonbinding document, the DOJ has cheaply created a functional equivalent of that standard.

By providing a vague standard of compliance and severely punishing corporations that fail that illusive standard, the DOJ stifles experimentation and differentiation. Instead, corporate entities are far more likely to adopt programs that have been publicly designated “best practice” by regulators, prosecutors, or various members of the growing compliance industry.<sup>158</sup> As Professor David Zaring has observed, however, best practice regimes do not always result in *best* practices, but rather, the *same* practices.<sup>159</sup>

Prosecutors, in turn, are not only aware of this herd mentality, but welcome it: “[G]overnance . . . enforced through a multi-year deferred prosecution or non-prosecution agreement can become new standards for an entire industry—a kind of *regulation by prosecution*.”<sup>160</sup> (emphasis added). In other words, it is the government’s intent that non-regulated entities review publicly announced DPAs and then enact some or all of the reforms present in the agreement.

Unfortunately, “regulation by prosecution” invokes more questions than answers. Unlike regulations that are promulgated by agencies subject to the Administrative Procedure Act and subject to extensive judicial review, regulations by prosecution are subject to none of the checks and balances that ordinarily accompany agency regulations, such as expert analysis, notice and comment periods, and political accountability for final rules.<sup>161</sup> In sum, there is no mechanism that assures accountability for the informal regulation that is wrought by an individual

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158. See Laufer, *supra* note 18, at 1343 (describing “elaborate cottage industry” of experts who “lay claim to dramatically reducing the likelihood of criminal liability”); Rose, *supra* note 122, at 925–26 (criticizing “homogenization” of corporate governance industry); Linda Klebe Trevino, *Out of Touch: The CEO’s Role in Corporate Misbehavior*, 70 BROOK. L. REV. 1195, 1196–97 (2005) (noting that Ethics Officers in charge of compliance programs “meet regularly to benchmark and discuss best practices in ethics and legal compliance management”).

159. Zaring defines “best practices” as a form of regulation that encourages regulated parties’ input and experimentation instead of handing down distinct rules. David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 297 (2006). Regulation is “horizontal” instead of “hierarchical” insofar as organizations look to each other for the content of rules. *Id.* Zaring observes that although best practices “might suggest a rather democratic form of regulatory experimentalism,” wherein organizations learn from each other and regulators publicize their successes, “best practices usually fall short of this ideal. They are not a panacea, not always horizontal, and often, at least in effect, not really voluntary. In short, although best practices purport to be ‘best,’ there is nothing particularly ‘best’ about them. The rulemaking technique is a way of obtaining *common* practices, not ideal ones.” *Id.* at 297–98 (emphasis in original).

160. Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1185 (2006).

161. Rachel E. Barkow, *Separation of Powers and the Criminal Law*, 58 STAN. L. REV. 989, 1024–25 (2006) (arguing for greater oversight of prosecutor’s plea bargaining power). See also Garrett, *supra* note 10, at 861–69 (observing that the government’s agreement with KPMG effectively regulates the manner in which accounting firms provide certain tax planning advice).

prosecution.<sup>162</sup> Moreover, “regulation by prosecution” creates additional inefficiency insofar as there exists no mechanism for a corporation to determine in advance if its program passes muster with the prosecutors who “regulate” corporate compliance *ex post*.<sup>163</sup>

Finally, because corporate compliance programs have been married to the criminal justice system, they may undermine attempts at creating the very type of culture that is most likely to encourage law-abiding behavior.<sup>164</sup> Because compliance is judged by prosecutors and judges, organizations appoint lawyers to design and maintain their compliance programs.<sup>165</sup> Lawyers, in turn, tend to prefer command-and-control systems.<sup>166</sup> Command-and-control systems, particularly those that are backed up by singularly punitive measures such as termination, are not only extremely costly, but they are also ineffective at creating the types of norms that encourage compliance with internal rules and external laws. To the contrary, they may undermine employee morale and compliance.<sup>167</sup>

In lieu of extensive command-and-control rules, extensive monitoring systems, and harsh disciplinary systems, some scholars have argued that organizations should direct more of their focus to intangible items such as the development of “self-regulatory” norms within the corporation.<sup>168</sup> The focus on “norms” creation may well be more effective over the long term than a checklist of rules and procedures that a company implements upon the advice of its lawyers. Nevertheless, risk averse compliance lawyers will choose the programs that intuitively “look better” to prosecutors, regardless of whether they work.<sup>169</sup>

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162. Although Christopher Wray and Robert Hur agree that the proliferation of corporate prosecutions raises the possibility that the government will inconsistently enforce corporate governance standards, their proposed solution is for DOJ officials to watch for inconsistency and, if necessary, impose a more centralized system. *See* Wray & Hur, *supra* note 160, at 1187–88.

163. In contrast, Ayers and Braithwaite assumed that the “enforced self-regulatory” model of compliance would include an individualized *ex ante* review of the corporation’s compliance program before wrongdoing was detected. IAN AYERS & JOHN BRAITHEWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 106 (1992). “Under enforced self-regulation, the government would compel each company to write a set of rules tailored to the unique set of contingencies facing that firm. A regulatory agency would either approve these rules or send them back for revision if they were insufficiently stringent.” *Id.*

164. *See* Tom E. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-Regulatory Approaches*, 70 *BROOK. L. REV.* 1287, 1301–02 (2005) (command-and-control systems “consume organizational resources. Even if they work, these strategies are costly and inefficient.”).

165. Langevoort, *supra* note 37, at 75–76 (stating that lawyers are primary “compliance engineers” in many firms).

166. Ironically, the DOJ’s “flexible” standards encourage firms to adopt command-and-control internal compliance regimes. *See* Cunningham, *supra* note 56, at 307; Langevoort, *supra* note 37, at 73.

167. Langevoort hypothesizes that lawyers in particular prefer rules and command-and-control based systems. *See* Langevoort, *supra* note 37, at 118.

168. Tyler, *supra* note 164, at 1300–01 (arguing that the “self-regulatory” approach is preferable to command-and-control systems because employees are more likely to follow rules that conform to their ethical values and are promulgated by institutions they view as fair).

169. *See* Cunningham, *supra* note 56, at 307–09.



## 2. Post-Detection Overpayment: Cooperation through Uncertainty

Overpayment continues and increases after the organization becomes the target of a federal investigation or prosecution. Attorneys have widely criticized the DOJ's pervasive pressure on organizational defendants to waive attorney-client privilege and the manner in which the "culture of waiver" has chilled contact between employees and corporate counsel.<sup>170</sup> Aside from the waiver issue, however, overpayment can occur in other aspects as well.

First, companies may initiate internal investigations with the express intention of handing over their findings to the federal government.<sup>171</sup> This may sound like a good development in theory. If federal agents are already aware of (or even demand) the investigation, however, the entity's internal investigators, who intend from the outset to demonstrate the organization's cooperation, may concede or declare wrongdoing more quickly than an objective fact-finder.<sup>172</sup>

Cooperation (at least as envisioned by the DOJ) may also undermine the organization's relationship with its employees. In a further attempt to curry favor with the government, an organization might fire employees who are in fact innocent or, as was the case in KPMG, coerce employees to speak with government agents by threatening to terminate those who declined to speak with the government.

Christopher Wray and Robert Hur, both former high-level Justice Department officials, contend that the pressure for corporations to cooperate is "merely the outgrowth of similar leverage strategies used by prosecutors for years to 'flip' individual targets or defendants on each other."<sup>173</sup> This analogy, however, is incomplete. In the individual context, the defendant comes to the table with more leverage than the corporation. He may remain silent and despite the angst and economic harm he may suffer from an indictment, the worst collateral effects will not occur until he is convicted. The fact that an individual may choose to go to trial (a choice that has more or less practical meaning depending on the defendant's individual

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170. For an overview of these arguments, see Bharara, *supra* note 2, at 96–97 (describing pressure on organizations to waive privilege).

171. In *Stolt-Nielsen*, an antitrust case, the corporation's counsel (a former DOJ antitrust attorney) initiated an internal investigation after he had already contacted the government and had advised it of possible illegal conduct. See *Stolt-Nielsen S.A. v. United States*, 352 F. Supp. 2d 553, 556–57 (E.D. Pa. 2005) (internal counsel purposely notified government prior to completing investigation in order to preserve marker for company), *rev'd*, 442 F.3d 177 (3rd Cir. 2006). He contacted the DOJ prior to completing his investigation because he wished to preserve his client's chances of obtaining amnesty under the Antitrust Division's Amnesty program. The Antitrust Division employs a corporate leniency program that immunizes the first entity that discloses illegal conduct. For a general discussion of the program and its effect on enforcement of antitrust violations, see Bruce H. Kobayashi, *Antitrust, Agency, and Amnesty: An Economic Analysis of the Criminal Enforcement of the Antitrust Laws Against Corporations*, 69 GEO. WASH. L. REV. 715 (2001) (arguing that excessive fines and "first to cooperate" amnesty policy may lead to overdeterrence within firms).

172. Professor Laufer has argued that the company might purposely scapegoat an innocent employee in order to gain the government's good will and obtain a DPA. See Laufer, *supra* note 18, at 1413–14.

173. Wray & Hur, *supra* note 160, at 1182.

resources and access to competent counsel) moderates the bargaining that goes on between prosecutors and individual defendants. At the very least, both parties know that somewhere down the line, the court will get involved insofar as it metes out the defendant's sentence.

By contrast, the "flip" in the corporate context goes to the central question of the corporate entity's "guilt" and effectively removes the corporation from the criminal process altogether. Because the prosecutor alone determines the severity of the "flip" (which in turn determines the charge, if any, imposed on the entity), the prosecutor has more leverage in the corporate context and the corporate defendant has far more incentive to "scapegoat" innocent employees (as opposed to merely ratting out the guilty ones).<sup>174</sup> Indeed, far from intentionally scapegoating employees, it may simply go along with the prosecutor's view of the facts if the corporation's defense counsel deems the facts to be in equipoise. Between the corporate entity's skin and the fair treatment of a potentially innocent employee, the rational defense counsel for the entity will—and indeed should—go along with whatever the government wants.

Cooperation also differs in the corporate context because the organization, unlike the individual, lacks complete knowledge of what "it" has done and lacks complete control over what "it" will do in the future. Board members who must make decisions on the shareholder's behalf are unlikely to have a full picture of the situation *before* they agree that the entity will cooperate, and they cannot exercise absolute control over their employees *after* they agree that the entity will cooperate. This lack of control, in turn, creates risk for the cooperating organization because the DPA invariably permits the government to file charges at a later date (and use all the information the organization has willingly handed over) if the government later learns that someone in the organization was less than truthful.<sup>175</sup>

### 3. Post-Detection Overpayment: Monitoring and Corporate Abdication

Overpayment also results from the monitoring and reporting systems that are often imposed as a condition of either a DPA or, if the organization has in fact been convicted in court, as a sentence of probation under the OSG.

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174. The power exercised by way of the "flip" is also unnecessary in the corporate context because the organization is already obligated to answer government queries for information and documents. *See Hale v. Henkel*, 201 U.S. 43 (1906).

175. Boeing entered into an agreement with the DOJ that explicitly stated that future crimes by low-level employees would *not* be considered a violation by Boeing. Peter Lattman, *Boeing's Non-Non Prosecution Agreement*, WALL ST. J. LAW BLOG, July 6, 2006, <http://blogs.wsj.com/law/2006/07/06/boeings-non-non-prosecution-agreement>. This provision, however, has not been widely used. In another prosecution, Stolt-Nielsen became a victim of its lack of information when prosecutors in the Antitrust Division, having learned that one of Stolt's employees lied to Antitrust investigators about the date he terminated his conduct in a price-fixing cartel, withdrew their prior leniency agreement and decided to indict the company, despite its prior cooperation efforts. *See Stolt-Nielsen, S.A. v. United States*, 442 F.3d 177 (3rd Cir. 2006) (company cannot attempt to enforce leniency agreement until after government obtains grand jury indictment), *cert. denied*, 127 S. Ct. 494 (2006); Press Release, Dept. of Justice, Stolt-Nielsen S.A. Indicted on Customer Allocation, Price Fixing, and Bid-Rigging Charges for its Role in an Int'l Parcel Tanker Shipping Cartel (Sept. 6, 2006), *available at* [http://www.usdoj.gov/atr/public/press\\_releases/2006/218199.pdf](http://www.usdoj.gov/atr/public/press_releases/2006/218199.pdf).

To date, the benefits and drawbacks of using federal monitors to report on and supervise corporate compliance with federal laws and civil and criminal settlements have not been studied in depth.<sup>176</sup> Professor James Jacobs has described their usefulness in ridding unions of organized crime.<sup>177</sup> Corporate organizations, however, differ significantly from unions. Whereas a monitor's role in overseeing a union may be fairly well-defined and include at least some level of judicial oversight, the monitor's role in establishing "good corporate governance" within a public corporation is far more indeterminate and subject to little or no judicial oversight.<sup>178</sup> Recent perceived abuses in the appointment of monitors have spurred the DOJ's recent circulation of a memo advising United States Attorneys to avoid potential conflicts of interest in the selection of monitors and to treat the monitor as an "independent third party."<sup>179</sup>

Because the monitor effectively reports to the government and not the corporation,<sup>180</sup> the monitor may well overcharge the corporation for his services by

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176. One of the few articles addressing this topic is Brandon Garrett's *Structural Reform Prosecution*, which analyzes DPAs and concludes that the DOJ has "consistently pursued compliance" through monitors and other structural reforms. Garrett, *supra* note 10, at 860. For two recent discussions of issues created by corporate monitoring, see Jennifer O'Hare, *The Use of the Corporate Monitor in SEC Enforcement Actions*, 1 BROOK. J. CORP. FIN. & COM. L. 89 (2006); Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar*, 105 MICH. L. REV. 1713 (2007).

177. See JAMES JACOBS, *MOBSTERS, UNIONS, AND FEDS: THE MAFIA AND THE AMERICAN LABOR MOVEMENT* 138–60 (discussing the use of federal monitors in the context of civil RICO suits filed by DOJ against various unions). Borrowing a page from bank regulation, Professor James Fanto has proposed that the SEC hire, train, and pay yearly salaries to corporate monitors who would "engage in a constant dialogue with management of the public firm and alert officers and directors at an early stage to problematic transactions and SEC concerns." James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 859, 915 (2006). Although Fanto's proposal alleviates some of the overbilling concerns discussed *infra* in the text, it does not solve the confidentiality and authority issues that a monitor poses for the board and the corporation's management. Similar problems plague Cristie Ford's proposal for independent "third party" monitors to report to the SEC on corporate governance issues within firms. See Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 798 (2005).

178. One notable exception to the lack of oversight problem is Richard Breeden's oversight of MCI, which occurred in the context of the MCI bankruptcy and was overseen by the district court supervising the bankruptcy process.

179. Craig Morford, Acting Deputy Attorney General, Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations, March 7, 2008, available at [http://lawprofessors.typepad.com/whitecollarcrime\\_blog/files/doj\\_principles.pdf](http://lawprofessors.typepad.com/whitecollarcrime_blog/files/doj_principles.pdf) [hereinafter Morford Memo] The Morford Memo was released in advance of a March 11, 2008, House Hearing on deferred prosecution agreements and corporate monitors. See U.S. House of Representatives, Committee on the Judiciary, *Hearing on Deferred Prosecution: Should Corporate Settlement Agreements Be Without Guidelines?*, <http://judiciary.house.gov/oversight.aspx?ID=425>.

180. Although the monitor has no legal obligation to report to the corporation's board, management, or shareholders, the DOJ's newly-released Morford Memo recognizes that the monitor may wish to communicate with both the Government and the "corporation." Morford Memo, *supra* note 179, at 6. The same Memo, however, also implies that it may be appropriate

providing excess services or by overbilling for his services.<sup>181</sup> At the very least, the monitor will have little incentive to minimize costs.<sup>182</sup>

Second—and perhaps of greater concern—the imposition of a monitor may result in the organizational leaders’ abdication of responsibility to make decisions on behalf of the owners and stakeholders.<sup>183</sup> For example, the board of a publicly owned corporation might rationally decide to leave questionable decisions to the corporate monitor since any decision approved by the monitor is less likely to result in criminal liability. The problem with this strategy is that the owners of the corporation did not elect the monitor to run the business; they elected the board.

In 2005, Bristol Meyers-Squibb (BMS) signed a DPA with the United States Attorney’s office in New Jersey as a result of the United States Attorney’s investigation of channel stuffing—the practice of placing high amounts of inventory with dealers and sellers in order to inflate sales temporarily. In exchange for foregoing indictment, the United States Attorney demanded that BMS enter into a DPA that, among other things, required it to employ and pay an outside monitor.<sup>184</sup> The monitor, Frederic Lacey was paid by BMS, but he submitted reports and received direction from the government.<sup>185</sup> Christopher Christie, the United States Attorney of New Jersey who negotiated the DPA with BMS, argued that the DPA demonstrated “the unique value of deferred prosecution agreements and the advantages that they offer the government and corporate America.”<sup>186</sup>

In the Fall of 2006, allegations of an unrelated crime (that BMS’s representatives had made a side deal with a competitor, Apotex, regarding a rival patent and Apotex’s threatened distribution of a generic version of BMS’ blockbuster drug, Plavix) triggered an investigation by the DOJ’s Antitrust Division. The Antitrust Division’s new investigation, in turn, triggered an investigation by BMS’s monitor and a separate investigation by BMS’s board. Shortly after the new investigation was announced, in September 2006, the BMS board fired its CEO, Peter Dolan, and its general counsel following a special board meeting attended by both the monitor and the United States

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to communicate *solely* with the Government about the corporation’s progress in meeting the terms of its DPA. *Id.*

181. I am not suggesting that the monitor will intentionally defraud the corporation. Without any market restraints or significant oversight, he either may provide excessive services or charge in excess of their value.

182. Prosecutors who are supported by attenuated yearly budgets are least likely to be sensitive to these costs.

183. The Delaware judiciary has criticized and overturned agreements in which the board abdicates its judgment to legal advisors in the context of a merger agreement. *See ACE Limited v. Capital Re Corp.*, 747 A.2d 95, 106–07 (Del. Ch. 1999) (criticizing contract provision that delegated a merger decision to outside lawyer’s legal opinion: “does it make sense for the board to be able to hide behind its lawyers?”).

184. Bristol-Myers Squibb, Deferred Prosecution Agreement (June 15, 2006), <http://www.Bristol-Myers.com/static/pdf/dpa.pdf>.

185. Following his appointment as monitor, Lacey and members of his law firm, LeBoeuf, Lamb, Greene & MacRae “became regular fixtures at Bristol-Myers” and provided the United States Attorneys Office with quarterly reports of 400 to 500 pages that were unavailable to the public. *See* Stephanie Saul, *A Corporate Nanny Turns Assertive*, N.Y. TIMES, Sept. 19, 2006, at C1.

186. Christie & Hanna, *supra* note 105, at 1044.

Attorney, Christopher Christie. Christie allegedly demanded Dolan's ouster during the actual board meeting.<sup>187</sup>

Nine months later, on June 11, 2007, BMS pled guilty in the District of Columbia to two counts of making false statements to the FTC, in violation of 18 U.S.C. § 1001.<sup>188</sup> BMS admitted in court that a former employee (believed to be Dr. Andrew Bodnar) promised a representative at Apotex (the producer of a generic rival to BMS' Plavix) that he would oppose the launch of a BMS-produced generic version of Plavix provided Apotex and Plavix resolved their patent dispute.<sup>189</sup> Bodnar also allegedly implied in his conversation with Apotex's representative that BMS's then-CEO supported this side deal—all of which was not disclosed to the FTC, which had been reviewing a proposed resolution of the patent litigation between BMS and Apotex.

Despite the allegation that a BMS employee lied to the FTC, no further evidence has surfaced that either BMS's CEO or its general counsel approved Bodnar's statement or were even aware of it. Indeed, even as it resolved the matter with the FTC and DOJ, BMS continued to deny that there was any side deal with Apotex.<sup>190</sup> The United States Attorney's Office, meanwhile, further clouded the issue by agreeing to a fairly light punishment (a one million dollar fine) and, more important, by announcing that, despite the alleged crime, BMS "fulfilled" the letter and spirit of the DPA agreement, which expired on June 14, 2007.<sup>191</sup>

The BMS episode demonstrates several problems with regulation-by-prosecution of corporate entities. Although BMS's senior management may have completely mishandled the company's dealings with a rival producer of a generic drug, the remedying of that problem should have been the board's responsibility because the board, and not the United States Attorney, answers to the company's shareholders. The

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187. See Saul, *supra* note 185.

188. For discussion of the facts leading up to BMS's guilty plea, see *Bristol-Myers Faces Charges*, L.A. TIMES, May 31, 2007, at C6; Press Release, U.S. Department of Justice, Bristol-Myers Squibb Pleads Guilty to Lying to the Federal Government About Deal Involving Blood-Thinning Drug (May 30, 2007), available at [http://www.usdoj.gov/atr/public/press\\_releases/2007/223634.pdf](http://www.usdoj.gov/atr/public/press_releases/2007/223634.pdf).

189. John Carreyrou, *Bristol-Myers Settles Probe of Apotex Deal*, WALL ST. J., May 11, 2007, at B2; Press Release, Bristol-Myers Squibb, (June 11, 2007), available at [http://newsroom.bms.com/index.php?s=press\\_releases&item=271](http://newsroom.bms.com/index.php?s=press_releases&item=271).

190. BMS's press release states in pertinent part:

The company acknowledge[s] that a former Bristol-Myers Squibb senior executive made oral representations to Apotex for the purpose of causing Apotex to conclude that [BMS] would not launch an authorized generic in the event that the parties reached a final revised settlement agreement. Those representations included the former senior executive's statement that he expected to oppose personally the launch of an authorized generic in the future, his statement that he expected to advocate against such a launch, and his implied suggestion that the company's former CEO shared his views. . . . The company acknowledged in court today its responsibility for the conduct of the former senior officer.

The company continues to believe that there was no "side agreement" with Apotex.

Press Release, Bristol-Myers Squibb, (June 11, 2007), available at [http://newsroom.bms.com/index.php?s=press\\_releases&item=271](http://newsroom.bms.com/index.php?s=press_releases&item=271).

191. Carreyrou, *supra* note 189.

board might well have been justified in dismissing BMS's CEO and general counsel for their lack of control over the negotiation, but the integrity of that decision was diluted significantly by the government's presence and participation.

Moreover, while the prosecutor and monitor quickly moved for the CEO's termination, they permitted the executive who was the alleged culprit of the "side deal" and ultimate false statement to the FTC, to remain at the company while the investigation was ongoing.<sup>192</sup> In other words, because they acted in haste and were subject to none of the usual checks and balances of criminal litigation, the United States Attorney and BMS monitor either placed blame in the wrong place or assumed more serious conduct than what actually occurred.<sup>193</sup> Either way, they increased the risk of error.

Finally, the manner in which the investigation was ultimately disposed—a relatively light fine paired with the United States Attorney blessed expiration of the DPA—sent a confusing signal to BMS's shareholders. The matter was important enough to warrant the prosecutor's interference in the company's corporate governance, yet not so important as to warrant an overturning of the earlier DPA. Because the prosecutor is not required to explain his reasoning, there is little opportunity for corporate boards to learn anything from this episode. As for BMS's shareholders, the only lesson they may have gleaned is that for a period of time, someone other than the elected board of directors was running their company.

## II. PROPOSED REFORMS: WHY TWEAKING THE SYSTEM FALLS SHORT

Many scholars have agreed that the current system of corporate criminal liability is problematic, but they have not agreed on a single solution. Some have called for a stricter standard of liability<sup>194</sup> and some for heightened evidentiary requirements.<sup>195</sup> Others have called for greater judicial intervention in the negotiation process.<sup>196</sup>

### *A. Alteration of Liability Standard*

Many proposals alter the liability standard to limit the number of potentially liable organizations. A narrower liability standard presumably leads to less leverage for prosecutors and fewer instances of prosecutorial overreaching.<sup>197</sup> Professor Buell, for example, has argued that liability should attach only when the government can demonstrate that the employee's "primary purpose" was to benefit his employer.<sup>198</sup>

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192. Bodnar's resignation was announced on May 14, 2007. See Shannon Pettypiece, *Shakers: Business Personalities in the News*, INT'L HERALD TRIB., May 14, 2007, <http://www.iht.com/articles/2007/05/13/business/bxshake.php>

193. Significantly, the Antitrust Division, which initiated the investigation, has not filed any charges against BMS and its two former top executives.

194. See Buell, *supra* note 39, at 532 (arguing that liability should attach only when it was employee's primary intent to benefit employer).

195. See Bierschbach & Stein, *supra* note 40, at 1775.

196. Greenblum, *supra* note 41, at 1898.

197. See Bharara, *supra* note 2, at 112 (arguing that Congress and the courts should develop "clear and expert standards" in order to shift discretion away from prosecutors).

198. Buell, *supra* note 39, at 532.

Buell's proposal rests on the assumption that criminal liability is warranted whenever institutions encourage their agents to transgress the law.<sup>199</sup> Accordingly, Buell's "primary purpose" test is intended as a means of inferring *ex post* whether the institution should be "blamed" for its wrongful "effect" on its employee.

Leaving aside the unproven proposition that formally defined "institutions" encourage wrongdoing (as opposed to larger or smaller informal subgroups such as one's family, one's social group, or smaller sub-units of a given corporation), Professor Buell's proposal is particularly costly to administer insofar as it relies on two inferences, the employee's purpose and the institution's effect on the employee. Moreover, its outcome is difficult to predict *ex ante* and leaves in place both the prosecutor as chief enforcer and arbiter, as well as the extralegal effects of indictment.<sup>200</sup>

Elizabeth Ainslie contends that the federal standard should be reformed to look more like the Model Penal Code, which permits corporate liability for corporations whenever:

(a) the offense is a violation or the offense is defined by a statute other than the Code in which a legislative purpose to impose liability on corporations plainly appears and the conduct is performed by an agent of the corporation acting on behalf of the corporation within the scope of his office or employment, except that if the law defining the offense designates the agents for whose conduct the corporation is accountable or the circumstances under which it is accountable, such provisions shall apply; or

(b) the offense consists of an omission to discharge a specific duty of affirmative performance imposed on corporations by law; or

(c) the commission of the offense 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.<sup>201</sup>

Ainslie's proposal is salutary insofar as it would, among other things, force Congress to identify particular statutes for which it believed corporate criminal liability was warranted. If Congress did designate such liability, however, it is difficult to see how corporations would fare much better than now since paragraph (a)'s liability standard is as broad as the current standard. Although Congress might decline to enact such a law right now, the minute a new scandal appeared on the horizon, legislators and prosecutors would hastily agree to enact laws that quickly returned us to the old system.<sup>202</sup> Moreover, even if Congress declined to explicitly designate corporate liability, many corporations would continue to come under prosecutorial control as a

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199. *Id.* at 477. "The truth is that institutions do produce wrongdoing." *Id.* at 493.

200. Buell praises reputation effects as a means of disciplining firms. *See* Buell, *supra* note 39, at 535.

201. Model Penal Code § 2.07(1) (2001); Ainslie, *supra* note 18, at 120–21.

202. Stuntz, *supra* note 135, at 529 ("Legislators presumably want to stay in office, and perhaps to position themselves for higher office. To do those things, legislators must please their constituents.").

result of paragraph (c) since most competent prosecutors could plausibly argue in most instances that serious employee crimes were “authorized, requested, commanded, performed, or recklessly tolerated” by a “high managerial agent.” In a company the size of Walmart or Pfizer, it should not be too difficult to find a “high managerial agent,” and it will be even less difficult to find someone who “recklessly tolerated” such conduct.

Finally, Andrew Weissman and David Newman have called for the adoption of a negligence standard whereby prosecutors would have to prove, as an element of their case that the entity “failed to have reasonably effective policies and procedures to prevent the conduct.”<sup>203</sup> Thus, Weissman and Newman consciously adopt a negligence standard of criminal liability and, unfortunately, all of the problems that come with it.<sup>204</sup> Although the proposal is beneficial in that it makes prosecutors more accountable for their decisions (they would have to actually *prove* that the company’s processes were deficient rather than just say so), it still leaves the definition of compliance quite vague. As a result, *ex ante* it would generate uncertainty and overdeterrence among firms. Firms would no doubt invest in showy and expensive measures designed to impress prosecutors who would still retain the final say on whether to present the case to a grand jury for indictment.

Moreover, the cognitive biases that attach to prosecutorial decision-making might well filter down to courts and juries. It is difficult to perceive how hindsight bias would not cloud a juror’s determination as to whether a given corporate compliance department’s policies were “reasonably effective” when the juror becomes aware of (presumably) numerous employee violations.

Finally, Weissman and Newman’s proposed negligence rule fails to consider at least one benefit of strict liability: efficient activity levels. Assuming certain firms—either because of their industry or some other characteristic—are unable to mitigate their compliance risk, we still would want to find a mechanism that internalizes their costs to a point that they reduce their activity to efficient levels.

#### *B. Reining in Prosecutors: Self Discipline and Judicial Oversight*

A second set of reforms call for more explicit checks on prosecutorial power.<sup>205</sup> Professors Stein and Beirschbach suggest that in order to reduce the *ex post* harms to corporate entities, laws should be reformed to make corporate convictions less likely. One way to do that, Stein and Bierschbach theorize, is to cloak the corporation with a “removable” Fifth Amendment privilege that would prevent prosecutors from serving subpoenas on corporations for documents unless and until prosecutors developed separate “probable cause” that a “corporate crime” had been committed, at which time prosecutors could seek a court warrant.<sup>206</sup> Unfortunately, Stein and Bierschbach’s proposal is either too broad or too narrow to work. If applied to all corporate investigations, the warrant requirement would severely hamper the government’s investigation and prosecution of individual white-collar crime, the evidence of which is

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203. Andrew Weissman & David Newman, *Rethinking Criminal Corporate Liability*, 82 IND. L.J. 411, 414 (2007).

204. *See supra* text accompanying notes 74–76.

205. Greenblum, *supra* note 41, at 1865.

206. Bierschbach & Stein, *supra* note 40, at 1776.



generated and maintained primarily in corporate files. On the other hand, if the proposal applied solely to investigations of organizations, it would be fairly meaningless because the documents that demonstrate individual employee crime almost automatically demonstrate corporate liability.

In a student note, Benjamin Greenblum has proposed judicial oversight of prosecutors to “counterbalance” prosecutorial power.<sup>207</sup> Greenblum’s proposal, however, stops short of imposing oversight over the negotiation process, in part because there is no doctrinal support for judicial presence in pre-indictment negotiations. Instead, Greenblum proposes that judges adopt a “wait and see” approach and then reinsert themselves during the implementation of the agreement.<sup>208</sup> Assuming one believes that judges are less conflicted or prone to error than prosecutors, Greenblum’s proposal has merit in that it might deter or eliminate some of the more inefficient DPA terms or prosecutorial interventions in corporate governance. Nevertheless, the oversight itself would be inconsistent in that it would rest largely on the judge’s own views and discretion. Inconsistency, in turn, would breed uncertainty.

### C. Elimination of Criminal Liability

Finally, a number of scholars have, over the years, called for the complete elimination of corporate criminal liability, and replacing it with the tort system as a means of regulating business entities and their monitoring of employees.<sup>209</sup> Professors Fischel and Sykes have argued that in all instances, the civil liability system can more efficiently set organizational penalties for entities than criminal liability.<sup>210</sup> According to Fischel and Sykes, criminal penalties are generally inefficient—in other words, they do not approximate the malfeasor’s social harm, adjusted for the probability of detection. If an employee causes \$100,000 worth of social harm and there is a one in ten chance that his crime will be detected, the optimum penalty for his crime is a \$1,000,000 fine.<sup>211</sup> Any fine above that amount is excessive and likely to overdeter the

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207. Greenblum, *supra* note 41, at 1865; *see also* Garrett, *supra* note 10, at 924 (arguing courts could impose “reasonableness” review on DPA process).

208. This would require that all agreements be filed in court. *See* Greenblum, *supra* note 41, at 1900.

209. *See* Ainslie, *supra* note 18, at 110–15 (“civil sanctions can generally be shaped far more precisely to meet the targeted evil”); Khanna, *supra* note 34, at 1275–76 (“Most, if not all, of the advantages of corporate criminal liability can be achieved by various forms of civil liability at lower cost to the government and society.”); Fischel & Sykes, *supra* note 2, at 322–24: “[economic deterrence arguments] are not arguments for corporate criminal liability in particular, but, rather, arguments for a set of monetary penalties, properly calibrated in light of the social harm caused by the criminal acts of corporate agents.”).

210. Fischel & Sykes, *supra* note 2, at 321.

211. “[A] total penalty equal to the social cost of crime, discounted by the probability of nondetection, is an appropriate rule of thumb to use in setting the penalty.” Fischel & Sykes, *supra* note 2, at 325–26. Additional factors, such as the penalty’s effect on enforcement costs or likelihood of detection may also affect the penalty. *Id.* at 326. In addition, a proper system should also consider the penalties imposed on the individual employee—apart from those imposed on the organization—because the individual employee presumably will demand greater compensation *ex ante* to make up for the *ex post* damages he may suffer. *Id.*; *see also* Ronald Coase, *The Problem of Social Cost*, 3 J.L. ECON. 1 (1960). This Coasian shift is rather uneven.

employee and the organization tasked with monitoring him. Legislatures, according to Fischel and Sykes, fail to follow this rule of thumb when setting penalties; instead, they focus more on impressing the public with a get-tough-on-crime stance.<sup>212</sup>

As Fischel and Sykes recognized in their 1996 article, politicians have had few incentives to eliminate corporate crime. Between the media's coverage of corporate scandals and the growth of a compliance industry, the public would not have looked favorably on legislation that freed corporations from criminal liability, even if it exposed them to vicarious liability in civil form. Moreover, putting aside the difficult question of whether the criminalization of an entity's lack of monitoring retains any expressive value, the wholesale *decriminalization* of entity-based corporate crime might send unintended signals that entities can ignore (or even encourage) their employees' misconduct.

This is not a concern to be taken lightly. As most commentators would agree, fraud *is* bad for the securities markets, and the corporate form should not be used as a shield to hide and perpetuate criminal conduct. However, some of these worries could be alleviated through, among other things, increases in individual criminal liability for certain offenses, such as perjury and obstruction of justice. This would demonstrate to firms that the withholding of properly requested information will not be tolerated. Obstructive conduct by entities could be deterred through civil or administrative provisions such as fines, denial of permits or other similar measures.

In any event, Fischel and Sykes' article concerns itself primarily with the question of why entity-level criminal liability is inappropriate. It does not focus on how we might move from a criminal regime to a primarily civil regime with improved monitoring incentives. Part III of this Article therefore suggests such a mechanism.

### III. INSURING CORPORATE CRIME: THE PROPOSAL FOR COMPLIANCE INSURANCE

The essential problem with composite criminal liability is that it causes organizations to overpay for their employees' actual and potential crimes before and after they become targets of federal investigations.<sup>213</sup> Inspired by their healthy fear of the DOJ and the extralegal consequences of indictment, business entities are likely to adopt overly expensive monitoring and compliance systems and agree to suboptimal settlement terms with prosecutors. Moreover, the current regime, although supposedly less taxing than pure strict liability, continues to create a false expectation of near perfection despite the fact that perfect compliance at any cost is neither possible nor desired.<sup>214</sup>

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When liability is aimed primarily at the corporation and not the manager, the corporation will have a difficult time shifting liability back to the manager because negotiation with management is not arm's length. Khanna, *supra* note 34, at 1255. This problem, however, would seem to be limited to top managers and not all employees.

212. According to Professor Stuntz, this tendency toward criminalization is shared and supported by prosecutors. See Stuntz, *supra* note 135, at 534 (“[A]t the most basic level, elected legislators and elected prosecutors are natural allies.”). Although Stuntz was referring to elected prosecutors, this alliance should extend to political appointees as well.

213. “[B]ecause the costs of excessive monitoring must be recovered through prices, improperly high penalties create additional inefficiencies because the price of goods or services produced by corporations will exceed their social costs.” Fischel & Sykes, *supra* note 2, at 324.

214. See Cunningham, *supra* note 56, at 308–09 (discussing perception gap between legal culture's expectation of “absolute assurance” and reality of leakiness); Fischel & Sykes, *supra*

Corporate employees are human beings with complex motivations. As Professor Macey has observed, they may commit crimes to mask subpar performance, to comply with what they view as the prevailing corporate or industrial culture, or simply because they misunderstand the law.<sup>215</sup> Although education, indoctrination, and monitoring can correct some of these problems, they inevitably will fall short; organizations are not and will never be all-knowing or omnipotent. Ceaseless efforts at monitoring may hamper an organization's legitimate business goals either by redirecting resources from more socially beneficial activity or by undermining the employees' morale, loyalty, or entrepreneurial creativity.<sup>216</sup>

This Article proposes<sup>217</sup> compliance insurance as a plausible solution to the overpayment problem.<sup>218</sup> Unlike the current system, which forces organizations to guess at how well they should self-insure, a "compliance insurance" system would create a market that would enable its participants to: (a) measure a corporation's compliance risk *ex ante*; (b) pool and reduce aggregate risks; (c) monitor and control corporate compliance by charging the corporation a premium based on its calculated risk; and (d) retain funds for victims of wrongdoing. Under this system, business entities would retain the incentive to monitor their employees to the extent such monitoring was cost effective. Prosecutorial excess and mindless devotion to compliance for the compliance industry's sake, however, would disappear because prosecutors and compliance professionals would be replaced by a totally different set of agents: the insurance carrier and the regulators who set minimum coverage targets for insureds.<sup>219</sup>

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note 2, at 346 (compliance at all costs not desirable); Langevoort, *supra* note 37, at 73 (perfection not possible).

215. Jonathan Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. Rev. 315, 326–32 (1991) (describing three primary causes of corporate crime). For further discussion of how corporate culture allegedly causes crime, see generally Ford, *supra* note 116, at 762.

216. Baysinger argues that corporate compliance programs should be judged like any other corporate output: "Like other aspects of production, the outputs of compliance programs must be judged realistically: no system that is cost effective and otherwise tolerable to live with can be absolutely foolproof." Barry Baysinger, *Organization Theory and the Criminal Liability of Organizations*, 71 B.U. L. Rev. 341, 367–68 (1991).

217. Because of the uncertainties about whether and how a market would function, my proposal presumes that the program would be optional for a defined period of time. After the market was established, the regime could become mandatory for organizations above a certain size in terms of capitalization or employees. *Cf.* Richard Epstein, *Imperfect Liability Regimes: Individual and Corporate Issues*, 53 S.C. L. REV. 1153, 1160–61 (2002) (discussing benefits of mandatory insurance tort regime for small corporations). Whether compulsory compliance insurance is necessary or advisable, however, is beyond the scope of this article.

218. By "insurance," I mean the company's purchase of insurance from an insurance carrier, who pools and aggregates the risks of multiple organizations. I do not mean "self-insurance," which the current regime of corporate criminal liability effectively requires. *See* Laufer, *supra* note 18, at 1349 (explaining how corporate compliance has become "a carefully conceived and arguably overpriced form of risk management that serves as an insurance function").

219. Admittedly, the process for devising a schedule of minimum coverage could itself become quite complex and/or inefficient, particularly if the regulator who set a mandatory schedule of minimum insurance set amounts too high or too low as a result of making incorrect assumptions or becoming politically captured by one or more parties. *See* Hanson & Logue, *supra* note 95, at 1267 (discussing information inefficiencies of performance-based regulation).

To some degree, insurance carriers have already begun to encroach on this territory. Contemporary D&O policies extend coverage not only to the costs of defending directors and officers against claims of wrongdoing (which the industry often refers to as “Side A” coverage), but also to entity-based securities claims (“Side C” coverage).<sup>220</sup> This proposal would extend insurance coverage (either through the D&O policy or some separate policy) to nearly all instances of entity liability for individual employee criminal conduct.<sup>221</sup>

This proposal also bears some resemblance to financial statement insurance (FSI), which Professors Ronen and Cunningham, respectively, have proposed and amplified.<sup>222</sup> Under Professor Ronen’s and Cunningham’s proposals, instead of hiring auditors to review financial statements, corporations purchase FSI from carriers to insure the reliability of their financial statements. To judge the risks imposed by financial statements, carriers hire auditors to audit the corporate insureds. Thus, instead of working directly for corporate managers (creating an inherent conflict of interest),

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If the schedule were transparent, however, and subject to the ordinary rule-making notice and comment procedures outlined by the APA, the inefficiencies would likely be less than those caused by the processes described in Part I of this Article.

220. See Griffith, *supra* note 44, at 1167–68.

Coverage under Side A (referred to as Insurance Clause 1 in some policies) provides coverage to individual insureds where the company is legally or financially unable to indemnify them. Coverage under Side B (or Insuring Clause 2 in some policies) provides corporate reimbursement coverage to the extent the company indemnifies the individual directors and officers, usually in excess of a large deductible. Finally, many traditional D&O policies today also include Side C coverage that provides entity coverage for securities claims, again in excess of a large deductible.

John C. Tanner and David E. Howard, *Blowing Whistles & Climbing Ladders*, 23 No. 4. ACC Docket 32 (April 2005) at 50. Professor Coffee has explained that Side C coverage came about because of allocation issues that arose when both the corporation and managers were sued in class action suits. Carriers would “demand an allocation of the defense costs between their clients [the individual directors and officers] and the corporation...[and] thereby plac[e] the individual defendants at risk for these payments.” Accordingly, in or about 1996, carriers began to extend entity-based coverage, “which directly reimbursed the corporation for its own litigation expenses, its own settlement payments in securities cases, and certain other forms of litigation.” Coffee, *supra* note 115, at 1569–70.

221. Entity-based policies do not currently cover losses caused by fraudulent or dishonest conduct. See David T. Case and Matthew L. Jacobs, *Insurance Coverage for Governmental Investigations of Financial Institutions*, 123 BANKING L.J. 256, 260 (2006); *supra* note 127.

222. Ronen, *supra* note 44, at 48 (“We need to create ... an agency relationship between the auditor and an appropriate principal—one whose economic interests are aligned with those of investors, who are the ultimate intended beneficiaries of the auditor’s attestation... [I]nsurance carriers are an eminently reasonable candidate.”). See also Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1738–47 (2006) [hereinafter Cunningham, *Too Big To Fail*]; Cunningham, *supra* note 44; Lawrence A. Cunningham, *A Model Financial Statement Insurance Act*, 11 CONN. INS. L.J. 69 (2004). Other scholars have called for the imposition of limited strict liability to force auditors to behave “more like insurers.” Frank Partnoy, *Strict Liability For Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 375 (2004); see also Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001); Coffee, *Gatekeeper Reform*, *supra* note 45, at 349.

auditors work for, and their interests are instead aligned with, insurance carriers, who in turn are financially bonded by FSI policies.<sup>223</sup> Whereas FSI is intended to combat the inherent conflict of interest that undermines the auditor's independence and credibility when assessing financial statements, compliance insurance, in contrast, prices the cost of corporate noncompliance rather than criminalizing it.<sup>224</sup> As such, it places entity responsibility for corporate crime back under the tort umbrella. Moreover, unlike financial statement insurance, which pertains only to financial statements,<sup>225</sup> compliance insurance would relate to potentially all types of criminal conduct by an entity's employees.

An outline of compliance insurance and how it might work is set forth below.

#### A. General Outline of the Program

Imagine a public company known as C Corp. C Corp employs thousands of employees across several states. C Corp produces, markets, and sells products and services to private and public entities, including local, state, and federal agencies. C Corp has hired a compliance officer and additional employees who routinely educate the organization about the law, and it has instituted an ethics hot-line and a Code of Business Conduct to improve its corporate culture. Periodically, C Corp's compliance officer updates C Corp's audit committee on the company's compliance program. Nevertheless, despite the company's publicly stated commitment to compliance, C Corp still finds that some of its employees commit crimes in the course of their employment, even though such conduct is prohibited by C Corp's ethics code and corporate policies. Because C Corp sells products and services to government agencies and because some of these services are covered by any number of federal regulations, C Corp's business would be significantly damaged by a corporate indictment. If investigated, C Corp would most likely agree to virtually any DPA term in order to avoid a criminal indictment, even though these concessions might not be in the best interests of its shareholders, employees, or customers.

Now imagine that if C Corp purchases a specified minimum amount of insurance coverage, it can opt out of the criminal system. Henceforth, C Corp's employees' crimes will, at worst, result only in civil penalties resulting from lawsuits initiated by private or government parties. These penalties will be paid by C Corp's insurance policy or C Corp itself in the event those penalties exceed the limits set by the policy. Instead of acting as a *de facto* insurer for all its employees' criminal conduct (in which the rates are set *ex post* by prosecutors), C Corp will pay *ex ante* for the costs associated with the risk of those crimes by obtaining insurance from an underwriter called Underwriter U.

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223. See Cunningham, *Too Big to Fail*, *supra* note 222, at 1742. In his latest article, Cunningham suggests that FSI should be mandatory instead of optional. *Id.* at 1738.

224. "[T]he criminal law prohibits while the civil law prices." Coffee, *supra* note 58, at 1884 (criticizing legislative habit of criminalizing violations of agency-promulgated regulations).

225. Under Ronen's proposal, instead of paying auditors to audit the corporation's financial statements, corporate managers would purchase financial statement insurance from insurance carriers. To assess their risk of payout, insurance carriers would employ auditors to review the corporate books. This alters the agency cost problem because auditors are no longer paid by the very party (corporate managers) that they are auditing. Ronen, *supra* note 44, at 48–49.

Underwriter U sells a product known as “compliance insurance.” Compliance insurance might be an extension of either a general commercial liability policy or Side C of a D&O policy;<sup>226</sup> it covers the entity for all entity-based penalties and fines resulting from its employees’ criminal conduct. Unlike the current D&O policy, however, it extends beyond wrongdoing to conduct that has been labeled criminal. Since C Corp has purchased a minimum amount of compliance insurance, it is no longer criminally liable as an entity for its employees’ conduct. It may, however, still be liable civilly to either private lawsuits or claims brought by administrative agencies. Compliance insurance would cover some or all of these claims.

To begin the process, C Corp would approach Underwriter U and request a proposal for a compliance insurance policy. Underwriter U would then review C Corp’s compliance program, its compensation policies, its history of misconduct and any other aspects of its business that Underwriter U deemed relevant to C Corp’s risk of employee criminal misconduct.<sup>227</sup> Pursuant to this inquiry, C Corp would give Underwriter U substantial access to C Corp’s personnel, policies, and documentation.<sup>228</sup> Because Underwriter U would be in the business of evaluating compliance programs, Underwriter U would possess substantial information about not only C Corp’s program but also about similar programs administered by corporations in similar industries or of similar size. Thus Underwriter U’s policy would be a function of: (a) C Corp’s historical conduct and compliance structure; (b) C Corp’s industry, structure, number of employees, or other factors that affect compliance risk but are not necessarily unique to a particular company or its compliance program; and (c) competition within the “compliance insurance” market.

Following Underwriter U’s review, Underwriter U would present C Corp with a proposal for compliance insurance, which could be either a separate policy or a component of the entity’s general liability or D&O policy. The proposal would include a premium, a deductible, and a schedule of insurance coverage. The proposal might also include restrictions, exceptions, or compliance reforms mandated by Underwriter

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226. A D&O policy covers directors, officers, and insured entities for litigation against directors and officers for violations of fiduciary duty. D&O policies are most often paid out for shareholder litigation.

227. Insurance carriers already perform some of these tasks when assessing risks for D&O policies. See Tom Baker & Sean Griffith, *Predicting Governance Risk: Evidence From the Directors’ and Officers’ Liability Insurance Market*, 74 CHI. L. REV. 487 (2007) [hereinafter Baker & Griffith, *Predicting Governance Risk*]; James Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 L. & CONTEMP. PROBS. 1, 31–32 (Fall 1997); Griffith, *supra* note 44, at 1175.

228. Because compliance risk would include matters known to internal counsel, Underwriter U might request privileged information and/or access to C Corp’s privileged documents. A similar issue has already been flagged with regard to auditors who review financial statements. See ABA TASK FORCE REPORT, *supra* note 19, at 1052. As a result of the Sarbanes-Oxley Act, auditors have begun to demand from corporate clients documents that historically were considered covered by the attorney-client privilege. *Id.* at 1052–53. Although the ABA Task Force did not take a formal position on the issue, it noted with apparent approval the suggestion that Congress enact selective waiver legislation that would permit corporations to supply materials to auditors but maintain the attorney-client privilege or work product protection with regard to other parties. *Id.* at 1055 & n.106. Similar legislation could apply to compliance insurance.

U, as a result of its review of C Corp's policies and past experience. If C Corp were a large entity, it might likely secure policies from multiple carriers, each of which would insure a certain level of liability above the primary amount insured by Underwriter U.

In order to ensure an appropriate reserve of funds for victims of criminal acts, the federal government would specify a minimum schedule of coverage that C Corp must purchase in order to opt out of entity-based criminal liability, which would remain the default system.<sup>229</sup> The schedule might be based on some combination of named factors such as the company's capitalization, number of employees, and type of industry; or it might rely on other relevant factors. C Corp would pay the premium, and Underwriter U would adopt C Corp's risk and pool it with the risks of other companies. By pooling the risk, the insurance system could reduce the aggregate costs of employee noncompliance across the pool.

### *B. Damages and Claims*

Compliance insurance is preferable to corporate criminal liability if it more efficiently encourages entities to identify, quantify, and reduce their compliance risks *ex ante* but also continues to compensate victims *ex post*.<sup>230</sup> This system therefore would have to pay attention to the manner by which it compensated the victims of C Corp's employees' criminal conduct.<sup>231</sup>

It is important to note that the purpose of this proposal is not to generate new private causes of action or reduce the corporate employee's individual criminal liability. Moreover, one of the goals of this proposal is to maintain some level of compensation for those harmed by corporate executives and who otherwise would remain unpaid by judgment proof individuals. Accordingly, this proposal would replace corporate criminal liability with civil penalties assessed by courts and sought primarily by civil government attorneys (which is already largely the case due to parallel litigation under numerous regulatory regimes), and require corporations to purchase minimum insurance coverage to cover these penalties.<sup>232</sup>

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229. Critics will argue that the federal regulator who sets the schedule will likely re-introduce inefficiencies into the system. *Cf.* Hanson & Logue, *supra* note 95, at 1281 (“[The process] place[s] huge information demands on regulators . . . . Without perfect information, regulators will set prices too high or too low, and they will be unable to respond properly to changes in the amount of harm a product does.”). However, assuming the regulator *published* the schedule and its factors every year and made this schedule available for notice and comment, it would be far more transparent and still less inefficient than the current system.

230. Some might argue that this system makes sense only for economic crimes (which are the bulk of crimes that occur within corporate settings) and not those employee crimes that lack a readily quantifiable value, such as obstruction of justice. (I am thankful for Steve Schulhofer's comment on this distinction). Although certain crimes may cause valuation problems, those problems would persist regardless of whether the underlying crime resulted in either criminal or civil fines imposed on the entity.

231. Since this system presupposes the elimination of corporate criminal liability, the insurance carriers would take on the organization's liability in tort for all civil fines and penalties assessed as a result of the organization's employees' criminal misconduct.

232. Since some criminal statutes do not have a civil or regulatory component, Congress might enact an omnibus statute permitting civil government lawsuits on behalf of victims against corporations whose employees were found guilty of federal crimes. This would ensure

Thus, the proposal would move entity-based liability back into the realm of tort law. To be efficient, the standard of liability would be composite, presumably with a strict liability phase followed by a penalty phase that would reflect the harm caused by the corporation's employees, modified by the likelihood of detection, *plus* some reduction or reward for monitoring and self-reporting.<sup>233</sup>

The reward is necessary to induce firms to monitor and report offenses. If Underwriter U's premium and coverage is linked to the carrier's assessment as to how much money it is likely to pay out for C Corp's employee crimes, its risk calculation will include not only the likelihood and magnitude of crimes committed by C Corp's employees, but also the likelihood that those crimes will be detected.<sup>234</sup> This, in turn, will create the same perverse problems that Professors Arlen and Kraakman observed for all strict liability regimes.<sup>235</sup> In other words, if Underwriter U charges a higher premium because C Corp's compliance program increases the likelihood of detection without sufficiently decreasing losses caused by criminal harm, C Corp will either shut down its compliance program or erect a fake one.

Thus, as predicted by professors Arlen and Kraakman, entity liability for employee crimes in a civil system will function best under a system of composite liability, whereby judges and juries (and thereby carriers) reward firms for monitoring and self-reporting. On the other hand, to the extent such a reward is offered *ex post*, firms may *ex ante* devise otherwise inefficient monitoring and compliance regimes designed to impress juries and judges (and to a lesser degree, carriers), much as they currently fund compliance regimes with an eye toward impressing prosecutors.<sup>236</sup> These are certainly problems; but despite them, the resulting system still would be preferable to corporate criminal liability.

First, the legal standard that would determine if and when the corporation was entitled to the reward would be more transparent and subject to correction. Judicial determinations of whether a given entity was entitled to a penalty reduction would be placed on the record in writing and would be subject to appeal. Firms could exercise their right to appeal without fear of the collateral consequences of a criminal indictment.

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that the federal government had the same ability to pursue corporate entities civilly for the same crimes that previously would have triggered corporate criminal liability. The difference, of course, is that corporations would be forced to insure the liability, and the collateral consequences of criminal indictment (and the leverage accruing to the prosecutor as a result of those consequences) would drop out.

233. This article presumes that corporations would continue to be held strictly liable (albeit with some encouragement for self-reporting) for their employees' crimes. I choose strict liability as a baseline because: (a) employees may be insolvent and therefore entity liability will prevent the employee's moral hazard; and (b) the costs and errors associated with discerning negligent monitoring outweigh the value of a negligence scheme.

234. The expected value would be a multiple of the expected criminal penalty for a given crime multiplied by the probability of detection.

235. See Arlen & Kraakman, *supra* note 33, at 707–09. Although presumably the same problem should plague D&O liability (whereby increased corporate governance leads to greater detection but not a sufficient decrease in actual wrongdoing), Griffith does not address it. See Griffith, *supra* note 44, at 1181 (“By continually optimizing its governance structure, a corporation ought to find that it pays consistently less for D&O insurance than its competitors.”).

236. I am grateful to Professor Krawiec for bringing up this point.



Second, it would spur less uncertainty. Organizations would base their conduct on judicial decisions and jury verdicts, and not by guessing how the latest United States Attorney (or the department as whole) would handle a given offense. Obviously, some level of uncertainty would remain (particularly in the beginning while the standard was taking shape), but not as much as exists within the current system.

Third, it would eliminate errors and inefficiency currently caused by prosecutorial biases and conflicts of interest. Jurors and judges would determine the penalty based on the organization's *prior* conduct and not on future promises to assist in the prosecution of designated employees. This is not to say that the company should be given a free pass to obstruct justice. Separate civil fines for obstruction (and separate criminal prosecutions for those who intentionally hindered a federal investigation) would be implemented and encouraged. However, the concept of prosecutorial cooperation would no longer clog up the concept of composite liability, which should be used to encourage *ex ante* monitoring and self-reporting.

### *C. Who Is Covered? Moral Hazard and Fortuity*

The strongest argument against insurance will be the fear of moral hazard. In other words, if insurance buffers the consequences of bad behavior, insureds engage in more of that behavior.<sup>237</sup> Moral hazard is arguably the reason that state courts reject insurance of criminal conduct as a matter of public policy.<sup>238</sup> At the same time, most state courts have upheld insurance contracts for punitive damages when the insured is only vicariously liable.<sup>239</sup> The principle that appears to divide the insurable from the noninsurable conduct is fortuity. If the insured has complete control over how and when the act will happen, the act cannot and should not be insured. On the other hand, if the insured knows only that there is a great risk that an event will occur, the event is insurable because it is fortuitous.

In the context of corporate crime, the criminal act is fortuitous when it is beyond the control of the entity that purchases the insurance. If one defines the "insured" as the organization's control group (i.e., the board of directors and senior executive officers), then fortuity fails to exist whenever control group members commit crimes.<sup>240</sup> State

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237. See generally Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 270 (1996).

238. See *Nw. Nat'l Cas. Co. v. McNulty*, 307 F.2d 432, 440 (5th Cir. 1962) (proclaiming insurance against criminal penalties void and against public policy in deciding against insurability of punitive damages); see also Catherine M. Sharkey, *Revisiting the Noninsurable Costs of Accidents*, 64 MD. L. REV. 409, 421–32 (2005) (discussing debate over insurability of punitive damages and suggesting that insurability should fall along lines of whether conduct was intentional instead of whether given relief is labeled compensatory or punitive).

239. Sharkey, *supra* note 238, at 428–29 ("Most of the states that prohibit insurance for punitive damages on public policy grounds nonetheless permit that insurance when punitive damages are vicariously (as opposed to directly) assessed against a defendant."). See also Deborah Travis, Comment, *Broker Churning: Who is Punished? Vicariously Assessed Punitive Damages in the Context of Brokerage Houses and Their Agents*, 30 HOUS. L. REV. 1775, 1812 (1994) (explaining that as of 1988, all but three states permitted insurance of vicarious punitive damages).

240. This at least provides a doctrinal backdrop to the otherwise completely intuitive notion that management's participation in a criminal act should result in greater penalties for the

courts have adopted the control-group theory when considering the insurability of punitive damages for corporations that have been held vicariously liable for their employees' misconduct.<sup>241</sup> Because an employee's crime is as fortuitous to his employer as his tort, there should be no logical barrier preventing the extension of this rule to criminal conduct.<sup>242</sup>

If, on the other hand, the "insured" is perceived as the collective group of shareholders who bear the cost of insurance, then insurance should apply in all instances of employee crime, except where the owner—such as a controlling shareholder in a closely held corporation—has participated in the crime. In other words, the *shareholder's* purchase of insurance through the corporation makes the *shareholder* no more likely to commit criminal conduct.<sup>243</sup> The control group's purchase of *entity level insurance*, assuming it is structured in a way as to *not* alleviate directors' and officers' personal criminal liability, need not cause this problem either. The moral hazard problem only occurs when managers and directors purchase entity-level insurance that covers not only the entity's liabilities, but also the directors' and officers' individual liabilities.<sup>244</sup> Accordingly, to prevent moral hazard, compliance insurance would apply only to entity-based penalties; in no circumstances would it apply to monetary penalties assessed on individuals through the criminal justice system.

Between the two rules—control group or ownership—the ownership rule adheres more faithfully to the notion of the corporate form and seems more sympathetic to the problem of agency costs. If there is a separation between management and ownership, then any crime—whether it is committed by a lowly employee or a CEO—is unintentional and fortuitous insofar as a public shareholder is concerned. If shareholders foot the bill for the company's insurance, it is a double insult that in addition to suffering the costs of agency shirking, shareholders must also lose the benefit of their insurance bargain through conduct over which they inherently have little or no control. In fact, even though current D&O liability insurance policies exclude coverage for the director's intentional criminal acts, most policies sever this exclusion for outside directors when management's conduct is deliberately fraudulent

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organization. *See generally* Khanna, *supra* note 34.

241. *See* Michael A. Pope, *Punitive Damages: When, Where and How They Are Covered*, 62 DEF. COUNSEL J. 539, 541 (1995) ("If the persons responsible for the corporation's misconduct are officers or directors of the corporation, the misconduct is generally attributed directly to the corporation.").

242. *Cf.* Sharkey, *supra* note 238, at 432 (criticizing label-based approach to deciding availability of insurance for punitive damages). The resistance to insuring criminal liability—even liability that is vicarious in nature—may stem from the historical fears that insurance fuels crime. *See* Baker, *supra* note 237, at 259 (explaining that morality of insurance is linked to exclusion of criminals and those "linked with" criminals).

243. It might increase overall investment in corporations if shareholders believe an insurance system results in less waste and uncertainty than under a corporate criminal liability regime.

244. This in fact has become the problem with D&O insurance. The corporation not only purchases D&O insurance for the directors and officers, but it also purchases Side C coverage for entity-level penalties incurred during securities litigation. Because one insurer covers everything, directors and officers need not worry about allocation or contribution, except where the penalties exceed coverage. Coffee, *supra* note 115, at 1567 ("[I]f the settlement is fully covered by the corporation's own liability insurance . . . the board has little reason to resist a settlement that involves no contribution by the individual defendants.").

or otherwise violates the terms of the insurance policy.<sup>245</sup> Severability provisions such as these “protect innocent outside directors’ coverage from the misconduct of inside managers.”<sup>246</sup> If such protection is available for outside directors, then, one might reasonably wonder why the same protections should not be available for (presumably) innocent shareholders in a public corporation. Finally, it is easier and cheaper to adjudicate an ownership rule than a control group rule, which is highly contextual and fact-specific.<sup>247</sup>

Unfortunately, since most states adhere to a control-group rule, the adoption of an ownership rule would incur transaction costs. Although the federal government retains the power to regulate insurance under the Commerce Clause (presumably where either the carriers or the organizations purchasing the insurance operate in interstate commerce),<sup>248</sup> insurance has nevertheless explicitly been delegated to the states by the 1944 McCarran-Ferguson Act.<sup>249</sup> Replacing the control group test of vicarious liability with the ownership rule would require Congress to partially repeal McCarran-Ferguson and expressly preempt state laws. If a legislator were to consider the opposing rules, she would have to balance the administrative efficiencies of the ownership rule against the political costs of upending the control-group rule.

Assuming an ownership rule were adopted (and promulgated through federal legislation that preempted state insurance laws), the following scenarios could result:

If C Corp is a closely held corporation and its owners are committing crimes, C Corp will be denied compliance insurance coverage because insurance would present a moral hazard in this instance. Without compliance insurance, both C Corp *and* its owners may be charged criminally and held subject to substantial penalties.<sup>250</sup>

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245. Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1087 (2006) (“[P]olicies are now widely available that provide for full severability with respect to both conduct exclusions and the insurer’s right to rescind the policy.”).

246. *Id.*

247. One way to shore up an ownership rule is to require that all insurance contracts are negotiated and approved by independent directors. *Cf.* Coffee, *supra* note 115, at 1575 (suggesting that SEC require independent directors to examine proposed class action settlements to prevent self-dealing).

248. *See* United States v. Se. Underwriters Ass’n, 322 U.S. 533 (1944).

249. 15 U.S.C. § 1011 (2000):

Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

Over the years, commentators have periodically called for a repeal of the McCarran-Ferguson Act on various grounds. *See* Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 641–44 (1998) (discussing Congressional criticism of state regulation of insurance). Following the terrorist attacks on September 11, 2001, Congress partially preempted state regulation of insurance with the passage of the Terrorism Risk Insurance Act of 2002. Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, 116 Stat. 2322.

250. Under this analysis, partnerships ordinarily would be ineligible for such insurance as well.

Prosecutors will retain the same power over the privately held C Corp and its employees.

If C Corp is a *public* corporation and it has purchased a minimum floor of compliance insurance, it will no longer be subject to criminal prosecution for its employees' criminal acts. If employee crimes occur, civil attorneys may pursue C Corp for entity-level fines or other penalties, which will be set by a court. Underwriter U will pay those fines and may in fact defend the litigation. Finally, if C Corp detects employee crime and promptly reports that crime to its carrier, Underwriter U, corresponding penalties will be decreased and Underwriter U will presumably pass along those benefits through a cheaper policy.

Continuing with the assumption that C Corp is a public corporation and has purchased compliance insurance, if it fails to detect criminal conduct or its top executives participate in criminal conduct, C Corp still will be covered by the insurance policy, but its civil penalties may be higher. Following the incident, Underwriter U may drop C Corp as a client, charge C Corp higher premiums or insist that C Corp change its governance structures. To prevent this consequence, C Corp must improve its employee screening, adopt better crime detection mechanisms, or adjust production levels to a socially optimal level.<sup>251</sup>

#### *D. Claims, Occurrences, and Adjudication*

Once an organization successfully obtained coverage, its employees' subsequent criminal misconduct would no longer subject it to entity-level criminal liability. Thus, for covered entities, the DOJ's internal charging memos and the Organizational Sentencing Guidelines would cease to be relevant. Individual employees, however, would remain criminally liable for their wrongdoing.

That still leaves the question of who initiates the claim. Because corporate criminal liability is premised on the idea that the United States was itself a victim or represents "the people" generally as a victim, one could imagine a system in which government attorneys (either agency attorneys or attorneys employed by the civil division of the United States Attorneys offices and the DOJ) would continue to file claims where violations of federal laws were concerned; payments either would compensate identifiable victims or go to the public fisc. Class actions and other private methods of enforcement would be unchanged by this proposal.

Admittedly, this proposal presumes that government attorneys who prosecute civil suits are subject to fewer conflicts of interest, greater judicial oversight, and more accountability than their counterparts in the DOJ's Criminal Division. The proposal also assumes that in most cases, carriers would assume control of the company's defense in court.<sup>252</sup>

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251. There is some evidence that auditors charge higher fees to issuers with higher liability risks. See Coffee, *Gatekeeper Reform*, *supra* note 45, at 348–49 (expressing concern that auditor screening may drive law-abiding firms from the market); Partnoy, *supra* note 222, at 374 (citing Ronald A. Dye, *Auditing Standards, Legal Liability, and Auditor Wealth*, 101 J. POL. ECON. 887, 908 (1993)).

252. D&O carriers do not assume defense of claims, which unfortunately permits greater *ex post* loss. In other words, management will settle any claim that does not exceed the coverage amount. Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The*

In some cases, insurance companies would simply settle with the government. Unlike DPAs, however, the carriers' settlements would be approved by a federal judge. Accordingly, it is less likely that settlements would include terms designed to leverage the prosecutor's prosecution of individual employees. Moreover, where the government sought too high a payout (or disagreed that an entity was entitled to a reduction in penalty owing to its compliance program), insurance carriers (and companies, to the extent the government sought penalties in excess of the coverage amount) would have incentives to litigate the claim at trial.<sup>253</sup> Unlike the current system, which forces corporate defendants to settle because they fear the extralegal costs of an indictment, carriers would have no such fears. The government would have no more power over the carrier than it does over any civil litigant.

Although the burden of proof technically would shift from "beyond a reasonable doubt" to "preponderance of evidence," this shift would nevertheless result in less overall liability for most firms because: (a) collateral consequences would decrease substantially; and (b) penalties would be assessed by courts and juries and not prosecutors.<sup>254</sup>

Finally, to best align the underwriter's interests with that of shareholders and the government in deterring crime, claims would be made on an occurrence basis. In other words, if the government brought a claim in year three for a crime that took place in year one, the underwriter that wrote the policy for year one would be on the hook for payment.<sup>255</sup>

#### *E. Disclosure and Market Signals*

For public companies, disclosure of Compliance Insurance is desirable because it can alert investors as to whether a particular company is at risk of noncompliance.<sup>256</sup> Insofar as the insurance underwriter is measuring and assessing the corporation's

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*Directors' and Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1813–17 (2007) [hereinafter Baker & Griffith, *Missing Monitor*]; see also Baker, *supra* note 227, at 270 (discussing *ex post* losses and moral hazard). In other insurance contexts, such as commercial liability, carriers take over the entire defense of the claim. Baker & Griffith, *Missing Monitor*, *supra* at 1814. It is unclear how compliance insurance would function in this context. Again, if the insurance contracts were negotiated and approved by outside directors, carriers might obtain the right to defend the claim, rather than reimburse the corporation for its own defense.

253. Assuming a strict liability regime, litigation costs should be lower than current costs under a criminal regime. Ideally, compliance insurance would assume some of the characteristics of "first party insurance" in that the finder of fact should not focus time and energy on how or why the crime was committed by the given employee. Cf. MARK GEISTFELD, *PRINCIPLES OF PRODUCTS LIABILITY* 55–56 (2006).

254. As the role of criminal prosecutors decreased, regulatory agencies might see their role increase under this system. Overall, this should be a good result. See Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 35 (1997) (preferring "expert regulators" to criminal prosecutors in field of corporate crime). However, inefficient aspects of the criminal process, such as overly intrusive unbonded monitors, might reappear through civil and regulatory settlements. I leave these worries for future consideration.

255. See Cox, *supra* note 227, at 33 (criticizing the fact that D&O insurance is on a claims made and not occurrence basis).

256. Griffith theorizes that disclosure of D&O premiums creates an additional incentive to reduce the premiums and improve governance. See Griffith, *supra* note 44, at 1181–82.

compliance program, the insurer bears some resemblance to the auditors, credit rating agencies and lawyers who assess and review corporate controls on a regular basis and who are regularly deemed corporate “gatekeepers.” Either the SEC or Congress could require C Corp (and any other public company) to disclose its yearly compliance insurance policy in public filings. To the extent that compliance insurance policies bore similar standardized characteristics for groups of similarly situated corporations (or for example, a given corporation’s policy remained stable over time), these policies would send signals to the investor markets, which analysts and institutional shareholders could further question and explore.<sup>257</sup> Disclosure would increase transparency and create an additional incentive for C Corp to improve its compliance program.<sup>258</sup>

#### *F. Potential Challenges*

Despite its benefits, numerous problems may arise in the attempt to implement Compliance Insurance. I address some of the more prominent ones here.

##### 1. Reductions in Prosecutions of Individual Employees

Prosecutors would most likely object to an insurance-based system on the grounds that the government cannot effectively prosecute individual employees unless it has the ability to pressure companies to hand over information and cooperate.<sup>259</sup> Although this should remain an important concern, it is not insurmountable. Aside from the government’s overwhelming power to obtain documents through subpoenas and search warrants, the government would also retain the benefit of (1) whistleblower hotlines; (2) provisions that have strengthened gatekeeper oversight by attorneys and auditors; (3) federal statutes and sentencing guidelines that subject even minor participants to prohibitively high sentences (thus increasing the attraction of individual cooperation agreements); and (4) numerous regulatory controls (such as civil fines and contempt orders) that regulators could employ when organizations affirmatively attempted to shield employees from blame. Moreover, when board members or upper management appeared to be intentionally hindering an investigation, prosecutors might make greater use of statutes such as 18 U.S.C. § 3 (accessory after the fact) and 18 U.S.C. § 4 (misprision of a felony).<sup>260</sup>

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257. Griffith raises similar arguments in his proposal for D&O disclosure. *See id.* at 1182–85.

258. Ronen also proposes disclosure for Financial Statement Insurance. Ronen, *supra* note 44, at 48–49 (describing “flight to quality” that occurs when companies realize that their policies will signal quality of their financial statements and controls).

259. *See* Bharara, *supra* note 2, at 107. “[T]he elimination of all criminal liability for business entities would completely eviscerate prosecutors’ leverage against corporations to obtain incriminating information about individual miscreants.” *Id.*

260. 18 U.S.C. § 3 states in pertinent part:

Whoever, knowing that an offense against the United States has been committed, receives, relieves, comforts or assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact. . . . [A]n accessory after the fact shall be imprisoned not more than one-half the maximum

It is also helpful to remember that the prosecutors' main implement in the "war" on white collar crimes is not the corporation's "cooperation," but rather the testimony of whistleblowers and coconspirators, buttressed by the writings contained in company documents. Scott Sullivan, not entity liability, led to the successful conviction of Bernard Ebbers for defrauding Worldcom's shareholders, and Andrew Fastow performed the same service where Ken Lay and Jeffrey Skilling were concerned. (Indeed, Enron had ceased to exist by the time Lay and Skilling were tried for their crimes.)

In the one recent case where a company, the law firm of Milberg Weiss, refused to cooperate and was indicted as a result, the company's refusal did not appear to make any dent in the government's case. Regardless of Milberg Weiss' lack of assistance, the government was able to obtain guilty pleas from one of the firm's partners, David Bershada, who was expected to testify in the prosecution of his law partners, who ultimately pleaded guilty to the charged conspiracy.<sup>261</sup> The Milberg episode demonstrates that although prosecutors might like companies to bend over backwards to identify (and even pressure) suspected wrongdoer-employees, the government is by no means dependent on companies to do so.

## 2. Limits of Coverage

Even if politicians and courts agreed that the public policy exception against insuring criminal conduct should not apply to organizations, there still would be organizational limits to the types of business entities that could take advantage of compliance insurance. Partnerships and closely held corporations, for example, might be ineligible for coverage or might find themselves restricted to coverage for crimes committed by non-partners or non-shareholders. This is unfortunate because the innocent partners and shareholders in closely held organizations have far more to lose than public shareholders in the event criminal conduct takes place. Following detection of a criminal event, partners may lose all of their personal assets, and shareholders of closely held corporations could quickly find their shares inalienable. On the other hand, members of smaller firms presumably have better ability to monitor and prevent criminal conduct by their peers.<sup>262</sup>

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term of imprisonment or . . . fined not more than one-half the maximum fine prescribed for the punishment of the principal.

18 U.S.C. § 4 states in pertinent part:

Whoever, having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be fined under this title or imprisoned not more than three years, or both.

261. See Julie Creswell, *Ex-Partner at Milberg Pleads Guilty to Conspiracy*, N.Y. TIMES, July 10, 2007, at C1. For the plea agreement, see Plea Agreement for Defendant David J. Bershada, No. CR 05-587(B) JFW (C.A.C.D. July 9, 2007), available at [http://www.nylawyer.com/adgifs/decisions/071007bershad\\_agreement.pdf](http://www.nylawyer.com/adgifs/decisions/071007bershad_agreement.pdf). Bershada's plea agreement was followed by William Lerach's and Melvin Weiss' guilty pleas. See Anthony Lin, *Weiss Agrees to Plead Guilty to Role in Kickback Scheme*, NEW YORK L.J., March 21, 2008, at 1.

262. Smaller organizations, however, may not need compliance insurance. Cf. Clifford G. Holderness, *Liability Insurers as Corporate Monitors*, 10 INT'L REV. L. & ECON. 115, 124 (1990) (finding from review of 1979 data that smaller closely-held organizations and

### 3. How and If Carriers Would Monitor Insureds

Two related questions that arise from this proposal are how carriers would assess risk and whether risk would be reduced or simply shifted onto those carriers. For many lines of insurance, the carrier foregoes intensive investigation and instead places the insured in a particular risk pool based on certain basic characteristics and the carrier's actuarial tables.<sup>263</sup> Other lines of insurance, such as title insurance and the proposed financial statement insurance, presume an investigatory audit by the carrier.<sup>264</sup>

It is premature to say which approach would be more amenable to compliance insurance. On one hand, a full-scale audit might provide greater guidance *ex ante* to corporations on how to improve monitoring and corporate governance. Such audits, however, would cost money, and those costs would be reflected in expensive premiums.<sup>265</sup> Moreover, if investigation yielded insufficient returns in predicting whether an organization's employees would commit crime, then carriers should be permitted (and in fact encouraged) to use other less expensive methods of predicting risk.<sup>266</sup> However, as Professor Cunningham points out, risk pooling is ineffective when the insured's risks are dependent on each other. In other words, if the risk of noncompliance rises for all companies due to some cultural event, then pooling fails to diminish risk.<sup>267</sup> Given the different types of noncompliance that may beset different companies, one would expect carriers to find a way to establish a workable pool.

In addition, the empirical evidence of what carriers actually do, as opposed to what they should do, is mixed. In two forthcoming articles, Professors Baker and Griffith report on extensive interviews with over forty participants in the D&O market. Baker and Griffith's articles are particularly relevant because one might expect D&O carriers to be the carriers who sold compliance insurance, either as a separate policy or as an extension of the D&O policy. (One could also imagine compliance insurance as an extension of the corporation's general commercial liability policy.) In any event, Baker and Griffith's inquiry as to the actions and views of D&O carriers is relevant insofar as D&O insurance extends to the wrongful conduct of managers.

As a result of their interviews, Baker and Griffith conclude that D&O carriers *do* investigate the corporate governance characteristics of potential insureds, and that carriers *do* build these characteristics into the price of the carrier's D&O premium.<sup>268</sup> This demonstrates that carriers could presumably take on the role of insuring corporate liability for crime. In writing their D&O or general commercial liability policies,

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partnerships do not purchase D&O insurance).

263. Cunningham, *Too Big to Fail*, *supra* note 222, at 1743 ("Most insurance underwriting exercises involve classifying risks using general actuarial tools rather than specific investigation.").

264. *Id.* at 1743–44 (listing other products in which carriers rely on specific investigation).

265. For example, for FSI, Professor Cunningham presumes that insurers would hire external auditors to assess the reliability of the corporation's financial statements. *Id.* at 1744.

266. Indeed, we might learn through a compliance insurance regime that it is simply impossible to reduce certain risks of employee crime in certain sectors or industries beyond a certain point. If so, the costs of that crime should simply be internalized and expressed as a cost of doing business, rather than cited as cause for moral shame and massive penalties.

267. *Id.* at 1740.

268. Baker & Griffith, *Predicting Governance Risk*, *supra* note 227, at 489.



carriers could simply expand the inquiries that they already make and price the additional risk into their policies.

Unfortunately, in a second article, Baker and Griffith also report that although D&O carriers price corporate governance into their policies, they explicitly *do not* monitor insureds during the life of the policy.<sup>269</sup> Although carriers monitor insureds in other contexts, including commercial liability policies, they do not engage in similar conduct for D&O policies because corporate managers are unwilling to pay for the monitoring.<sup>270</sup> Thus, D&O insurance does not reduce risk; rather, it simply redistributes it to carriers. Since shareholders could just as easily distribute that risk by diversifying their portfolio, Baker and Griffith conclude that D&O insurance encourages agency shirking by managers and should not be purchased.<sup>271</sup>

Baker and Griffith theorize that agency costs are behind the managers' purchase of D&O insurance-minus-monitoring. In other words, managers benefit from an insurance policy that caps the company's exposure and protects their own position and compensation, but simultaneously shields them from the monitoring and intervention that D&O carriers might otherwise provide on behalf of shareholders.<sup>272</sup> Although Baker and Griffith theorize that the lack of D&O monitoring may also result partially from other factors, including futility or prohibitive cost of monitoring, lack of monitoring expertise, D&O carriers' fears of liability for mistakes in monitoring advice, and various market failures, they still conclude that agency costs are the primary reason that public corporations decline the carriers' loss intervention services in the D&O context.<sup>273</sup>

Baker and Griffith's analysis is daunting to say the least. If D&O insurance can be replicated through portfolio diversification without cost, then what does that say about the current proposal for compliance insurance? Would managers simply use the compliance insurance as a means for smoothing risks and further shirking their fiduciary duties?

Hopefully not. Baker and Griffith's analysis is not addressed directly to the topic of corporate compliance, and as a result they fail to consider several explanations besides agency costs that might explain the current lack of interest in D&O monitoring.

First, corporations may be rationally engaging in the perverse behavior that Professors Arlen and Kraakman identified with regard to corporate criminal liability.<sup>274</sup> In other words, if a corporation perceives that a carrier's monitoring will simply increase detection of wrongdoing without a corresponding benefit for such detection in terms of lessened penalties, then firms will choose not to monitor. Although firms nominally receive credit for monitoring and detection under the McNulty Memo and Organizational Sentencing Guidelines, these standards are quite vague and subject to little or no oversight. Thus, one would expect the perverse incentives identified by Arlen and Kraakman to continue to play some role. Moreover, because criminal

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269. Baker & Griffith, *Missing Monitor*, *supra* note 252, at 1813.

270. According to Baker and Griffith, the one carrier of which they were aware that made an attempt to specialize in loss prevention could not demonstrate the value of their services and eventually left the D&O market. *Id.* at 1810–11.

271. *Id.* at 1822.

272. *Id.* at 1833–34.

273. *Id.* at 1840–41.

274. *See supra* note 235 and accompanying text.

liability is so devastating, the company might reasonably worry that by involving a carrier in the process, it would effectively relinquish control over how it handled questionable violations of law and how and when it would bring those violations to the attention of both government authorities and the public.

Second, even where pure prevention services are concerned, various formal and informal regulations already require public corporations to purchase corporate compliance services from lawyers, accountants, and other personnel. Although insurance carriers may indeed be the more efficient architects of compliance because they are bound financially by their mistakes, they are not currently favored over lawyers, compliance consultants, and accountants by regulators and prosecutors. Accordingly, the advice that a corporation currently purchases from an insurance carrier either may be duplicative of the advice that it is already receiving or in conflict with that advice. If it is duplicative, the corporation may choose not to purchase the advice even if a carrier could provide such advice more cheaply because the corporation perceives regulators and prosecutors prefer its current stable of advisors. If the carrier's advice is in conflict with the other compliance experts, the corporation will ignore it because under the current regulatory environment, the governance advice preferred by prosecutors and regulators will be the advice that the corporation adopts, regardless of whether that advice is in fact correct.<sup>275</sup>

Finally, fear of an evidentiary paper trail might also derail interest in carrier monitoring. For example, following a carrier's audit, a carrier might offer the corporation a reduced premium in exchange for an alteration in a particular method of governance. In the current environment, however, the corporation might fear that its rejection of that method, although completely reasonable and permissible under the business judgment rule, would result in significantly higher penalties in subsequent civil or criminal litigation.

In sum, the lack of monitoring by D&O carriers may result from factors other than agency costs or market failures; it should not, by itself, derail further inquiry into the possibility of compliance insurance.

#### 4. Lack of a Market

A separate challenge is whether a sufficient number of private carriers would enter the compliance insurance market at all.

Private carriers might reasonably conclude that insuring entities for intentional wrongs is either too risky or too likely to encourage moral hazard. Similarly, carriers might write policies whose premiums and deductibles are so high as to offer little

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275. Another possibility is that shareholders want their agents to purchase D&O insurance-minus-monitoring because: (1) they know that their agents inflate the company's books; and (2) they believe that they will, on average, benefit from their agents' fraud. If they believe that they will benefit from such fraud, they will prefer a policy that caps wealth transfers to loser shareholders, but still permits their agents the latitude to continue inflating the books. By contrast, portfolio diversification zeroes out the shareholders' wins and losses. D&O insurance-minus-monitoring preserves benefits for "winner" shareholders, which they willingly share with their agents. Although this theory would undermine some of my arguments against corporate criminal liability (shareholders are usually viewed as innocents), it does not seem particularly plausible beyond a small portion of traders who are particularly savvy and enjoy risk.

coverage to the insured. Moreover, we know from experience that the insurance industry has endured cycles of “hard” markets (where premiums are high and coverage is difficult to obtain) and “soft” markets (where premiums are low and coverage terms are cheaper and more desirable).<sup>276</sup>

There are several possible answers to this problem. To the extent carriers were concerned about moral hazard, several provisions would continue to deter individuals from intentional wrongful misconduct. First and most important, this proposal presumes that individual criminal liability would continue unabated. Whereas directors and officers may not harbor much personal financial worry with regard to securities shareholder litigation,<sup>277</sup> officers and directors do harbor real fears of jail and fines, and they should continue to harbor those fears.<sup>278</sup>

As for carriers’ fears of excessive penalties, carriers could reduce their overall exposure by reinsuring the risks. Moreover, similar to casualty and property insurance, corporations that offered the greatest risks presumably would spread their coverage over several carriers.<sup>279</sup>

### 5. Overly Concentrated Market

Even if a market formed, it is possible that it would come to be dominated by a few players. Concentrated markets could pose several problems. Insurance carriers might collude and agree to carve up the market and extract excessive premiums from potential corporate clients or price some clients out of the market altogether.

Although the possibility of a concentrated market is a concern, it still represents an improvement over the current system, which grants the federal prosecutor a monopoly. Firms presumably would prefer to pay an expensive premium over the combined costs of an inefficient compliance program and the risks of an exorbitant DPA or criminal prosecution.

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276. See Sean M. Fitzpatrick, *Fear is the Key: A Behavioral Guide to Underwriting Cycles*, 10 CONN. INS. L. J. 255, 259 (2004) (“[P]ricing volatility and periodic constrictions of supply will be inevitable in the insurance market, as insurers react to unforeseen changes in the underlying liability environment that affect policies written in earlier periods, or simply to having ‘guessed wrong’ in their pricing in a stable liability environment.”).

277. Coffee, *supra* note 115, at 1550 (explaining that the corporate entity and the insurer ordinarily pay entire amount in securities litigation). In fact, one of the exceptions to this rule is when individual defendants have been prosecuted criminally. *Id.* at 1551.

278. Officers, however, do sometimes face civil liabilities in excess of their insurance coverage. *Id.* at 1577.

279. See Baker & Griffith, *Predicting Governance Risk*, *supra* note 227, at 504 (describing “towers” of coverage, which are essentially “separate layers of insurance policies stacked to reach a desired total amount of insurance coverage”). According to Baker and Griffith, the layering of coverage may decrease each carrier’s incentive to monitor the insured’s corporate governance practices because the costs of the monitoring are borne solely by the monitoring carrier while the benefits are spread to all layers of insurance. Baker & Griffith, *Missing Monitor*, *supra* note 252, at 1811 n.72, 1839.

## 6. Overdeterrence

Some might worry that eventually, insurance carriers would extract the same overpayment through premiums that prosecutors extract through DPAs. This problem may be magnified if the employee responsible for purchasing the insurance, the organization's risk manager, purchases excess coverage or authorizes excess premiums because she is risk adverse or overly worried about her career.<sup>280</sup>

If carriers and risk managers are as risk adverse as prosecutors, what benefit is there to having a market for compliance insurance? There are several. As an initial matter, risk managers should be no worse than the compliance "experts" and regulators who urge corporations to adopt costly compliance mechanisms regardless of their effectiveness. To the contrary, because carriers are bonded financially to their governance advice, they have little to gain from demanding showy (but ineffective) monitoring systems.<sup>281</sup> Finally, insofar as entity liability under this system is civil, the extralegal consequences of a criminal conviction drop out. Accordingly, carriers will write policies that insure against the costs of all civil liabilities, but not the criminal costs that organizations currently self-insure. Finally, as discussed above, unlike prosecutors or judges, carriers are at least partially constrained by a market and, therefore, are less likely to be able to get away with systematically demanding overpriced premiums.

Another concern might be that insurance carriers are as prone to command and control systems as lawyers, judges, and compliance professionals. The evidence from the D&O market, however, seems to suggest otherwise. According to Professors Baker and Griffith, D&O carriers carefully assess risk by reviewing and considering the corporate entity's culture and character because psychologists have identified these characteristics as the most relevant to encouraging corporate compliance.<sup>282</sup>

## 7. Underdeterrence

The opposing concern is that the insurance system would underdeter corporate crime as a result of carriers being captured or conflicted.

Following the fall of Enron and the detection of similar corporate reporting scandals, observers commented that auditors compromised their independence and failed to report or detect fraudulent financial statements because they were focused on retaining clients for their consultation services.<sup>283</sup> Consequently, the Sarbanes-Oxley Act of 2002 prescribes auditors from offering consultation services to clients.<sup>284</sup>

Although similar legislation could prevent Underwriter U from offering consulting services to C Corp, a slightly different conflict arises in the insurance context because insurance companies presumably sell insurance products other than Compliance Insurance. Thus, there is a possibility that an underwriter might underprice its Compliance Insurance premium in order to maintain or increase business in other insurance markets. (This would presume that the other markets are sufficiently less

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280. See Baker & Griffith, *Missing Monitor*, *supra* note 252, at 1833–34.

281. Indeed, this is why they are the preferred monitor. See *id.* at 1834–35.

282. Baker & Griffith, *Predicting Governance Risk*, *supra* note 227, at 516–25.

283. Ronen, *supra* note 44, at 47.

284. See Title II of Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

concentrated). Similarly, if the insurer had a long-term relationship with the same corporate entity over a long period of time, the insurer might lose its objectivity and adopt the views and needs of its client. This phenomenon is often referred to as capture. Capture and conflict both undermine the third party monitor's independence.

At first blush, the threat of capture and conflict appear less prevalent than in the auditor context. Unlike auditors, who might systematically ignore or miscalculate the risk that they will be held liable for financial misstatements, insurers are in the business of affirmatively calculating and accepting financial risks.<sup>285</sup> Moreover, carriers are bonded not just by their reputation, but by their capital. Capture therefore seems far less likely.<sup>286</sup>

As for the concern that the carrier will purposely underprice compliance insurance in order to obtain the customer's business in more competitive lines of insurance, this becomes a problem only if the carrier itself lacks minimum solvency to pay the costs of C Corp's suboptimal deterrence. In other words, if Underwriter U underprices too many compliance insurance policies, sooner or later it will become responsible for paying the greater liabilities that result from its practices.

#### 8. Administrative Costs

A final potential argument against compliance insurance is that it would generate administrative costs that outweighed the benefits of dismantling corporate criminal liability.

Some of the costs of reviewing the organization's compliance program have already been absorbed by the corporation's D&O and general commercial liability premiums.<sup>287</sup> If coverage were expanded, however, to include insurance for entities as a result of employees' intentional wrongs, substantial transaction costs might accrue, particularly at the contracting stage, when experience was lacking, terms were ill-defined *ex ante*, and both sides were unsure how courts would interpret coverage terms *ex post*.<sup>288</sup> Over time, as both parties gained experience with these types of policies, however, these costs would abate. This proposal does assume, however, that the costs

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285. Moreover, one might argue that auditors systematically ignored risks because the "capital" they gave up—their reputation—was hard to define or calculate. See Coffee, *Gatekeeper Reform*, *supra* note 45, at 326.

286. Professor Griffith has argued:

Insurance companies are experts at assessing risk. Because the success of an insurer's business depends upon taking in more capital than it pays out, the insurer must develop an ability to assess the probable payout obligations of each exposure and then charge an appropriate premium for the risk. . . . D&O underwriters therefore ought to develop categories of high risk corporate governance and low risk corporate governance and, in a well-working insurance market, seek to price and sell their policies at least partly on that basis.

Griffith, *supra* note 44, at 1174.

287. Moreover, carriers already evaluate compliance risk insofar as they may be liable under D&O policies for the follow-on civil suits that are filed after the announcement of criminal charges.

288. Coverage disputes between insureds and carriers would further increase these costs. See Cox, *supra* note 227, at 32 (discussing D&O coverage disputes and their effect on management).

of supplying uncertain contractual terms in insurance policies are dwarfed by the costs imposed by the DOJ's internal charging policies and the uncertainty that flows from them.

#### CONCLUSION

The current system of corporate criminal liability results in overpayment by corporate entities that are subject to an extremely broad criminal liability rule and which rightfully fear the extralegal penalties of indictment. Overpayment, in turn, results in social inefficiency and may reduce compliance across organizations. An insurance system, in contrast, creates a market for compliance and places insurance carriers—who already assess corporate compliance risks in the D&O arena—in the position of judging corporate compliance programs *ex ante* instead of prosecutors who review compliance *ex post* with an eye to coercing organizations to assist in prosecuting individual employees.

Preventing corporate crime is and will remain an important topic for private and public entities alike. Just as communities have been unable to find ways to prevent their citizens from transgressing deeply held norms of what is right and wrong, so have organizations failed to prevent their employees from breaking the law. That failure is unlikely to change any time soon.

Insurance may not be the final answer on preventing socially undesirable behavior within corporate firms. It does, however, provide a promising framework for further discussion of how we might go about reforming corporate criminal law.