CHAPTER 1

Characteristics of Corporate Crime

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§ 1.01 Introduction

“I thought I was going to die.”

Suman Dey, senior operator at Union Carbide’s plant in Bhopal, India, gauged his chances as he watched deadly fumes from the plant envelope him early in the morning of December 3, 1984. Dey and his individual terror were only a small part of a much larger tragedy acted out through organizational processes and on an organizational scale that day. The deadly fumes, which were the product of a runaway chemical reaction at the plant that is still not completely understood, escaped into nearby neighborhoods, killing

over 2,000 and injuring an estimated 200,000. Many of the nearby residents died in their sleep. Others ran into the toxic cloud by mistake, breathed the deadly fumes, and dropped dead in their tracks. Among the thousands injured, many suffered debilitating injuries to their eyes and respiratory systems.

Dey survived by using emergency breathing equipment stored near his control room post. In a position to know as much as anyone about the tragedy, Dey was interviewed a few weeks later by American journalists. Although he was able to recount many of the operating procedures and developments leading to the gas leak, Dey and his co-workers supplied no answer to the simple question: “Who was responsible for the disaster?”

Perhaps with the benefit of hindsight, twenty years later, we can know what those on the scene could not. Who caused the Bhopal tragedy? The best—and chilling—answer is: no individual. The deaths and injuries at Bhopal were products of organizational failure, both corporate and governmental.

Studies of the Bhopal disaster have identified numerous contributing causes, many of them related to the management of the Union Carbide subsidiary in direct control of the plant. Problems at the plant included operating errors, design flaws, maintenance failures, training deficiencies, and economy measures that increased risks of harm. Yet none of the risks raised by these problems was appreciated by plant personnel.

Some observers have concluded that the gas leak stemmed from a lack of oversight of Bhopal operations by officials from the American parent company of the plant operator. The American officials were at fault, these critics have asserted, in specifying an inadequate design for the plant and in failing to exert their financial and managerial clout so as to ensure safety at the Bhopal plant.

American corporate officials, in turn, have asserted that their Indian counterparts altered the original design for the plant in ways that increased risks and failed to carry out their responsibilities to maintain safe practices at the plant. Union Carbide’s American executives have also claimed that Indian government officials shared responsibility for the deaths at Bhopal because Indian officials approved the plant site and then allowed large residential neighborhoods to be built up around the plant. Finally, although no supporting evidence was ever found, Union Carbide executives have repeatedly asserted that the source of the disaster may have been sabotage.

The tragedy in Bhopal taught many lessons about corporate misconduct and the need for corporate criminal liability. The tragedy is a symbol of organizational misconduct for our time, in its scope, its deadly consequences, its technical complexity, and its multiple managerial sources (before, during,
and after the toxic gas discharge). Above all, the Bhopal disaster is symbolic in its lack of evil actors intentionally inflicting harm on others. Its horrific results, stemming from multiple operating mistakes and decisions, provide compelling reminders of the importance of constant management attention to public safety and features of corporate operations aimed at public protection.

More than just a warning to future corporate managers, Bhopal graphically illustrated the need for corporate criminal liability as a pressure compelling managerial attention to public interests. While it may serve other purposes, corporate criminal liability is primarily a device to encourage corporate managers to ensure that the corporate activities they initiate and oversee are conducted within lawful bounds and with due regard for public interests. In short, corporate criminal liability forces corporate managers to pay attention to law compliance amidst economic forces and the crush of other affairs that might otherwise cause them to ignore law compliance defects in corporate operations. Even if corporate managers have not caused these defects, corporate criminal liability ensures that these managers have reasons to exert themselves to recognize illegal defects in corporate conduct and to react with preventive improvements in corporate operations.

Corporate criminal liability ties the interests of the public in lawful corporate conduct to the financial well-being of each firm. A firm that promotes or tolerates illegal activities by employees and other agents carrying out its affairs will suffer significant fines. In competition with more legally responsible firms, relatively lawless firms will not—and should not—survive. Managers, responsible for weak corporate finances due to poor law compliance records, will tend to be forced from their positions by superiors or shareholders in favor of managers more inclined toward law compliance. Absent such changes, firms with poor financial performance due to law compliance problems will be taken over by other owners more interested in law compliance or such firms will fail. In any case, these firms will be removed as a public threat. Of course, corporate managers who can foresee these consequences may be loath to embark on the downward path that accompanies corporate crime. Hence, corporate criminal penalties have great power to prevent and deter offenses within corporate organizations.
§ 1.02 Defining Corporate Crime

Corporate crime is crime undertaken in corporate business activities.¹ Usually, corporate crimes are committed to realize corporate benefits like increased revenues or reduced law compliance expenses. They may also be aimed at personal gain for the individuals involved or at avoiding negative consequences to those individuals for failures to achieve assigned performance goals. While persons sometimes say that corporations commit crimes—a verbal device that will often be used in this book as well²—what we really mean by attributing criminal action to an inanimate corporate enti-

¹ Corporate crime is a subset of white-collar crime. While commentators differ over the proper definition of white-collar crime, see, e.g., Geis, “White-Collar Crime: What Is It?” in White-Collar Crime Reconsidered 31 (1992), many still embrace Professor Edwin H. Sutherland’s definition in coining the term. See: id. at 47; Braithwaite, “White Collar Crime,” 11 Annual Rev. of Sociology 1, 19 (1985). Sutherland viewed a white-collar crime as “a crime committed by a person of respectability and high social status in the course of his occupation.” Sutherland, White-Collar Crime: The Uncut Version 7 (1983). Criminologists often distinguish between corporate crime and occupational crime as subcategories of white-collar crime. Corporate crime includes “offenses committed by corporate officials for their corporation and the offenses of the corporation itself.” See Clinard & Quinney, Criminal Behavior Systems: A Typology, 188 (1973). In contrast, occupational crime involves “offenses committed by individuals for themselves in the course of their occupations and the offenses of employees against their employers.” Id. A somewhat broader view of corporate crime extends that term beyond offenses by corporate officers to embrace crimes by all corporate employees. Today, “[m]ost writers . . . use the term [corporate crime] to refer to crime committed by the corporation itself or on behalf of the corporation by its employees, in furtherance of the corporate interest.” Hopkins, “The Anatomy of Corporate Crime,” in The Two Faces of Deviance, 214 (1978). For an excellent summary of the accountability problems that distinguish many corporate crimes from offenses of individuals acting alone, see Fisse & Braithwaite, Corporations, Crime, and Accountability, 1-16 (1993). Many of the unresolved questions surrounding corporate criminal liability concern how these special accountability problems should be addressed. Two major schools of thought have emerged about how these accountability problems should be conceptualized. Under one view—dubbed the “agency model”—corporate activities, including offenses, are treated as primarily the result of rational actions by individuals serving as corporate agents. Under the second view—termed the “structure model”—social, political, and organizational structures and practices are seen as having a much more important role in shaping corporate criminal activities. Studies from each of these two perspectives can be used to examine the four key issues surrounding corporate crime: (1) the causes of corporate crime; (2) standards for the liability of corporations and individuals in cases of illegal corporate actions; (3) appropriate sanctions for illegal corporate conduct; and (4) the types of regulatory relationships between corporations and public agencies that will be most effective in corporate crime control. See Lofquist, “A Framework of the Theories and Issues in Corporate Crime,” in Debating Corporate Crime, 1, 1-29 (1997).

² The use of this and similar verbal crutches extends to the Supreme Court. For example, even in the course of recognizing that the liability of a corporate entity for torts requiring malice is based on a principle of representation under which the features
of corporate action are measured directly from those of corporate agents, the Court summed up its findings about the lack of evidence of malice on the part of certain corporate agents by saying that there was insufficient proof of “the existence of malice on the part of the corporation,” thereby implying that corporations as entities were capable of such malice. Philadelphia, Wilmington, & Baltimore Railroad Co. v. Quigley, 62 U.S. 202, 214, 16 L.Ed. 73 (1858). Cf. French, Collective and Corporate Responsibility, xiii (1984) (noting the tendency of observers to use references to corporate responsibility as shorthand substitutes for more sophisticated responsibility attributions).
ty is that one or more corporate agents have committed a crime for which the firm is accountable.\footnote{This interpretation applies a principle of representation to measure the liability of corporations from the acts of their agents without necessarily requiring further culpability on the part of the corporation itself. See, e.g., Philadelphia, Wilmington, & Baltimore Railroad Co. v. Quigley, 62 U.S. 202, 209-210, 16 L.Ed. 73 (1858). Some criminologists have argued that crimes committed by a corporate organization can be distinguished from offenses by individual corporate agents. See generally, Cressey, "The Poverty of Theory in Corporate Crime Research," \textit{in I Advances in Criminological Theory} 31 (1989) (tracing the development of this view of corporate crime). Corporate offenses are seen by these criminologists as employee offenses that are promoted by operational goals, standard operating procedures, and cultural norms of a corporate organization and intended to benefit the corporation itself. See, e.g., Kramer, "Corporate Criminality: The Development of an Idea," \textit{in Corporations as Criminals}, 16, 18 (1984). Under this view, a corporate organization commits crimes though the systematic impact of management policies and practices. This type of anthropomorphizing of corporations is probably more misleading than helpful. It does focus attention on the possibility that group processes may produce added amounts of corporate crime. That is, groups of corporate employees or other agents may take actions resulting in illegal conduct that would not have occurred through the individual actions of the parties involved, see Braithwaite & Fisse, "On the Plausibility of Corporate Crime Theory," \textit{in II Advances in Criminological Theory}, 15, 22 (1990). However, this is simply a reflection of group action by individuals and is best analyzed as such. Attributes of quasi-human qualities to corporate entities tend to be carried too far, resulting in false analogies of human features to portions of corporate organizations and attempts to apply tests for personal responsibility and liability to corporate actors. As noted by one perceptive observer, "[t]here has been much sententious discussion of the need for an organizational perspective in the analysis of corporate crime, but adequate theorizing must mediate organizational norms through individual actors who make decisions." Levi, "A Criminological and Sociological Approach to Theories and Research into Economic Crimes," \textit{in Economic Crime: Programs for Future Research}, 32, 45 (1985). See also: Cressey, \textit{supra}, at 48-49; Geis, "Toward a Delineation of White-Collar Crime Offenses," 32 Soc. Inquiry 160, 163 (1962).} Rationales for holding corporations accountable for the misconduct of their agents vary, with each supporting a somewhat different range of corporate criminal liability.\footnote{Rationales for corporate criminal liability and the scope of liability they support are discussed further in Chapter 2.} Top corporate managers’ initiation or knowing toleration of criminal conduct by other corporate employees and agents is often cited as a basis for corporate criminal liability, on the theory that these top executives personify the guiding intelligence of the corporation and that their culpability is fairly representative of the corporation’s culpability as well. A similar logic is sometimes extended to criminal activities initiated or tolerated by lower-level corporate managers.

A second ground sometimes cited for imposing criminal liability on corporations is that corporate managers have, in effect, deliberately caused criminal conduct by implementing facially legitimate practices or policies that lead through foreseeable steps to criminal conduct by employees or agents. Personal criminal liability of the managers involved may not be war-
ranted in these cases due to their modest culpability in causing the offenses involved. However, imposing corporate liability ensures that the policies and practices leading to foreseeable criminal results are recognized, punished, and deterred.

A third basis for attributing crimes to corporations is to punish firms for inadequate reactions by corporate managers to hints of criminal misconduct within corporate ranks. These inadequate responses may involve information gathering gaps, as where corporate managers do not investigate upon receiving partial information indicating misconduct, or weaknesses in substantive responses, as where managers stop discovered misconduct but take no steps to prevent reoccurrences. This notion of corporate criminal liability ties corporate penalties to reactive fault on the part of corporate managers.

Yet another view of corporate criminal liability turns on preventive fault—that is, the failure of managers to take sufficient actions to prevent offenses in connection with the legitimate business activities they initiate or oversee. Under this view, the scope of corporate criminal liability turns on organizational features such as law compliance programs and the adequacy of corporate policies and practices in directing employees toward lawful behavior.

A different measure of corporate criminal liability revolves around publicly valuable efforts by corporate managers to detect and reveal offenses by employees and to ensure that responsible individuals are brought to justice. While this type of meritorious service is usually not a complete defense to corporate criminal liability—for the same reason that voluntary confessions by individuals do not provide such a defense—cooperation with law enforcement officials by corporate managers can convince prosecutors not to bring charges against a corporation. In addition, where the firms involved are prosecuted, post-offense cooperation with public authorities can dramatically reduce corporate fines, at least for federal offenses.

Finally, some corporate liability standards impose criminal liability for all offenses by corporate employees and agents that are committed within the offenders’ scope of employment or agency and for corporate benefit. Three different explanations may support this type of vicarious corporate liability for the crimes of corporate employees and other agents. First, while acting for corporate benefit and within her authority, a corporate employee or agent may be seen as the embodiment of the corporation such that her culpability is corporate culpability and no further managerial culpability is needed to establish corporate criminal liability. Second, even if managerial fault is generally viewed as the proper basis for corporate criminal liability, such fault may be believed to be so commonly present in connection with employee offenses that, for purposes of corporate criminal liability assessments, proof of an offense is taken as proof of probable managerial fault as well. Third, the presence or absence of managerial fault may be ignored in assessing corporate criminal liability because linking corporate liability and employee offenses beneficially encourages corporate managers to extend their crime prevention efforts to all employee offenses, not just those involving managerial fault. The last rationale recognizes an economic basis for corporate criminal liability and treats corporate criminal liability on a par with corporate tort liability for the acts of employees and agents.
§ 1.03 Social Significance of Corporate Crime

Corporate crime is a significant social phenomenon because of the central role that corporations occupy in modern society. Corporate activities and their products pervade our lives. Corporations not only act on a superhuman scale, we often rely on them for our most basic needs. Indeed, in using corporate products from cars to pharmaceutical drugs, we entrust them with our lives.

Our reliance on the success of corporate activities in modern society accounts for the significance of corporate crime as a social phenomenon. We rely on corporations as sellers of goods and services, employers, sources of profitable investment opportunities, neighbors, and taxpayers. Corporations are, at their best, far superior to individuals in many capacities. Given our experience with that success, we now expect it and shape our conduct in reliance on it. Because we rely on corporate performance in so many ways, and sometimes cannot avoid interaction with corporate products and activities, we are stakeholders in the quality of corporate activities—both their effectiveness and their legality. When corporate performance drops below legally required levels, individuals who have shaped their conduct in expectation of competent, lawful corporate performance may suffer in a variety of ways.

Corporate crime can injure public stakeholders in corporate performance in at least four ways. First, corporate offenses may injure stakeholders directly. For example, corporate customers may be injured by an improperly marketed drug following a criminal failure to comply with food and drug testing laws. Second, corporate offenses may cause additional injuries because stakeholders lose trust in corporate activities and forgo advantageous activities. For example, potential corporate shareholders may refrain from desirable investments because they are uncertain about the fairness of securities markets following securities fraud offenses affecting other shareholders. Third, corporate offenses may cause additional damage to stakeholders when convicted firms fail due to the financial impact on the firms of criminal fines, civil damage claims, or impaired business reputations. For example, employees who lose their jobs when a firm fails following a criminal conviction suffer this type of harm. Fourth, corporate crimes can injure the public by implying an acceptance of lawless behavior that reduces other actors’ willingness to comply with criminal laws. For example, if corporations commit tax fraud without consequences, people who would otherwise feel an obligation to comply with tax laws may react to the corporate violations with anger and an increased willingness to engage in tax fraud themselves. In short, corporate offenses flouting the collective obligations imposed through criminal laws

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2 In 2000, Wal-Mart Stores employed more people—1,244,000—than were employed by the states of California, New York, Texas, Florida, and Michigan combined. “How the Companies Stack Up,” *Fortune*, p. F-29 (April 16, 2001); United States Census Bureau, N. 1 *supra*, at 300.
3 Corporations produced 68 percent of the net business income in the United States during 1999. U.S. Census Bureau, N. 1 *supra*, at 472.
may have spillover effects in increased offenses of others, reflecting an equal
disdain for legal requirements.

Both the scale and nature of harms associated with corporate crimes
distinguish these crimes from earlier offenses undertaken by individuals.4 When corporations pursue legitimate business activities, benefits are often
realized on a superhuman scale. However, when corporations act illegally,
they can inflict injuries on an equally gargantuan scale. The magnitude of
corporate operations potentially misdirected due to illegal conduct means
that corporate offenses can produce different types of injuries and larger
numbers of victims than are usually associated with individual offenses.

Given the breadth and magnitude of the harms that corporate crimes
sometimes involve, it may seem paradoxical that many corporate crimes are
difficult to detect. The isolation of many corporate activities from detailed
scrutiny by law enforcement agents and members of the public facilitates the
concealment of corporate offenses. Corporate efforts to maintain secrecy about
company activities for legitimate competitive reasons may inadvertently
conceal misconduct as well. In addition, key information sources may be
uncooperative. A complete evaluation of the sources and nature of corporate
misconduct often requires extensive information held only by persons with-
in corporate organizations. However, these persons often have reasons to
conceal their knowledge to minimize their own liability, shield their fellow
employees, or avoid penalties for their firm. The result of such forces tending
to conceal corporate misconduct is that crime victims are often unaware that
corporate offenses are the sources of their injuries.

These two features—the scale of actual and potential harm from illegal
corporate activities and the difficulty of identifying and understanding the
sources of those activities—are the defining features of corporate crime.

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4 Either because of their longer history or simpler content, traditional crimes like assault or
burglary and the harms associated with them, rather than corporate counterparts like fraudulent
product testing or price-fixing, tend to come to mind when we think about crime. Yet, in the
aggregate, corporate offenses probably inflict a far greater dollar loss on victims than offenses
by individuals acting outside of corporations. See Ermann & Lundman, “Overview,” in Corporate-
rate and Governmental Deviance, 3, 3-4 (1992).
§ 1.04 Public Injuries from Corporate Offenses

The nature and significance of public injuries from corporate offenses are often unclear. In some cases (for example, a fraud offense involving the delivery of defective equipment that is quickly replaced at an increased cost to the affected party), the immediate economic damage resulting from a corporate offense provides a good measure of its significance. Estimates indicate that the direct economic harm resulting from corporate offenses is startlingly high.\(^1\) For example, the General Accounting Office estimates that health-care fraud by corporations and other organizations costs up to $100 billion per year, while an estimate by University of Cincinnati Professor Francis T. Cullen estimates losses from antitrust and trade offenses at $250 billion per year at least.\(^2\)

The size of these aggregate loss estimates is easy to understand when some of the loss figures for just a few serious corporate offenses are considered. A single corporate offense or pattern of related offenses by a large firm can produce billions of dollars in losses. Many of these enormous losses stem from activities that could only have been undertaken by large corporate organizations. For example, illegal radioactive waste dumping by Rockwell International at its Rocky Flats plant cost $1 billion to clean up. However, even these large costs are dwarfed by the losses associated with the Exxon Valdez oil spill. Exxon paid an estimated $2 billion in cleanup costs,\(^3\) and agreed to pay another $1 billion in civil damages and restitution as part of its settlement of criminal charges.\(^4\) Additional civil damage claims totaling more than $50 billion were also pressed against the corporation.\(^5\) Just one corporate offense of this sort may inflict much greater economic injuries than thousands of street crimes.\(^6\)

Economic losses from corporate crimes are often particularly large because crime victims have relied on lawful corporate conduct and the general integrity of corporate operations. In such circumstances, victims are often vulnerable to injuries on a much larger scale than they would have exposed themselves to in dealings with individuals. For example, betrayals

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3 See id.


5 Berliner, N. 4 supra.

of trust in the integrity of savings and loan institutions accounted for many
of the injuries to investors flowing from fraud offenses uncovered during the
1980’s in the savings and loan industry. Similarly, misplaced trust in the
legitimacy of publicly reported corporate activities led to widespread
investor injuries from the numerous cases of corporate accounting fraud

Of course, economic harm is often not the most significant consequence
of corporate crime. Serious noneconomic damage from corporate offenses
includes physical harm such as increased cancer rates resulting from illegal
pollution, and injuries and deaths from unsafe work conditions or products.
Environmental harm like that resulting from the Exxon Valdez spill also
entails societal losses that cannot be adequately gauged in monetary terms.
Large portions of the public consider such environmental injuries to be
among the most serious consequences of corporate crime. A survey of 1,000
adult Americans found that 84% felt that illegal pollution was a serious
offense. Environmental offenses were deemed serious by more of the sur-
veyed adults than other important corporate offenses such as worker safety
violations, price-fixing, and insider trading.

In other situations, corporate offenses produce consequential harm that is
difficult to measure because the causal links between the offense and the
harm are uncertain. Often, consequential losses follow from changes in pub-
lie conduct due to a reduction in corporate trust accompanying an offense.
As recognized by one leading criminologist,

[F]inancial loss from white-collar crime, great as it is, is less important
than the damage to social relations. White-collar crimes violate trust and
therefore create distrust, and this lowers social morale and produces social
disorganization on a large scale.

For example, in cases of securities fraud, the most important harm may
lie in altered investor actions as a consequence of an offense. Following a

\footnote{7} For an overview of the illegal practices found in the savings and loan industry
and the sources of those practices, see Federal Deposit Insurance Corp., “The S & L
\footnote{8} See: The Corporate Library, Corporate Scandal Quick Sheet, thecorpo-
ratelibrary.com/spotlight/scandals/scandal-quicksheet.html (2003); The Washington
Post, “Corporate Scandal Primer,” available at www.washingtonpost.com/wp-srv/busi-
\footnote{9} See generally: Frank & Lynch, Corporate Crime, Corporate Violence: A Primer
(1992); Barrile, “Agency Model: Improving Prevention,” in Debating Corporate
\footnote{10} “Survey Says Pollution Worst Corporate Crime,” Sacramento Bee, p. E2 (July
9, 1991).
\footnote{11} Seventy-four of the persons surveyed ranked worker safety offenses as serious,
60% characterized price-fixing as serious, and only 40% gave insider trading the
same ranking. See id.
\footnote{12} Sutherland, White-Collar Crime, 10 (1983).}
corporate conviction based on intentional misstatements in financial disclosure statements, investors may have reduced confidence in the integrity of information subsequently released by the defendant firm and by similar firms generally, resulting in a reduction in potentially beneficial stock investments.\footnote{13} Consequential damages also follow corporate crimes when fines, damage payments, and other crime-related expenses cause the affected firms to fail and to harm persons relying on the future performance of those firms.\footnote{14} As noted by former Attorney General Meese, the public has suffered consequential damage from corporate crime as we have seen “our banks close because of fraud; our pensions jeopardized by embezzlement; our taxes increased by health care and food-stamp fraud; and our national defense weakened by shoddy work, cost-padding, and false claims.”\footnote{15}

Finally, the significance of some corporate offenses lies in the harm that is threatened by the offense, not the injury that actually results. If a firm adopts operating practices that risk public injury or that impair law enforcement efforts aimed at preventing such injury, the threat raised by such conduct may justify a corporate conviction to discourage and prevent future harm although no injury has yet occurred. For example, where a corporation fails to comply with reporting requirements under federal environmental laws, there may be no identifiable harm from the offense, but the effectiveness of related law enforcement efforts may be impaired. Here, the significance of the company’s offense lies in the heightened risk of injury that its conduct entails and the greater public injuries likely to result over time.

\footnote{13}{This pattern of reduced investor confidence and activity was present in the wake of revelations in 2002-2003 of securities fraud offenses affecting a number of large companies. See BBC News, “Confidence in Corporate America: Ask an Expert,” available at http://news.bbc.co.uk/1/hi/talking_point/forum/2116568.stm (2002) (corporate scandals revealed in 2002 “destabilized stock markets around the world and hit confidence in corporate America”).}

\footnote{14}{Corporate offenses revealed in 2002-2003 resulted in large enough fines and losses to force even some of the country’s biggest corporations to file for bankruptcy. See CNN Money, “MCI Hit With Criminal Charges,” available at www.money.cnn.com/news/specials/corruption/ (2003) (citing Enron, Worldcom, Global Crossing, Kmart, and Adelphia as indicted or investigated firms that have filed for bankruptcy).}

\footnote{15}{UPI, Sept. 18, 1985, available in LEXIS/NEXIS Library, Omni File.}
§ 1.05 Relationship Between Corporate Crime and Corporate Management

Corporate crime may best be understood as a facet of corporate operations which, like other corporate activities, is subject to influence through management processes and at least partial control. Corporate crime can be interpreted from a corporate manager’s perspective, using the knowledge of management principles and limitations that well-informed corporate managers apply to understand and manipulate other corporate activities. From this perspective, past deficiencies in managerial processes that account for corporate crimes can not only be identified, but the means to improve those processes to reduce subsequent offenses can be described in terms of concepts and practices that are familiar to the managers who must implement them.

From a managerial perspective, corporate crime is frequently a troublesome offshoot of legitimate corporate activities. While some corporate crimes are actively initiated or promoted by corporate managers, most are not undertaken with the direct approval of top corporate managers. Rather, they are initiated by middle- or low-level managers or nonmanagement employees. These individuals below top corporate ranks typically resort to criminal conduct to attain levels or types of legitimate corporate performance demanded by corporate superiors. In these circumstances, where high-level demands and low-level choices to meet them illegally both contribute to corporate crime, the proper degree of culpability to ascribe to corporate managers and their organizations is unclear.

Some analysts have argued that the culpability and criminal liability of corporations should depend on managerial actions that promote corporate crimes. For example, a belief that culpable managerial action should be a prerequisite to a corporate offense underlies the view that corporate crime is limited to

criminal acts . . . which are the result of deliberate decision making (or culpable negligence) by persons who occupy structural positions within the organization as corporate executives or managers. These decisions are organizational in that they are organizationally based—made in accordance with the operative goals (primarily corporate profit), standard operating procedures, and cultural norms of the organization—and are intended to benefit the corporation itself.¹

The difficulty with this and other similar interpretations of corporate crime is that they take too narrow a view of managerial responsibility for corporate offenses. While they sometimes participate directly in criminal

activities, corporate managers more often initiate legitimate business activities that are carried out by others through illegal means. In these circumstances, there may be little basis to attribute the resulting offenses to positive management actions or policies. Criteria such as the coherence of illegal conduct with "standard operating procedures" or the "cultural norms of the organization" are too imprecise for useful culpability analyses, at least for purposes of determining corporate criminal liability.

However, direct managerial promotion of corporate crimes does not exhaust the bases for managerial culpability concerning corporate offenses. Despite the absence of any direct furtherance of illegal conduct, corporate managers are also responsible for corporate crimes if the managers initiate corporate activities, yet undertake insubstantial efforts to detect related misconduct and adjust corporate operations to eliminate that misconduct.  

Without assuming any managerial responsibility for initiating or condoning the offenses themselves, corporate crimes can be considered to be a type of defect in corporate performance that corporate managers have an obligation to minimize through the same types of managerial techniques they apply to eliminate other types of defective corporate performance. Where managers have failed to take reasonable efforts to minimize these defects, both they and their firms bear some responsibility for corporate crimes. Because it involves mere negligence of a sort that does not ordinarily justify criminal penalties for individuals, managerial inattentiveness to crime prevention will rarely justify personal liability for corporate managers who do not participate in offenses. However, it may be enough to justify treating offenses by corporate agents as aspects of corporate affairs and holding firms criminally liable for those offenses. This text will frequently use the framework of characterizing corporate crimes as preventable (or at least reducible) defects in corporate performance as a means for evaluating corporate crimes and related liability standards.

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2 This notion of managerial fault is similar to, but broader than, the reactive fault standards advocated by some commentators as measures of corporate criminal liability. See: Fisse & Braithwaite, "The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism, and Accountability," 11 Sydney L. Rev. 468, 505-507 (1988); French, Collective and Corporate Responsibility, 145-163 (1984); Fisse, "Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions," 56 S. Cal. L. Rev. 1141, 1183-1213 (1983). Under reactive fault standards, firms bear organizational fault and liability where firm managers fail to improve corporate policies and practices adequately following a detected corporate offense. By contrast, fault determinations based on the quality of corporate efforts to prevent crimes by employees focus on more than just post-offense reforms. In addition to assessing the adequacy of reactions by corporate managers to corporate offenses, an evaluation of corporate fault in failing to prevent offenses by corporate employees turns, in part, on whether due care was undertaken by corporate managers to recognize and stop illegal conduct, particularly where patterns or hints of illegal behavior gave managers ample opportunities to detect that conduct.
§ 1.06 Sources of Corporate Crime

Evaluations of sources of corporate crime must focus simultaneously on organizational and individual factors. No account of corporate crime can ignore individuals since organizations do not commit offenses, people do.¹ However, the sorts of individual choices and motivations that explain offenses undertaken by individuals acting outside of corporate settings, while also sufficient to explain some corporate crimes, are not adequate to account for the full range of corporate offenses. Organizational forces shape and limit individual behaviors in corporate operations, leading to offenses that individuals would not commit if acting in isolation. Therefore, distinctly organizational sources of corporate crime stem from features of corporate operations that increase the willingness of corporate employees to commit offenses.² Of course, corporate employees often commit offenses for a combination of corporate and personal benefits. To the extent that employees commit corporate offenses for personal gain, their motivations and the sources of their criminal conduct may differ little from the motivations and sources accounting for crimes outside of corporate settings. If firms share in the benefits from these offenses, they may be obligated to stop the offenses or risk criminal penalties. However, offenses based solely on individual greed or malice and achieving potential rewards to the offenders that do not depend on corporate action are not distinctive types of crimes merely because they occur in corporate environments. Because they are not peculiar to corporate environments, offenses stemming solely from these individual considerations will receive no further attention here. This section examines

² See Ermann & Lundman, N. 1 supra, at 7. Empirical studies have not yet been conducted to determine the relative importance of decisions by individuals within corporations, corporate organizational structures and operating practices, and external business pressures as sources of corporate crimes. Without attempting to judge the relative significance of these factors, one recent study concluded that there is growing empirical evidence the following factors affect the likelihood of corporate crime in a given firm:

(1) the financial health of the corporation involved;
(2) the perceived benefits of illegal actions to individuals who are capable of deciding to commit crimes;
(3) the perceived risk and severity of punishment if an offense is detected;
(4) aspects of the moral climate or “culture” of a company supporting or discouraging illegal conduct (including whether illegal actions were common at the firm);
(5) industry- and firm-specific factors affecting opportunities to commit crimes; and
(6) the degree of law compliance controls within a company.

distinctive sources of corporate offenses which distinguish such crimes from misconduct by individuals acting outside of corporations.

Criminologists have identified several crime sources that are unusually important in corporate environments. These sources can be divided into three categories: characteristics of individual offenders within corporate organizations, features of corporate environments, and corporate management policies and practices.

[1]—Individual Offenders

Several studies of corporate crime have focused on reasons why individual corporate agents choose to commit corporate offenses. One view—originated by noted white-collar crime scholar Edwin Sutherland—is that crimes by corporate agents are largely products of individual attitudes built up through differential association.\(^3\) Advocates of this view contend that criminal behavior by individuals is learned like any other behavior and that this learning occurs primarily in associations with groups of individuals already holding favorable attitudes toward criminal conduct. The more that an individual is in close association with persons disposed to criminal conduct and isolated from others likely to counsel against criminal conduct, the more the individual is likely to adopt the values of his associates and engage in criminal conduct himself. Thus, a willingness to engage in criminal conduct of a particular sort is a product of "differential association" with others supporting that conduct.

Translating this theory into corporate terms, Sutherland concluded that corporate agents commit crimes because they learn to act that way, often from their associates. That is, if one assumes an initial set of employees disposed to criminal conduct, the typical isolation of corporate employees from regular social interactions with persons of differing views\(^4\) and the tendency of corporate workforces to develop group loyalties make corporate workplaces self-perpetuating spawning grounds for corporate crime. Related work by Donald Cressey suggested that corporate agents also learn rationalizations from their co-workers for their illegal conduct.\(^5\) These rationalizations further neutralize the impact of normative standards that might otherwise have directed corporate agents away from criminal behavior. Subsequent empirical studies of episodes of corporate crime—most notably, an evaluation of the heavy electrical industry price-fixing scandal of the 1960s by

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4 A corporate executive's contacts outside of her immediate business associates tend to be limited to individuals with similar backgrounds, if not to people working for the same company. See Drucker. *Concept of the Corporation*. 88 (1972).
Gilbert Geis—found support for these interpretations of the social psychology of corporate crime. The difficulty with these studies is that they do not identify the original sources of illegal conduct by corporate agents or the conditions that cause that conduct to take root in corporate organizations. While organizational processes supporting and perpetuating illegal conduct are at least partially explained by Sutherland's differential association theory, the individual motivations or characteristics that cause persons to initiate a pattern of organizational misconduct are still poorly understood.

Corporate employee selection and retention practices provide a partial explanation of why the attitudes of corporate workers may differ from those of the general population. Corporate managers in positions to make hiring decisions tend to select persons with values and attitudes like their own. Once hired, persons willing to set aside personal interests and values and to embrace and pursue corporate objectives are often the most likely to climb the corporate ladder and to survive workforce contractions in periods of corporate downsizing. These tendencies may skew workforces and management ranks toward a high representation of persons who place a high value on corporate interests. In part, this is a legitimate aim of corporate selection and advancement practices. However, the same processes that produce this select group may tend to exclude or not promote persons willing to elevate law compliance over corporate performance where the two are in conflict. While this negative selection for law compliance supporters is plausible, empirical research has not yet determined whether corporate employees (or corporate managers) are any more inclined toward illegal behavior than the general population.

Features of bureaucratic processes found in most large corporations may provide another explanation for the initiation of corporate offenses. Methods for assigning and rewarding work in corporate organizations may weaken normal ethical and legal constraints governing individual actions. Analyses of bureaucracies have found that superior organizational performance is often attained by encouraging employees to mold their activities to the pragmatic features of their jobs and to minimize the impact of individual characteristics like personal beliefs or ethical codes. As noted by Christopher D. Stone,

"[a]ny bureaucracy, and not only the modern corporation, evolves toward depersonalized relationships. Its very "success" depends upon the mobilization of personalities into roles—the better for the synchronization of behavior."

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7 Sutherland himself initially described these attitudes as a product of "social disorganization"—the isolation of certain classes of individual actors from broader social interactions—but eventually was forced to admit the failure of this explanation of individual attitudes. See Sutherland, White-Collar Crime: The Uncut Version, 255-257 (1983).

Some observers view these processes as part of a "structural immorality" plaguing American society.\textsuperscript{10} These processes may cause employees in firms to lose sight of the illegality of certain behavior or to ignore the seriousness of that behavior.\textsuperscript{11}

A related phenomenon that may influence corporate crime levels concerns corporate methods for constructing group efforts through person-independent definitions of job roles. These methods tend to treat the individuals occupying specific roles as interchangeable parts in a corporate enterprise. Managing corporate activities in accordance with this view is thought to further the long-term success of the enterprise by minimizing disruptions as employees come and go for various reasons. However, the ease with which firms can replace employees makes each individual somewhat vulnerable to coercion. Both managers who establish performance requirements and the operating employees who must meet those requirements are well aware of the potential for employee substitution. To employees carrying out job requirements, this is a threat that may encourage actions to achieve performance goals through illegal means rather than risk the loss of their positions for poor performance. To managers, the potential for substituting new employees may encourage strong performance pressures on present employees since managers can expect to turn to substitute employees should present employees fail to meet their performance goals. Both these perspectives on employee substitution tend to increase coercive pressures promoting illegal employee misconduct.\textsuperscript{12}

The narrowness of the job roles used as building blocks in conducting corporate affairs may also promote corporate crime by restricting the information horizon and sense of responsibility of each employee. Workers in many corporate positions acquire limited information about their firms. Their work may make only a small contribution to the overall activities of their organization. Hence, they may not know when their conduct is a small part of a broader corporate offense. Likewise, they may have a restricted appreciation of crimes by other employees. They may also have little interest in reporting or stopping misconduct by other employees since corporate accountability mechanisms will typically not hold specialized employees responsible for misconduct by fellow employees in other functional areas.

Professor Stanton Wheeler of the Yale Law School has proposed another intriguing explanation of corporate crime origins. In his view, pressures

\textsuperscript{9} Stone, Where the Law Ends, 234 (1975). Stone suggests that this type of depersonalization may be a more pervasive reason for moral insensitivity in corporate activities than the overly simplistic explanation of "corporate greed." \textit{Id} at 235.

\textsuperscript{10} Mills, The Power Elite, 343 (1959).

\textsuperscript{11} "The network of definitions in which employees participate may make unethical or illegal activities appear as just another routine aspect of the job and of no particular moral significance." Coleman, "The Theory of White-Collar Crime: From Sutherland to the 1990s" in \textit{White-Collar Crime Reconsidered}, 69 (1992).

tending to drive individual corporate agents to commit offenses stem from threatened drops in the economic status of the agents. These pressures can apply regardless of the individual’s absolute level of wealth. Corporate agents acquire a “fear of falling” based on their enjoyment of a particular level of affluence and attachment to affluence-related personal and family activities. Persons with this fear see a substantial utility in protecting their economic position and may decide to act illegally to avoid adverse consequences, such as drops in corporate profits or personal discipline for failures to attain assigned performance goals. Under this view, the primary candidates for criminal conduct in corporate operations are persons in positions where the potential for a drop in economic position is unusually or unexpectedly high due to changing personal or organizational circumstances. A recent study of white-collar offenders concluded that many organizational agents undertaking illegal behavior fit this offender profile.

Of course, these “fear of falling” scenarios do not exhaust all of the possible reasons for embarking on a corporate offense. Other personal motivations for illegal conduct by corporate agents may include simple greed, ideological goals, and revenge. The relative frequency of these personal motivations for corporate offenses in comparison with corporate sources of similar misconduct has yet to be measured.

[2]—Corporate Environments

Other corporate crime analysts have seen certain features of corporate operating environments as significant influences on corporate crime levels.
One important environmental factor is the scope of criminal laws applicable to various types of corporate activities. Crime is a human artifact, not a natural feature of society. We can choose to have more or less corporate crime by broadening or narrowing our definitions of corporate offenses in criminal statutes and cases. To the extent that criminal laws prohibit a broad range of corporate behavior in a particular field or require careful tailoring of corporate activities to stay within legal bounds, demands on corporate management to maintain law compliance in that field may be great. The likelihood of criminal conduct due to inadequate management attention to law compliance may be high in that field as well.

A related environmental feature that influences corporate crime levels is the political interplay that produces corporate crime standards. Political processes shaping corporate criminal laws are products of the political power of corporations, the power of groups advocating legal restrictions on various aspects of corporate conduct, and the values and attitudes of the public at large. These same forces shape prosecutorial choices about the ways criminal statutes should be enforced against corporations. By using their economic strength, their ability to organize political activities, and their access to elite power centers, corporations can exercise considerable influence over the scope and enforcement of criminal statutes.

Managers of a corporation also have some direct control over their company’s legal environment through their choices of business activities. If managers deem the constraints imposed by criminal law in a particular field to be unacceptable, they can sometimes shift their firm to a less demanding legal environment by choosing to pursue different business activities. Environmental maneuvering for this purpose may entail actions like dropping a line of business entirely, moving constrained activities to another jurisdiction, or restructuring “make or buy” decisions to shift legally constrained activities to suppliers.

Law enforcement methods are another aspect of corporate operating environments that directly affect corporate crime levels. It is hardly surprising that increases in efforts to investigate and prosecute offenses generally tend to deter subsequent offenders and reduce corporate crime levels. However, modes of enforcement can also affect internal corporate attitudes toward law compliance and thereby reduce the number of corporate offenses. For example, in a study of mine safety laws, criminologist John Braithwaite found that initially firm, but ultimately flexible and cooperative enforcement stances by public officials encouraged the development of a “culture of compliance” in mining firms. This achieved higher compliance levels than the treatment of

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20 “[C]orporations whose activities are subject to tight legal restrictions that are weakly enforced are the most likely to violate the law,” Coleman, “The Theory of White-Collar Crime: From Sutherland to the 1990s,” in White-Collar Crime Reconsidered, 53, 66 (1992).

corporations and their leaders as "irredeemably crooked," a stance that only engendered resistance to law compliance by responsible executives.  

Industry features are another environmental characteristic that may also influence the extent of corporate crime. Yet even industry features with seemingly obvious links to crime opportunities do not always correlate with offense levels. For example, studies that have attempted to link antitrust offense levels to economic concentration have produced contradictory results supporting no clear conclusions. Industry customs are probably more important in explaining corporate crime levels. There is considerable evidence that illegal conduct spreads across industries. Interactions among competitors may cause knowledge about opportunities for criminal conduct to spread from one competitor to another. Corporate employees seeing competitors increase their profits through illegal conduct may emulate that conduct to realize similar gains. Furthermore, if one firm successfully uses illegal conduct to lower its costs and reduce the prices of its goods, competitors may feel they have little choice but to match that conduct or be priced out of the industry.

[3]—Management Policies and Practices

Management policies and practices can promote corporate offenses through a number of mechanisms. These mechanisms fall into four categories. First, policies or practices can be the means to implement illegal conduct consciously desired by top corporate managers. In such circumstances, top executives can use management policies and practices to coordinate the efforts of multiple employees, thereby conducting, expanding, or

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22 This view also underlies a more recent proposal for a system of responsive regulation reserving punitive sanctions to the minimum circumstances and levels necessary to motivate reluctant or abusive actors. See Ayres & Braithwaite, Responsive Regulation, 3-52 (1992).


24 See, e.g., Clinard & Yeager, Corporate Crime, 60-63 (1980).


26 Id.

27 Id.

28 See generally, Ermann & Lundman, "Overview," in Corporate and Governmental Deviance, 3, 7-18 (1992). Management practices can promote illegal actions in pursuit of corporate goals because those actions are perceived by corporate employees as rational means to promote corporate profits and objectives or because employees see personal advantages in illegal conduct and surrounding corporate structures and practices do not sufficiently discourage or prevent such conduct. See Lofquist, "A Framework of the Theories and Issues in Corporate Crime," in Debating Corporate Crime, 1, 5-10 (1997). A number of organizational structures and practices can create private incentives for particular employees to undertake personally attractive offenses that are not in the best interests of an organization and can help to conceal those offenses from management scrutiny that would otherwise stop the misconduct. See Fisse & Braithwaite, Corporations, Crime, and Accountability, 101-132 (1993) (surveying reasons drawn from organization theory for explaining why a corporation may promote or allow offenses in the course of company activities).
concealing illegal activities in ways that would be impossible for individual offenders. Second, management policies or practices can indirectly promote corporate offenses by establishing employee conduct norms, rewards, and punishments that encourage criminal conduct. Through these mechanisms, corporate crime is increased as an unintended, but often foreseeable, offshoot of legitimate corporate activities. Third, management practices and policies that define how work is divided and structured in corporate organizations can limit the information possessed by particular employees about the implications of their actions, leading to inadvertently committed offenses. The compartmentalization and specialization of workers in modern firms constrains both the knowledge and thinking of corporate workers about legal and moral issues outside their narrow work domains. The result is a restricted appreciation on the part of many employees about the ways their individual actions may contribute to corporate offenses. Fourth, corporate policies and practices may promote offenses by failing to couple business activities with sufficient law compliance efforts. A firm’s law compliance precautions—as evidenced by such measures as corporate law compliance programs, legal audits, and post-offense investigations—are inadequate if they are not commensurate with the crime risks raised by firm operations.

[a]—Offenses Consciously Desired by Managers

Corporate managers may choose to operate their firms through illegal means for a number of reasons. Both entire firms and semi-autonomous sub-units of corporations such as divisions or branch offices are sometimes intentionally directed toward illegal conduct by corporate managers.

Decisions to operate a firm illegally sometimes follow from top managers’ conception of their firm’s mission as being the pursuit of socially risky business activities that can be undertaken more profitably by cutting corners in complying with legal requirements. For example, these sorts of decisions by top executives account for the behavior of some toxic waste disposal firms or marketers of highly risky investments that seek to boost their profits by failing to comply with the environmental and securities laws applicable to their respective activities.

Decisions by top executives to ignore legal requirements in favor of corporate profits lay at the heart of workplace safety offenses committed in the early 1980s on behalf of a small Illinois concern named Film Recovery Systems. Film Recovery Systems was in the business of recovering silver from used X-ray and photographic film. The company’s silver recovery process involved soaking the old film in foaming vats of cyanide. Employees of the firm regularly worked in close proximity to these vats and were periodically sickened by the deadly cyanide fumes coming from the vats. The company’s top executives, including its president and its plant manager, were well aware of these safety problems since their offices were downwind from the vats, just thirty feet from the plant floor. However, they consciously decided not to cease operations or install necessary safety devices, apparently to maintain the firm’s high profit levels. When one of Film Recovery Systems’s
employees became ill, did not recover through the steps employees usually used to overcome their nausea, and subsequently died of cyanide poisoning, several of the company’s executives were convicted of involuntary manslaughter. The sort of decision made by the top executives of Film Recovery Systems—that is, to pursue illegal business conduct through a relatively small concern isolated from public scrutiny—underlies some of this nation’s worst corporate crimes.

Top executives in small firms can also be encouraged to pursue criminal activities by strong profit and performance pressures imposed by shareholders. This is particularly true if a dominant shareholder is in a position to monitor corporate profits carefully and to threaten top executives with serious consequences for poor profit performance. This scenario is exemplified by the consumer fraud offenses of Beech-Nut. Performance pressures on Beech-Nut executives rose when a series of corporate sales made Frank Nicholas, a Pennsylvania attorney, and later Nestlé, a Swiss food conglomerate, the dominant shareholders of Beech-Nut, a maker of baby foods. In part to satisfy the heightened cost control and profit demands of these successive owners, Beech-Nut executives converted their legitimate apple juice production to a product comprised of sugar water colored brown to look like apple juice. Between 1977 and mid-1982, the company fraudulently sold this concoction as apple juice for babies. “Beech-Nut was under great financial pressure and using cheap, phony concentrate saved millions of dollars.” Beech-Nut was also driven by its intense competition with Gerber, then the market leader with 70% of baby-food sales. Beech-Nut’s fraud was a relatively easy way to meet its profit demands and competitive pressures because the bogus apple juice was difficult to detect. A Beech-Nut subsidiary subsequently pled guilty to 215 counts of introducing adulterated food into interstate commerce in violation of the federal Food, Drug, and Cosmetic act.

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29 Film Recovery Systems and two of its executives were originally convicted of homicide. These convictions were overturned on appeal due to inconsistent verdicts rendered at trial. See People v. O’Neil, 194 Ill. App.3d 79, 550 N.E.2d 1090, 1098, 1101, 141 Ill. Dec. 44 (Ill. App. 1990). However, the appellate court reviewing the case found ample factual support in the record for the homicide convictions. See id. at 1101-1102. The individual defendants in the case later pled guilty to involuntary manslaughter. The corporation was not retried, probably because it declared bankruptcy following the original trial. See “Company’s Homicide Case Ends in Pleas,” National Law Journal, p. 6 (Sept. 30, 1993). For descriptions of Film Recovery Systems’ activities and the resulting criminal prosecutions, see: Ermann & Lundman, “Overview,” in Corporate and Governmental Deviance, 17-18 (1992); Magnum, “Murder in the Workplace: Criminal Prosecution v. Regulatory Enforcement,” 39 Labor L.J. 220-231 (1988); Maakestad, “States’ Attorneys Stalk Corporate Murderers,” 56 Bus. & Soc. Rev. 21-25 (1986).

30 Other examples of this type of corporate crime intentionally pursued by top executives in a small firm include the illegal production practices and pollution discharges associated with the manufacturing of the pesticide Kepone by Life Science Products Corporations, a small Virginia concern formed to supply Kepone to the Allied Chemical Corporation. See Fisse & Braithwaite, The Impact of Publicity on Corporate Offenders, 63-64 (1983).


32 See id. at 125.
Act and paid a $2 million fine. 33 The president of that subsidiary pled guilty to ten felony counts of violating the Food, Drug, and Cosmetic Act. 34 In addition, Beech-Nut was suspended and debarred from federal contracting for five years. 35

These sorts of conscious decisions to pursue corporate profits through illegal means are not restricted to top executives of small concerns. Top executives of large companies have been willing to authorize illegal conduct where they perceive that it is needed to ensure the survival or well-being of their firm. From the 1950s to the mid-1970s, a number of top executives of large American concerns reached this sort of conclusion about the need for foreign bribes to obtain aircraft sales. 36 For example, between 1970 and 1975, the Lockheed Corporation made questionable payments in excess of $30 million to persons of influence in numerous foreign governments. Recipients of these payments from Lockheed included such notable figures as Prime Minister Tanaka of Japan and Prince Bernhard of the Netherlands. A group of Lockheed’s outside directors, charged with investigating these practices, placed the blame for the illegal conduct at the top levels of corporate management. They concluded that the corporation’s chairman and its president were “willing to distort such a primary principle as integrity for short-term expediency, in order to aid, in their mind, the company’s financial survival.” 37 Lockheed’s foreign bribes were not an isolated incident, but paralleled illegal bribes by such aviation giants as Northrop and McDonnell Douglas. These cases illustrate how an intense struggle for corporate survival can cause even the executives of our largest firms to turn to crime as a business method.

Choices to run their organizational sub-units through illegal means are also sometimes reached by corporate middle managers in charge of business components like divisions or branch offices. These managers may turn to illegal activities to meet otherwise unattainable performance requirements. For example, to meet growth targets mandated by top company managers, middle managers for the H.J. Heinz Corporation systematically misstated sales and cost figures in internal corporate reports, resulting in a cumulative misstatement of Heinz’s profits in public reports of approximately $8.5 million. 38 Similarly, where production demands by top managers unrealistically provided for no plant downtime, Chevrolet plant managers in Flint, Michigan, installed a secret switch to speed up the plant assembly line in violation

34 Id.
36 See generally, Fisse & Braithwaite, The Impact of Publicity on Corporate Offenders, 144-167 (1983).
of the company’s labor agreements.\textsuperscript{39} In another case where poor productivity threatened the closure of a plant, the manager of the glass-container manufacturing plant altered corporate records to inflate the plant’s apparent production by one-third, causing the company to overstate its profits in public reports.\textsuperscript{40} These middle managers’ choices to pursue illegal conduct for the good of their corporate sub-units raise many of the same public threats as corporate crimes orchestrated by top corporate executives in small firms. The only difference is that middle managers carry out their offenses through sub-units that are parts of larger organizations. The workforces of these sub-units are often comparable in size to the workforces of small companies, leading to similar types of offenses. The status of the sub-units as small portions of larger corporate enterprises may both discourage and encourage offenses. Oversight of a sub-unit’s business practices by senior corporate executives should discourage offenses; however, close monitoring of a sub-unit’s profits may encourage offenses by heightening performance pressures.

The ways managers analyze everyday business decisions may also affect the choices they and their subordinates make about law compliance. At least three different explanations of how corporate managers factor legal requirements into decisions have been proposed.\textsuperscript{41} First, corporate managers may act like “amoral calculators,” choosing to violate the law unless the anticipated legal or social penalties for criminal conduct are sufficiently great to outweigh the expected corporate gains from such conduct.\textsuperscript{42} Second, corporate managers may normally be inclined to comply with the law, but have distinctive views about appropriate public policy related to business conduct. Managers with such attitudes may choose to violate certain laws because they feel they have a principled disagreement with those standards and feel the standards to be arbitrary or unreasonable. Third, corporate managers may be committed to strict compliance with governing laws (or at least criminal laws), yet initiate conduct violating those laws due to deficient knowledge about what conduct is prohibited. Studies are still necessary to determine which of these types of decision making is most often behind conscious choices by managers to initiate or tolerate illegal corporate conduct. However, it may be that all of these are common types of corporate decision making, each comprising an important source of corporate crime under different circumstances.

\textsuperscript{39} Id.
\textsuperscript{40} Id.
\textsuperscript{42} This is the most commonly accepted view in the criminology literature concerning corporate crime. See Vaughan, “The Macro-Micro Connection in White-Collar Crime Theory,” in White-Collar Crime Reconsidered, 124, 131 (1992). It is supported by ample empirical evidence of a link between economic strain on corporate organizations and an increased frequency of corporate crime. See, e.g., Clinard & Yeager, Corporate Crime, 129 (1980).
[b]—Policies and Practices Unintentionally Encouraging Illegal Conduct

A variety of management policies or practices aimed at legitimate corporate ends may inadvertently promote corporate crimes. One corporate feature that indirectly influences corporate crime levels is the type of performance demanded from subordinates by corporate managers. Several corporate crime studies have found that crime levels are high in depressed industries and among poorly performing firms in all industries, suggesting that when corporate managers are under unusual pressures to improve corporate profits, the managers make increased demands on subordinates (or fail to lower their demands in the face of decreasing performance opportunities) in ways that tend to cause corporate crime levels to rise. Other commentators have argued that there is nothing special about corporate profit pressures and that crime levels tend to rise whenever exceptional performance pressures are placed on firms.

Where management pressures for increased performance rise, management’s attitudes about employee interchangeability may make those pressures particularly intense. Corporate hierarchies and organizations are comprised of building blocks of job roles, coordinated to accomplish corporate goals. Firms are operated on the premise that the individual employees holding those roles are largely interchangeable. An expectation that employees are interchangeable makes it easy for managers to make strong demands on subordinates, accept few excuses when those demands are not met, and replace the objecting employee with another either more capable in performing legitimate activities or more willing to engage in illegitimate ones to “get the job done.” Whichever sort of replacement employee is the perceived threat, a present employee may feel highly threatened by impossible performance objectives, yet see few alternatives other than illegal conduct as means to attain those objectives.

Choices by managers about business structures may also influence corporate crime levels. The dispersion of authority among numerous corporate managers may tend to reduce the impression of each that she is responsible for criminal conduct in which she plays but a small part. Alternatively, choices to conduct corporate activities through separately accountable business sub-units such as divisions or subsidiaries may increase demands for

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43 See, e.g., Clinard & Yeager, Corporate Crime, 129 (1980).
47 Id.
48 See Clinard et al., Illegal Corporate Behavior, 7 (1979).
profits from each of the sub-units and raise corresponding pressures to engage in illegal conduct to gain those profits.\textsuperscript{49} The separation of firm activities into divisions or subsidiaries may also tend to isolate low-level misconduct from scrutiny and control by top corporate officials who are concerned about law compliance.\textsuperscript{50}

[c]—Constraints on Information Transfers and Decision Making

Numerous features of corporate operations may constrain information transfers and decision making in ways that leave departures from legal standards unaddressed and thereby inadvertently promote corporate crime.\textsuperscript{51} The tendency of firms to define job roles in specialized, compartmentalized terms encourages corporate employees to focus their attention on their narrow range of assigned duties and to neither gather information about other aspects of corporate operations nor disclose information about their own activities to other employees or managers. This tends to conceal offenses committed through the combined efforts of multiple employees. Furthermore, as with carriers of bad news everywhere, employees are generally hesitant to disclose the illegal features of their own work to corporate superiors. Hence, bad news about impending or ongoing offenses may be bottled up at low corporate levels, permitting preventable offenses to proceed.\textsuperscript{52}

The criteria and methods used in making decisions about corporate activities can influence associated levels of corporate crime. Corporate decision-making procedures that emphasize short-term profits or productivity over other criteria may encourage pursuit of these types of corporate performance through illegal means.\textsuperscript{53} Conversely, required findings on legally significant topics prior to making related operating decisions may reduce crime levels. The inclusion in decision-making groups of persons with strong interests in or responsibilities for law compliance can reduce crime levels by ensuring that legal issues are recognized and properly resolved.\textsuperscript{54} Thus, decision-


\textsuperscript{53} See Vaughan, N. 52 \textit{supra}, at 72.

making mechanisms requiring the inclusion of corporate lawyers or other legal specialists in decision-making groups can reduce unlawful conduct. Likewise, corporate decision-making procedures requiring that certain legally significant decisions be made at top corporate levels can promote increased law compliance. Decisions by top executives on such matters tend to be better informed regarding legal issues and less influenced by day-to-day performance pressures than comparable decisions by operating personnel or low-level managers.

Finally, instilling greater interest in law compliance issues by creating a corporate culture emphasizing care and reflection toward legal requirements as regular parts of decision making in corporate operations can diminish corporate crime levels.  

[d]—Crime Prevention Measures

The emphasis given by firms to systematic law compliance efforts also can have an important impact on corporate crime levels. Aggressive use of crime prevention measures like law compliance standards and procedures, legal audits, and post-offense investigations can not only prevent or stop offenses, they can ensure that needed reforms are considered and adapted. These types of measures can also heighten internal crime deterrents by increasing employees’ perception that they will be caught if they engage in illegal conduct. Firms that institutionalize staffs with specialized responsibilities for ensuring corporate law compliance tend to engage in fewer legal violations than other firms, particularly where those staffs have clear-cut authority and respect in the corporate organizations involved.

Numerous analysts have recognized that the law compliance example set by top corporate managers is a key influence on decisions about corporate crimes by other corporate employees. Where top executives exhibit contempt or disregard for law compliance, employees are likely to adopt similar attitudes. One can imagine that law compliance was a low priority in Colonel Vanderbilt’s railroads in light of his public observation that “You don’t suppose you can run a railway in accordance with the statutes, do you?” In contrast, where top executives not only profess to expect law compliance by subordinates, but apply demanding law compliance standards in shaping their own conduct and in disciplining employees for unlawful behavior, the results are often different. Subordinates of these executives are likely to act lawfully, either out of genuine respect for the values held by the executives or fear of the consequences of disappointing the executives. Low-level corporate managers often cite the example set by top managers as the most important organizational factor determining corporate crime levels.

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55 See id. at 111-118.
§ 1.07[1] CORPORATE CRIMINAL LIABILITY 1-30

§ 1.07 Distinctive Features of Corporate Crime

[1]—Concealment

Corporate offenses are often unusually difficult to detect and investigate. In part, the concealment of corporate offenses is a consequence of the general secrecy surrounding legitimate corporate operations and the tendency of corporate employees to avoid disclosures of corporate operating methods. Corporate secrecy regarding criminal conduct is also a product of the means used to maintain and monitor law compliance in corporate organizations. Additional secrecy stems from the methods used by corporate counsel to defend firms and their employees against criminal charges and related civil claims. All these features tend to obscure external understanding of the extent and nature of corporate criminal activity.

[a]—Secrecy Concerning Legitimate Business Activities

In competitive corporate environments, secrecy is often a way of life. Firms maintain close control over information about internal operations for many reasons. Sometimes, secrecy is viewed as a means to maintain an edge over competitors. In other contexts, secrecy is maintained to avoid disputes with private parties seeking to challenge and change corporate practices. In still other settings, secrecy is a means to minimize public controversies over corporate operations and thereby avoid new government actions constraining corporate conduct.

These types of secrecy are means for corporate managers and employees to maintain control over the course of corporate business activities. Through control over information about corporate conduct, corporate managers and employees further their control over the conduct itself. As observed by organizational analysts Jeffrey Pfeffer and Gerald R. Salancik:

Information control ... is an important mechanism for both the exercise and the avoidance of influence. ... What information is available about organizational actions is the outcome of a political process in which social actors, each trying to advance his interests, attempt to acquire or withhold information as it serves their position in the political struggle. 1

Where secrecy regarding legitimate corporate activities also conceals evidence of corporate crime, crime detection by victims and law enforcement officials becomes a casualty of the political struggle over corporate information and control. If secrecy is the norm, little information about illegal corporate practices may leak out of corporate workplaces. While corporate secrecy policies will not prevent legally compelled disclosures as part of investigations by public authorities or discovery processes in civil suits, such secrecy policies may delay or frustrate external detection of an offense

where all or most of the inculpatory evidence lies in corporate records covered by internal corporate security arrangements.

[b]—Secrecy in Corporate Law Compliance Programs

Corporate efforts to maintain law compliance are often tailored to maintain the secrecy of damaging information about completed corporate offenses. Where possible, these programs are crafted to ensure that evidentiary privileges protect the confidentiality of information discovered about past corporate offenses. Where privileged investigations and audits are impossible, the law compliance practices of firms tend to minimize actions that would create records or other evidence of corporate crime. While the destruction of relevant evidence in pending cases is not legitimate, firms are permitted to structure their compliance and operating practices outside of litigation to minimize the collection and retention of potentially inculpating materials and records.

Indeed, many firms have systematic programs for destroying records that have little or no continuing significance in business activities, but which may provide evidence of past offenses. The logic behind such systematic destruction programs is that maintenance of the records serves little or no positive business purpose, but may injure the firm by providing evidence of actual or apparent offenses. A related explanation is that, if they tend to record exceptions to normal corporate operations, old records may tend to portray a skewed picture of corporate activities and indicate that offenses were more prevalent than they actually were.

[c]—Secrecy in Defending against Corporate Prosecutions

The methods used by corporations to defend against criminal prosecutions and related civil claims also tend to conceal the nature and extent of corporate crimes. In the course of preparing a criminal or civil defense, much of the information gathered by counsel is cloaked with the confidentiality protections of the attorney-client privilege or work-product immunity. The information collected by counsel in this context will typically only reach prosecutors and the public if it is discovered from other sources.

Techniques used by counsel to represent corporate defendants may also limit revelations about corporate offenses. Information control is the focal point of the defense of many corporate cases. Under this strategy, counsel pursue defensive measures to limit the disclosure of inculpating information to investigators and prosecutors, while staying within the bounds of legal disclosure requirements and professional conduct rules. By representing corporate defendants from the early stages of criminal investigations and using the extensive resources of those defendants to resist disclosures on a variety of fronts, corporate defense counsel can limit prosecutors’ understanding of

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2 The links between criminal defense practices and corporate secrecy described here are more thoroughly explored in Mann. Defending White Collar Crime. 231-240 (1985).
corporate offenses and their ability to establish corporate liability. Similar resistance to discovery may constrain disclosures to civil plaintiffs in later civil trials. Alternatively, settlements with civil plaintiffs coupled with nondisclosure agreements binding the plaintiffs not to discuss their cases can conceal the underlying nature of corporate misconduct.

Extended resources available to many large corporate defendants may also facilitate legal defenses incorporating careful information control. Available resources may influence the range of legal arguments researched and presented as barriers to information disclosures. Resources also affect the point at which corporations or individual corporate employees decide to "throw in the towel" and plead guilty to charges against them. Since these pleas can reveal information about corporate offenses and may be coupled with further disclosures as part of plea bargains, extensive corporate resources devoted to forestalling or narrowing guilty pleas can promote offense secrecy.

The sophistication of corporate clients often manifests itself in the employment of defense counsel at early stages of criminal investigations into corporate conduct. Corporate executives and other corporate personnel are increasingly sensitive to the need for assistance from counsel before responding to inquiries from public officials. Furthermore, once an investigation is underway, corporate personnel often have sufficient familiarity with legal requirements and proceedings to direct counsel toward potential sources of damaging information, thereby focusing information control strategies on resistance to the disclosure of that information. Finally, sophisticated clients and witnesses experienced with criminal investigations may be more successful than less well-informed parties in resisting efforts by public officials to extract damaging admissions during interviews or in testimony at trial.

Many investigations of corporate misconduct involve reviews by administrative agency officials before the referral of a case file to prosecutors and the filing of criminal charges. Besides increasing the opportunity of counsel to convince officials that a given case has little or no merit and to thereby avoid both corporate criminal charges and related disclosures, meetings with administrative officials in the course of these reviews can help defense counsel understand the evidence already possessed by the government and the legal theories the government may pursue. With this information, defense counsel can tailor information control strategies to frustrate the gathering of further information needed to prove the government's case.

Corporate crimes tend to be investigated through nonintrusive techniques like subpoenas or summonses, rather than physical searches and other more intrusive techniques. The relatively narrow focus of subpoenas and summonses on the specific information they seek, coupled with the time given parties to respond to them, allows defense counsel to carefully consider and control the information disclosed in response.

[d]—Corporate Control over Information Sources

Corporate executives often control sources of potentially inculpatory information related to corporate crimes. Law enforcement officials attempting to detect corporate crimes often must discern subtle signals of such
crimes in the actions of corporate managers or employees. Criminal investigations focusing on corporate activities often entail a sort of battle between prosecutors and investigators on one side and corporate personnel and counsel on the other. Prosecutors and investigators try to detect and interpret signals of criminal conduct, while corporate personnel and counsel try to conceal those signals or, at least, minimize their transmission.\(^3\)

In circumstances where corporate employees are not required to reveal information about criminal activities, they can legally control inadvertent disclosures and avoid the detection of many instances of misconduct. Even in the face of a formal investigation, unnecessary disclosures can be avoided through narrow construction of investigative inquiries and minimally forthcoming answers to questions from public authorities. Beyond their direct influence over corporate agents, corporate managers may have sufficient influence over major suppliers or customers to cause these outsiders to cooperate with firms and resist unnecessary disclosures to investigators.

[c]—Dispersion of Relevant Evidence

Evidence of offenses by corporate defendants is sometimes dispersed among multiple parties, thereby making government detection and investigation of corporate crimes more difficult than for violent offenses or street crimes where the testimony of a single witness is often sufficient to establish an offense. In addition, cases involving dispersed evidence often turn on key bits of information held by corporations that establish the legal significance of other information available from noncorporate sources. Hence, while evidence outside of corporate hands may provide a hint of a corporate offense, it often leads back to evidence that is subject to information control by corporate personnel and counsel.

[f]—Internal Corporate Pressures Discouraging Disclosures of Misconduct

Because of group loyalty or outright intimidation by corporate superiors, persons in corporate organizations who are aware of misconduct by other employees may refrain from revealing that misconduct to public authorities. Absent a voluntary whistle-blower or a culpable individual who chooses to cooperate with authorities in order to improve his own plea bargain and sentence, public authorities may be unable to gain sufficient initial evidence of a criminal violation to target an investigation.

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\(^3\) See Willmer, *Crime and Information Theory*, 8 (1970) ("With [the] concept in mind of the criminal as emitter [of information about his crime] and the police as receivers and interpreters of information, . . . the conflict between the criminal and the police can be regarded as a battle over information."). See also, Mann, *Defending White Collar Crime*, 260 (1985) (in white-collar crime prosecutions, defense counsel often have key roles in preventing the emissions of signals revealing crimes).
Corporate employees who are aware of illegal conduct often choose to conceal it out of misplaced loyalty to their firm or fellow employees. Groups of employees undertaking corporate crimes can develop shared values supporting illegal conduct. Group socialization can convince new group members that legally prohibited behavior is either not a significant offense (perhaps on the ground that it is only a "technical" violation) or a necessary evil since "everybody does it" and their firm must act illegally to keep up with the competition. For example, one executive convicted of price-fixing gave the following description of the impact of company and industry tradition on his activities:

Price agreements between competitors were a way of life. Our ethics were not out of line with what was being done in this company and, in fact, in this industry for a long time . . . . That's just the way I was brought up in the business, right or wrong.

Alternatively, corporate employees participating in violations may coerce others into concealing the offenses by threats of retaliation if the nonparticipants reveal the misconduct. One GE executive was so strongly pressured by his co-workers to continue a long-standing practice of illegal price-fixing that he committed suicide. Several other executives in the folding-carton industry were threatened with physical injury if they interfered with an ongoing price-fixing conspiracy.

The relative isolation of corporate workforces from broader social interactions may also play a role in convincing corporate workers that certain types of criminal conduct are not wrongful and do not need to be disclosed to public officials. Professor Edwin Sutherland, who coined the term "white-collar crime" some years ago, attributed much of that type of crime to the differential socialization of persons carrying on business activities in isolation from other community members. Sutherland felt that the isolation of business executives from other types of community members has two types of socializing effects that promote white-collar crime. First, business executives are effectively isolated from the outside parties who are generally the victims of white-collar offenses. Because they have little contact with those

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4 Employee loyalty toward corporate organizations or fellow employees may not even be necessary to prevent the disclosure of information that employees gain about internal misconduct. A choice to remain passive upon gaining knowledge about internal misconduct will suffice. Consumer advocate Ralph Nader believes that corporations encourage employees to act passively in these contexts. He recommends that employees resist corporate pressures to remain passive and blow the whistle on corporate misconduct by informing public authorities. See Wason, "Crime in the Suits Advances Will Create Need for Activism in Corporate Ethics. Nader Tells Students," Minneapolis Star Tribune, p. D1 (Oct. 24, 1992).


persons who suffer the harmful consequences, the executives tend to mini-
mize the seriousness of white-collar offenses. Second, in their isolation from
broader community values, business executives tend to establish their own
value schemes that recognize business success as a high virtue. In this
framework, business success achieved through illegal means may not trigger
shame and disapproval in the business community; rather, although its ille-
gal features may be criticized, business success achieved through illegal
means may be nonetheless tolerated and rewarded.

Even where corporate employees are not encouraged to act illegally by
these types of group processes, they may feel a loyalty to their corporate
employer and avoid disclosures to law enforcement officials that might
adversely affect their firm. Employees are encouraged to adopt these values
by corporate practices promoting employee loyalty to firms and the commu-
nities of employees within them. This loyalty may cause employees who have
not personally engaged in misconduct to lie to investigators or to avoid affir-
mative disclosures of detected misconduct. Alternatively, corporate employ-
ees may feel a personal loyalty to individuals involved in corporate miscon-
duct and seek to protect those individuals by avoiding disclosures of their
misconduct. Sometimes, this reluctance to reveal misconduct extends to dis-
closures to managers of a corporate employer. For example, some corporate
cynics describe corporate hotlines set up by management to receive whistle-
blowers’ reports of employee misconduct as “snitchlines” and “ratlines.”

[g]—Uncertain Illegality of Corporate Behavior

The illegality of some corporate behavior depends on complex legal stan-
dards and is correspondingly uncertain to persons without specialized legal
knowledge. Corporate managers or employees who are aware of such behav-
ior on the part of fellow employees may be hesitant to report it to public
authorities and risk unjustified embarrassment and condemnation of the
employees who are the subjects of the reports. Alternatively, while conduct
by other employees may be clearly illegal, co-workers with some factual
information about that conduct may lack sufficient information to appreciate
its illegal character and hesitate to report the conduct due to this type of
uncertainty.

Similarly, the scope and aggressiveness of investigations of corporate con-
duct by public officials may depend on whether the conduct at issue appears
to be of uncertain illegality. Where they perceive at an early stage of an inves-
tigation that corporate conduct is of uncertain illegality, public authorities
may temper their investigative zeal due to the realization that their efforts
may be wasted should the conduct their investigation documents be held not
to violate any law. Hence, when in doubt, investigators may conduct little or
no investigation of conduct at the boundaries of illegal behavior, thereby
retaining the secrecy of misconduct that may, indeed, have been illegal.

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8 Feder, “Helping Corporate America Hew to the Straight and Narrow,” New York
A further reason some corporate offenses may go unnoticed by both offenders and crime victims is that many types of illegal conduct in corporate settings are not so clearly harmful or immoral as to give notice of their prohibited character. In legal terms, many crimes committed by corporate employees are *malum prohibitum*, not *malum in se*. Many corporate employees may not appreciate when they or co-workers are committing a *malum prohibitum* offense defined under regulatory standards because such an offense does not require the sort of clearly immoral conduct that would unequivocally signal the presence of an offense. Outsiders may have similar difficulties in recognizing some *malum prohibitum* offenses by corporate personnel.

Only when special attention is focused on some aspect of corporate affairs and a thorough legal analysis is performed will the full extent of criminal conduct in those affairs tend to be revealed. For example, exceptionally close scrutiny triggered by the ensuing oil spill probably accounts for the detection of the misconduct leading up to the *Exxon Valdez* tanker disaster. This misconduct involved illegal officer staffing practices that were not obviously immoral, but which raised (as the *Exxon Valdez* spill itself attests) substantial environmental risks. Absent the attention focused on Exxon’s activities through investigations of the spill, these staffing errors might have remained undetected and their prohibited character continued to be unappreciated.

[h]—Overcoming Pressures to Conceal Offenses

Large incentives to whistleblowers have produced increasing numbers of disclosures of corporate crimes and associated qui tam actions under the federal False Claims Act. Through these actions, whistleblowers providing previously undisclosed information to the federal government about corporate misconduct can qualify for bounty payments upon successful government recoveries of sanctions imposed under the Act. The DOJ summarized the success of whistleblowers in these suits in 2012, as well as the significant increase in qui tam actions since amendments to the Act created strong incentives for such suits in 1986, as follows:

The increased incentives for whistleblowers have led to an unprecedented number of investigations and greater recoveries. Of the $4.9 billion in fiscal year 2012 recoveries, a record $3.3 billion was recovered in whistleblower suits. In fiscal year 2012 alone, relators filed 647 qui tam suits. Of the nearly 8,500 qui tam suits filed since the 1986 amendments, nearly 2,200 were filed since January 2009. Looking at qui tam recoveries for the same periods, the department tallied $24.2 billion since 1986, with nearly $10.5 billion of that amount recovered from January 2009 through fiscal year 2012. Since 1986, whistleblowers have been awarded nearly $4 billion, with $439 million in awards in fiscal year 2012.

“The whistleblowers who bring wrongdoing to the government’s attention are instrumental in preserving the integrity of government programs

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and protecting taxpayers from the costs of fraud,” said Principal Deputy Assistant Attorney General [Stuart F.] Delery. “We are extremely grateful for the sacrifices they make to do the right thing.”

Features of False Claims Act cases resolved in fiscal 2012 provide strong evidence of increasing government recoveries in these cases and of the important impacts of whistleblower reports in facilitating government detection and investigation of a wide variety of corporate misconduct. Government recoveries in fiscal 2012 increased for violations of both the federal False Claims Act and comparable state statutes. In all, federal recoveries of fines and civil settlement amounts totaled over $9 billion. Some state recoveries were also very large. One California case produced a $300 million recovery in a Medicaid HMO case.

Total federal recoveries in False Claims Act cases were over twice as large as in the previous year. One analyst attributed the rise in these cases to bigger pharmaceutical cases and government attorneys’ emphasis on recoveries in new types of False Claims Act cases - including banking and mortgage fraud.

According to Taxpayers Against Fraud, the top ten False Claims Act cases in fiscal 2012 were as follows:

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount</th>
<th>Claim Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>GlaxoSmithKline</td>
<td>$3 billion</td>
<td>Illegal marketing of drugs</td>
</tr>
<tr>
<td>Abbott Laboratories</td>
<td>$1.5 billion</td>
<td>Off-Label marketing of drugs</td>
</tr>
<tr>
<td>Bank of America</td>
<td>$1 billion</td>
<td>Mortgage and bank fraud</td>
</tr>
<tr>
<td>Merck</td>
<td>$950 million</td>
<td>Illegal marketing of drugs</td>
</tr>
<tr>
<td>Senior Care Action</td>
<td>$324 million</td>
<td>California Medicaid fraud</td>
</tr>
<tr>
<td>Network Actavis</td>
<td>$203 million</td>
<td>Drug overcharging</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>$202 million</td>
<td>False loan certifications</td>
</tr>
<tr>
<td>Oracle</td>
<td>$199 million</td>
<td>Failure to provide discount price</td>
</tr>
<tr>
<td>McKesson</td>
<td>$190 million</td>
<td>Inflating drug prices</td>
</tr>
<tr>
<td>Citigroup</td>
<td>$158 million</td>
<td>Loan approval fraud</td>
</tr>
</tbody>
</table>


8.4 Id.

8.5 Id.

8.6 Id. (summarizing the analysis of Patrick Burns of Taxpayers Against Fraud).

Of these top ten cases, all but one stemmed from a whistleblower report.\textsuperscript{8.8} Of the thirty largest False Claims Act cases in 2012 profiled, twenty-eight were whistleblower related.\textsuperscript{8.9}

Whistleblower reports tend to have two important impacts on cases in this area. First, insider insights brought to the attention of government attorneys and other law enforcement officials allow authorities to bring more cases. Second, the details about misconduct provided by whistleblowers permit government attorneys to establish broader impacts of misconduct than would otherwise be the case, resulting in larger dollar recoveries by authorities. Given the large bounty payments that whistleblowers can obtain upon successful government recoveries under the False Claims Act and comparable state statutes, whistleblower reports and associated disclosures of corporate violations of criminal and civil laws promise to continue to rise in the future.

\textbf{[2]—Diffuse Responsibility}

\textbf{[a]—Specialization Effects}

Corporate crimes are also difficult to identify and evaluate because the responsibility for those offenses is often distributed among multiple parties.\textsuperscript{9}

Trends toward specialization in corporate workforces—both vertical specialization separating management functions from operational activities and horizontal specialization carving the work assigned to particular employees into narrower and narrower components of larger tasks—have raised complex responsibility questions concerning corporate misconduct.\textsuperscript{10} The corporate ends served by employee actions are often invisible to a particular employee working on a specialized part of a larger task. Hence, a specialist may not appreciate that his work contributes to an offense when combined with the

\textit{(Text continued on page 1-37)}

\textsuperscript{8.8} Id.

\textsuperscript{8.9} Id.

\textsuperscript{9} In many cases of corporate misconduct, personal fault is so minimal or difficult to identify that “[i]t often makes perfectly good sense to ‘blame’ a corporation, or ‘praise’ it collectively, rather than to try to find out which individuals are ‘guilty’ or ‘meritorious.’” Held, “Corporations, Persons, and Responsibility,” in \textit{Shame, Responsibility and the Corporation}, 159, 162 (1986).

actions or knowledge of other corporate employees. Specialization can also hinder internal accountability for misconduct. Actions undertaken by corporate specialists having near complete control over their narrow domain may be reviewed only rarely by other persons in a corporate organization.

Where a corporate specialist engages in misconduct, several persons may be responsible. Of course, the specialist is responsible if he or she appreciates the wrongful character of the misconduct. In addition, the beneficiaries of the specialist’s efforts—for example, corporate superiors credited with the success of the specialist’s efforts or corporate employees in other portions of the corporate enterprise benefitting from the misconduct—are also responsible if they encouraged the specialist to produce these benefits with knowledge of their wrongful source. Finally, the superiors of the specialist may be responsible if they have directed the specialist to act in an illegal fashion or have made inadequate provisions for promoting law compliance in conjunction with the tasks delegated to the specialist.

However, none of these types of individuals undertaking specialized tasks may be responsible for criminal conduct if they lack critical information about the prohibited or injurious character of their actions. Such an information gap may arise where each of several employees is performing a compartmentalized task with the information necessary for that task, but without the broader perspective necessary to appreciate how the task is contributing to illegal misconduct. Each of the individuals contributing to the misconduct may be acting morally and legally within her individual framework. There is no person with culpable knowledge in these circumstances and no person to blame.

[b]—Information Barriers

Corporate operating systems can produce a number of barriers to the flow of information about the illegal character of corporate conduct. This can lead to unappreciated misconduct by corporate employees having only a partial understanding of the nature or implications of their actions. In some instances, corporate systems produce intense competition between employees, leading one employee to actively withhold information from another in order to demonstrate the knowledgeable party’s power within the corporate organization or to impede the performance of the employee who is denied the information. The separation of corporate operations into relatively autonomous divisions may also create barriers to information flow that isolate information about legally risky activities in one division where it cannot be used in evaluating or avoiding illegal conduct in another division. This sort of isolation results where employees in one division feel that they are in competition with those in another and withhold information to avoid aiding their internal competitors. It may also occur because employees are intensely focused on the problems and performance of their own division and relatively unconcerned and unresponsive to the information needs of other corporate employees beyond the boundaries of their own operating division.

11 See id. at 119-123.
[c]—Incentive Systems

Employee incentive systems sometimes promote crimes by corporate employees as byproducts of management efforts to tie individual interests to corporate objectives. To ensure that corporate employees will pursue corporate interests, firms select, train, socialize, and reward corporate employees in ways that tend to cause the employees to identify their individual success with corporate success. These processes are integral parts of the agency relationships upon which all corporate actions are based. The processes align the interests of corporate principals with the interests of employees acting as corporate agents. Without incentive schemes encouraging employees to perceive potential personal gains from the pursuit of corporate interests, employees might have few reasons to protect and promote the interests of their corporate principals.

However, these processes can work too well, giving corporate employees reasons to commit offenses that they would not undertake but for their corporate association. Sociologist Diane Vaughan describes this effect as follows:

Organizational processes . . . create an internal moral and intellectual world in which the individual identifies with the organization and the organization’s goals. The survival of the one becomes linked to the survival of the other, and the normative environment evolves that, given difficulty in attaining scarce resources, encourages illegal behavior to attain them.

Of course, not every corporate employee governed by a performance incentive system promotes corporate interests through illegal conduct. Indeed, this is the exception, not the rule. Where an employee acts illegally to gain incentive system rewards, this misconduct represents a complex product of the structural incentives established by the organization involved and the personal choice of the employee who has decided to act illegally.

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12 While corporate employees may seldom consciously choose to injure members of the public to increase corporate profits, they may be willing, particularly under intense pressures for improved performance exerted through employee evaluation processes, to trade increased public risks for improved corporate performance. Not only do corporate reward systems provide little if any incremental rewards for socially responsible actions per se, these systems may create perverse incentives encouraging employees to achieve superior corporate performance through activities creating substantial risks to the public. Immediate rewards such as bonuses or salary increases will tend to turn on raw performance measures like total sales or production figures, not more subtle measurements of societal risks raised in achieving that performance. Furthermore, persons who are willing to cut corners on law compliance when it will increase profit-oriented corporate performance may tend to rise in corporate organizations because their overall contribution to corporate profits will appear larger than those of comparable employees maintaining strict adherence to legal requirements. See id. at 122.

[d]—Measuring Culpability

The preceding discussions illustrate some of the complexity involved in determining responsibility for corporate crime. Where an offense promoting corporate interests is committed, significant questions may be raised as to whether the cause was deficient managerial practices at a corporate level or just the blameworthy choice of an individual employee to act illegally within an otherwise proper system. Did the offense stem from improper corporate values or structural incentives passed on to corporate employees and determining their conduct, in which case we can say that firm managers were responsible? Or were the values and structural incentives influencing the employee typical and appropriate, and the choice of illegal conduct a reflection of unpredictable, aberrant values held by that employee?

These types of questions have bedeviled criminologists for years. Some observers have attempted to identify corporate values and structural features that tend to cause corporate offenses and to use the presence of those values and features to attribute related offenses to companies rather than individuals. However, their predictions about the causal impact on offenses of particular corporate values and features have not always been borne out because individuals always exercise some discretion in selecting illegal corporate conduct and because the relative importance of individual and corporate factors in causing corporate offenses is not reliably ascertainable in most cases.

While some criminologists still hope to delineate the respective roles of organizational processes and individual choices in corporate offenses, this task has yet to be completed despite extensive study and effort. The reason for these poor results may be that there is no single system of interaction between corporate processes and individual values and circumstances that leads to corporate crime. Rather, corporate offenses may be offshoots of complex interactions between individuals and organizational processes in which the relative roles of individual decisions and organizational processes vary from firm to firm and case to case. Therefore, the search for general standards for measuring organizational responsibility in initiating corporate crimes may be a futile endeavor, like the search for descriptive rules in chaotic systems. Similarly, corporate fault and liability standards that turn on the presence in a company of organizational features likely to produce corporate offenses may not be capable of being stated with sufficient particularity and universality to be useful.

However, even if blameworthy organizational structures and processes that promote offenses can not be identified in a meaningful way, corporate culpability may be measurable from the preventive fault of corporate managers in failing to prevent offenses. If illegal misconduct in the service of corporate interests is viewed as a type of defective corporate performance, it may be possible for firms to prevent, detect, and reduce this type of performance. This is true even if the sources of illegal misconduct could not have been fully predicted before the illegal conduct occurred.

For example, an internal corporate investigation of an offense by a corporate employee may reveal a systemic source or a related pattern of conduct that otherwise would not have been discovered. This source or pattern
may be peculiar to the firm involved and not susceptible to prediction under any generally applicable theory of corporate crime. Nonetheless, managers in that firm can use their special knowledge about this pattern or systemic source to prevent further crimes in the same pattern or resulting from the same source. Furthermore, corporate fault can be determined from managerial efforts to follow up on corporate offenses this way—that is, to identify the sources and patterns of corporate offenses and to use this information to minimize subsequent offenses.

Under this approach, corporate law compliance is a quality control issue. Illegal conduct by corporate employees and other agents is a form of defective corporate performance that can be monitored, analyzed, and minimized. The merit of corporate law compliance efforts—and the scope of managerial fault in offenses by corporate employees—turns on the extent of affirmative efforts by corporate managers to promote high quality in corporate law compliance and to undertake monitoring and adjustments to minimize defective performance in the form of offenses by corporate employees and other agents.

Within this legal quality control framework, corporate managers have several tools to minimize legally defective corporate performance. Managers have many information sources that allow them to identify developing illegal conduct. These include direct managerial oversight of subordinates' conduct, reports by fellow employees about possible misconduct, regular audits of legal features of employee conduct, investigations of internal or external misconduct reports, and special monitoring for employees having shown a willingness to engage in illegal conduct. Where there are signs of specific risks of illegal conduct in the course of legitimate corporate activities, firm managers have several means to minimize the scope of those risks. These include detailed instructions for employees about how to meet legal requirements affecting their jobs, close monitoring of subsequent employee performance to identify conduct not conforming to the instructions, discipline for employees not following compliance instructions, and dismissals or reassignments to less legally sensitive areas for employees undertaking illegal conduct or threatening to do so. Even when offenses are not predictable in advance, they may be detectable after the fact. Corporate managers can react to past offenses with discipline, new instructions and training for employees like the offender, and heightened monitoring of subsequent employee performance in related areas to see if post-offense adjustments were adequate to prevent repeat offenses. The sufficiency of preventive actions like these may provide a useful basis for measuring managerial fault concerning subsequent corporate offenses.
§ 1.08 Distinctive Agency Relationships Constraining Corporate Crime

Law enforcement processes aimed at corporate offenses include a core of investigative and accountability mechanisms that are similar to those applied to individual offenders. However, in addition to these mechanisms, corporate offenses are restricted by a sophisticated web of law enforcement processes based on private agency relationships. These agency mechanisms are unlike those applied to most other types of crimes.

The relevant agency relationships include more than just the legally recognized agency relationships between corporate principals and the employees who carry out corporate activities as corporate agents. Agency relationships, as discussed here, include a broad class of functional arrangements whereby one person gives direction to a second person about how to undertake actions on the first person’s behalf, creates incentives for the second party to act accordingly, and receives the benefit of the second party’s performance.¹

Agency arrangements of this sort are subject to three universal problems: (1) the difficulty of defining desirable performance by agents when the nature of that performance is not entirely foreseeable before it is completed; (2) limitations on information available to principals for evaluating whether agents have achieved the desired performance; and (3) problems in the specification and administration of adequate rewards to motivate agents to pursue the performance desired by principals.² As will be seen from the discussion in this section, these problems have important impacts on agency processes governing corporate crime.

Agency relationships constraining corporate crime involve several processes through which parties other than traditional law enforcement officials promote law compliance by corporate employees. This section focuses on three types of agency relationships that have a potentially important impact in constraining corporate crime. These relationships include top corporate managers acting as agents of corporate owners, operating employees acting as agents of top corporate managers, and corporate managers and employees acting as agents of traditional law enforcement personnel.³

² Id.
³ All of these agency relationships differ from legally enforceable agency arrangements in which a principal can directly dictate how an agent is expected to act and can remove the agent if adequate performance does not follow. The relationships discussed here are merely functional relationships in which the agents are informed of and pursue the interests of other parties and are given clear incentives to act in this way. Cf. Cohen & Simpson, “The Origins of Corporate Criminality: Rational Individual and Organizational Actors,” in Debating Corporate Crime, 33, 39-40 (1997) (the agency relationships between owners and top corporate managers and between managers and employees may involve significant divergences of interests leading to corporate crimes that were not desired by the principals but were perceived as advantageous by the agents in these relationships).
Ideally, corporate directors and officers should function as agents of corporate shareholders for law enforcement purposes. These shareholders have claims to corporate assets and profits that are directly threatened by corporate fines and other criminal punishments. Since corporate shareholders have a clear financial stake in preventing unlawful corporate activities, they have reasons to monitor and discipline directors and managers who harm corporations through illegal conduct or who tolerate offenses by subordinates. Hence, agency relationships between shareholders and top corporate officials may be sources of privately imposed law compliance pressures that serve public as well as shareholder interests.

While these pressures may have a beneficial impact in firms with a few dominant shareholders, they will be inconsequential in many firms for at least three reasons. First, since shareholders bear no personal responsibility for offenses in which they do not participate, their only interest in crimes by corporate agents lies in crimes that, given the detection rates and probable penalties for the crimes, have net negative values to their firms. To the extent that crime “pays” in the sense that the likely gains from illegal conduct are greater than the expected penalties given the infrequency of corporate punishment, shareholders will tend, at least on an economic level, to prefer the initiation and continuation of profitable crimes by corporate agents. As Richard Posner has noted, where shareholders perceive a positive value in managers’ crimes, “they will have every incentive to hire managers willing to commit crimes on the corporation’s behalf.”

While shareholders may have problems in identifying and recruiting such managers, the same thinking will justify the toleration and advancement of managers whose job performance reveals that they are willing to commit crimes. Firms can “select” such managers by simply advancing them within the corporate structure based on the exceptional profits these managers produce while ignoring the illegal means used to gain those profits.

Second, in small, closely held concerns, corporate shareholders are often also corporate directors and officers, meaning that the agency relationship addressed here is collapsed and no useful agency monitoring or discipline will occur. In addition, as owners as well as managers, top executives in small concerns are often in a position to capture the full economic gains from illegal corporate activities. Hence, they have more direct motivations to pursue illegal activities that are apparently profitable to their firms than managers who are not owners.

Third, in most large, publicly traded firms, each shareholder typically owns only a small fraction of a company’s stock. Because they each bear

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6 See id. at 323.
only a small fraction of the risks resulting from offense penalties imposed on any particular firm, most shareholders in publicly traded firms have little reason to monitor the attention given to law compliance by corporate directors and officers in particular companies. Furthermore, even if shareholders in publicly traded firms gain sufficient information to identify cases of inattention to law compliance by corporate directors or officers, they may lack sufficient political power within the overall group of shareholders in the company involved to act on this information. This disability makes their knowledge meaningless in disciplining poor law compliance performance by corporate officials and in motivating such officials to pursue improved corporate law compliance. Finally, if shareholders in publicly traded firms are effective in monitoring some aspects of the performance of corporate directors and officers, the primary focus of this monitoring may be on the profit levels achieved under the corporate leadership of particular directors and officers, meaning that more complex and controversial questions about the directors’ and officers’ pursuit of law compliance may be ignored. Therefore, pressures originating from shareholders may do a poor job of encouraging top officials in large, publicly held firms to take strong measures to ensure law compliance within their organizations.

However, a different facet of the agency relationship between top officials in large firms and corporate shareholders may tend to cause those officials to avoid criminal conduct. The disparate risk perspectives of corporate shareholders and top officials may cause the latter to be more risk adverse with respect to personal involvement in criminal conduct. The primary benefit of an offense committed by a top corporate official for corporate gain would run to his firm and, hence, to corporate shareholders. However, the primary risk of criminal penalties would fall on the individual and, at least in the case of incarceration and most fines imposed on individuals, would not be transferable to the corporation. This disparate allocation of benefits to the firm and risks to the individual would logically cause top corporate officials to eschew criminal conduct for corporate gain.7

But this may only be part of the agency picture in large firms. If top corporate managers are risk adverse concerning corporate crime, this may only cause executives to adopt management styles that distance the executives from illegal activities or that minimize the monitoring of those activities to avoid acquiring culpable knowledge of them, rather than encouraging executives to stop illegal conduct or to manage subordinates in ways that avoid such conduct. Indeed, practices distancing themselves from offenses at lower levels put top executives in somewhat the same position as the corporate shareholders just discussed. Top managers will typically receive performance rewards associated with organizational profits achieved through illegal efforts by subordinates. However, assuming the personal culpability of top executives in connection with lower-level offenses cannot be shown, all of the risks of criminal penalties fall on subordinates or, perhaps, the corpora-

7 See id. at 322-324.
tion as a whole. Thus, once again, the relationship between corporate shareholders and top firm managers appears to impose few constraints on overall levels of corporate crime, although it may drive many instances of such crime downward in corporate hierarchies.

[2]—Operating Employees as Law Enforcement Agents of Corporate Principals

In large corporate organizations, day-to-day corporate operations are undertaken by large numbers of employees and managers at low levels in corporate hierarchies. These individuals are collectively referred to here as “operating employees.” These operating employees carry out the affairs of the corporation in accordance with policies, practices, and instructions defined by higher level corporate managers.

In defining operating policies and practices and in evaluating resulting performance by operating employees, corporate managers have opportunities to shape the agency relationships between corporate employees and their companies in ways that further law compliance. Managers can achieve this by directing and evaluating law compliance by subordinates and by creating incentives promoting lawful conduct in corporate operations. If these sorts of actions are taken, the agency relationships between corporate principals (as represented by the efforts of corporate managers) and employees acting as corporate agents are further possible sources of constraints on illegal corporate conduct. Unfortunately, certain features of corporate management processes tend to frustrate the crime prevention aspects of relationships between corporations and their employees.

Managers use various types of performance measurement practices and incentive plans to monitor and administer performance rewards for operating employees. Often, the emphasis in these monitoring and reward systems is on the contribution an employee has made to corporate profits, either in terms of increased profits or reduced costs. Corporate managers craft information systems and reward practices to make this linkage between corporate profit contributions and employee rewards as strong and clear as possible.

The net effect of closely monitoring profit contributions and granting associated corporate rewards is that the personal interests of operating employees are often strongly aligned with the short-term profitability of their firms. Hence, operating employees may see a significant personal advantage in crimes committed to realize short-term corporate gains. Unfortunately, the legitimate means many firms use to encourage employees to see a personal stake in corporate business profits and success also have the unavoidable side effect of giving employees a personal stake in profitable corporate crimes.

Another aspect of the relationship between operating employees and higher level managers may also encourage corporate crime. This has to do with the monitoring of performance by operating employees and the relative ease with which different aspects of employee performance can be perceived and evaluated. Even if firm managers want their subordinates to pursue corporate profits only through lawful means and are willing to monitor both the
profitability and legality of employee efforts, the relative ability of managers to examine and evaluate these two aspects of employee performance will tend to cause operating employees to strive more for profits than for lawful performance. Where two features of a single object or activity are measurable with different accuracy or ease, providers of that object or activity tend to compete in terms of the more easily monitorable feature and interested persons tend to evaluate the quality of the object or activity in terms of this easily measured feature. The result is a system in which evaluating parties are intensely interested in a certain facet of an object or activity and competition to improve that facet is equally intense. At the same time, features that are less accurately monitored receive less attention in evaluations and product or activity improvements.

This type of system will eventually reach a form of "lemons equilibrium," so named because, when consumers focus on price and give less attention to product quality, the market involved stabilizes into a pattern of competition between defective products—that is, an equilibrium of competition among lemons. Translated into the context of corporate crime, the competition between potential candidates for promotions and performance rewards within corporate organizations may produce a lemons equilibrium in which the profit-oriented performance of various employees is the focus of selection and reward processes (and, consequently, the object of concerted efforts by potential candidates for advancement), and the law compliance performance by the same employees is relatively neglected. Only the most egregious misconduct, such as an offense detected by public authorities, will gain managers' attention and disqualify an employee for advancement. Put another way, this system is one in which profit makers rise to the top, almost regardless of their attitudes or performance with respect to law compliance. The implications of this sort of agency process in heightening corporate crime risks are obvious.

[3]—Corporate Managers as Agents of Law Enforcement Officials

Recent changes in prosecutorial and sentencing processes within the federal criminal justice system have created another private agency process constraining and deterring corporate crime. In order to share investigative burdens and draw on the superior ability of corporate managers to detect corporate crimes, federal law encourages corporate managers to carry out law enforcement functions concerning offenses by corporate employees. For example, federal sentencing standards provide large sentencing rewards to firms that undertake law enforcement actions such as adopting law compliance systems for detecting internal misconduct, reporting detected offenses to public authorities, cooperating with law enforcement officials' investigations of misconduct by corporate agents, and aiding in official investigations

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8 See Thompson, "Why Do We Need a Theory of Corporate Responsibility?" in Shame, Responsibility, and the Corporation, 113, 122 (1986).
9 See id.
of criminal acts by other corporations or by individuals who are not corporate agents.

This shifting of law enforcement functions to corporate managers and employees is seen by some observers as a means to "subcontract" government's law enforcement duties to more cost-effective parties than public officials.\(^{10}\) The policy decision to encourage these sorts of privately pursued law enforcement measures can be viewed as a sort of "make or buy" decision regarding criminal law enforcement in corporate settings. Reliance on law enforcement processes within corporations will be an appropriate means to "buy" such enforcement from private parties if public agencies cannot monitor, detect and investigate illegal corporate conduct more efficiently than by obtaining equivalent enforcement efforts from firms through sentencing rewards. The propriety of this choice turns on whether public authorities can effectively administer agency relationships with corporations concerning law enforcement functions and whether proper performance of law enforcement functions in corporate organizations can be achieved without direct governmental control over those functions.

The new emphasis on internal enforcement of criminal laws by corporate personnel may also reflect an attempt to realize specialization efficiencies. Corporate managers acting in law enforcement capacities can utilize their background knowledge of corporate operations and the specific requirements of legal standards in the settings of their firms. These kinds of knowledge, coupled with the ability of corporate managers to use internal resources to determine the nature of employee conduct and to discipline and deter misconduct, are likely to make corporate managers more efficient and effective as law enforcement specialists within their organizational spheres than external generalists seeking to promote corporate law compliance (\textit{i.e.}, law enforcement officials with broader ranges of enforcement targets) would be. If this is the case, reliance on corporate managers for some law enforcement functions should achieve greater corporate law compliance than comparable external efforts.

§ 1.09 Measuring Corporate Crime

Corporate crime levels are difficult to measure. Criminal conduct in normal corporate business activities is often hard to identify.¹ This is particularly true in large corporate organizations where knowledgeable organization members typically have loyalties to the organizations or to fellow employees that encourage silence about corporate offenses. Therefore, total levels of corporate crime are probably significantly greater than reported levels.

Existing estimates of the detection rates for various types of corporate offenses are sketchy. Detection rates are probably low for many types of corporate offenses that involve types of damage which are not immediately traceable to corporate defendants. For example, the Justice Department estimates that only roughly one in ten antitrust offenses is detected and prosecuted.² If this estimate is correct, antitrust offenses are about an order of magnitude more prevalent than the number of offenses detected and prosecuted by public authorities. This degree of undercounting probably does not carry over to other sorts of corporate offenses—such as those leading to the Exxon Valdez oil spill—that produce extensive, unconcealable consequences. These consequences are frequently investigated, thereby leading to detection of the underlying offenses at a high rate.³ However, many types of corporate fraud and other commercial misconduct involve concealed harm mechanisms like those involved in antitrust offenses. Hence, they are likely to be as poorly detected as antitrust offenses. As a result, measurements of corporate crime based on corporate convictions probably only describe a small fraction of illegal corporate activities. Nonetheless, analyses of corporate convictions paint at least a partial picture of corporate crime.

¹ See, e.g.: UPI, Sept. 18, 1985, available in LEXIS/NEXIS Library, Omni File (observation by Attorney General Edwin Meese that economic crime is “extremely difficult to detect” and often goes unreported); Coffee, “No Soul to Damn: No Body to Kick, An Unscandalized Inquiry into the Problem of Corporate Punishment,” 79 Mich. L. Rev. 386, 394 & n.27 (1981) (noting the difficulty of estimating rates of white-collar crime in light of the likelihood that some victims are unaware of their injuries).

² Statement of Douglas H. Ginsburg, Assistant Attorney General, Department of Justice Antitrust Division, in Testimony before the United States Sentencing Commission, July 15, 1986, quoted in Cohen & Scheffman, “The Antitrust Sentencing Guideline: Is the Punishment Worth the Costs?” 27 Am. Crim. L. Rev. 331, 342 (1989). This estimate was apparently based on an evaluation of the failure of public authorities to detect many antitrust conspiracies for decades. Id. at 347 n.71. However, some commentators have questioned the empirical basis for this estimate. See id. Other estimates have placed the rates of detection of regulatory and business crimes at one in three to one in four. See Parker, “Criminal Sentencing Policy for Organizations: The Unifying Approach of Optimal Penalties,” 26 Am. Crim. L. Rev. 513, 578-580 (1989).

§ 1.09[1] CORPORATE CRIMINAL LIABILITY

[1]—Broad Range of Affected Firms

Surveys of corporate convictions have found a broad range of convicted corporations among the nation’s largest firms. For example, a study by the editors of Fortune magazine found that 11% of the 1,043 large companies they surveyed committed serious offenses over a ten-year period. An earlier study completed by noted criminologist Edwin Sutherland found that 60% of the seventy large firms he studied were convicted of criminal offenses over a forty-year period, with an average of four convictions per firm. In a more narrowly focused evaluation following extensive self-reporting of foreign payment offenses by large companies, SEC Chairman Roderick Hills concluded in 1976 that fifty-five of the nation’s 500 largest industrial firms may have made unlawful foreign payments to obtain business or political gains.

Business managers observe the same patterns from inside large firms. In a survey of the presidents of Fortune magazine’s top 1,000 firms, 60% of the respondents agreed with the assertion that many persons engage in price-fixing in American businesses. In another poll, three-fifths of corporate executives said that young business managers would commit unethical acts to exhibit their loyalty to superiors.

[2]—Federal Offenses

Studies performed for the U.S. Sentencing Commission by Vanderbilt University Professor Mark A. Cohen provide a clear picture of corporate convictions and sentences in federal courts. These studies describe the types

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4 Ross, “How Lawless Are Big Companies?” Fortune, p. 56-57 (Dec. 1, 1980). These crimes included bribery, criminal fraud, illegal political contributions, price-fixing, and bid-rigging. Id.
5 Sutherland, White-Collar Crime, 23 (revised ed. 1983).
7 Green et al., The Closed Enterprise System, 472 (1972).
8 Nader et al., Taming the Giant Corporation, 31-32 (1976).
of offenses targeted in corporate prosecutions, the sanctions imposed, and some characteristics of the convicted firms.

[a]—Types of Offenses Prosecuted

Most corporate prosecutions by federal authorities in 1988—the last year for which Cohen completed extensive studies—concerned the following types of offenses:\(^{10}\)

<table>
<thead>
<tr>
<th>Offense</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antitrust</td>
<td>29.9%</td>
</tr>
<tr>
<td>Government Procurement Fraud</td>
<td>18.5%</td>
</tr>
<tr>
<td>Environmental Crimes</td>
<td>9.0%</td>
</tr>
<tr>
<td>Government Program Fraud</td>
<td></td>
</tr>
<tr>
<td>(Medicare Fraud, etc.)</td>
<td>5.9%</td>
</tr>
<tr>
<td>Export Violations</td>
<td>5.5%</td>
</tr>
<tr>
<td>Commercial Fraud</td>
<td>4.6%</td>
</tr>
<tr>
<td>Tax Crimes</td>
<td>4.3%</td>
</tr>
<tr>
<td>Consumer Fraud</td>
<td>3.7%</td>
</tr>
<tr>
<td>Property Crimes</td>
<td>3.4%</td>
</tr>
<tr>
<td>Food &amp; Drug Offenses</td>
<td>2.7%</td>
</tr>
<tr>
<td>Currency Reporting</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

This breakdown suggests that firms are most at risk of federal criminal liability arising out of dealings with the federal government. A total of 40% of all corporate defendants convicted in 1988 were prosecuted to further the policing of government functions.\(^{11}\) Another 38.2% of corporate prosecutions concerned the commercial activities of defendant firms,\(^{12}\) with antitrust offenses as the major focus. Only the relatively small fraction of prosecutions for environmental crimes (9.0%) and food & drug violations (2.7%) concerned offenses directly threatening public health and safety.

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\(^{10}\) See Cohen, “Empirical Trends in Corporate Crime and Punishment,” 3 Fed. Sent. Rep. 121 (1990). An additional 9.9% of corporate defendants were prosecuted for a variety of types of offenses. Id. An earlier study of corporate prosecutions between 1984 and 1987 identified corporate prosecutions for the following types of offenses in addition to those mentioned in the text (numbers in parentheses are percentages of total corporate defendants): Motor Carrier Act violations (3.0%); conservation and wildlife offenses (1.9%); offenses involving the administration of justice (0.8%); mine safety offenses (0.6%); drug offenses (0.4%); immigration violations (0.3%); obscenity offenses (0.5%); election law offenses (0.1%); gambling offenses (0.8%); and offenses involving obstruction of the mails (0.1%). See Cohen, “Organizations as Defendants in Federal Courts: A Preliminary Analysis of Prosecutions, Convictions and Sanctions, 1984-1987,” 10 Whittier L. Rev. 103, 114 (1988).

\(^{11}\) This includes prosecutions for government procurement fraud, government program fraud, export violations, tax crimes, property crimes, and currency reporting.

\(^{12}\) This includes prosecutions for antitrust, commercial fraud, and consumer fraud.
Corporate defendants fared poorly once named in federal prosecutions. The conviction rate in 1988 was about 75%, while approximately 15% of the corporate defendants had their cases dismissed before trial and another ten percent were acquitted. Most of the corporate convictions resulted from guilty pleas. Such pleas produced 83% of the corporate convictions, with another 5% resulting from *nolo contendere* pleas and only 12% resulting from guilty verdicts following trials.

[b]—Sanctions Imposed

Statutory changes in maximum corporate fines during the mid-1980’s and the issuance in 1991 of the U.S. Sentencing Commission’s sentencing guidelines for organizational offenders have produced significant increases in corporate fines. According to one study, “criminal fines and total sanctions are significantly higher in cases constrained by the Guidelines than they were prior to the Guidelines. Controlling for other factors, criminal fines in cases constrained by the Guidelines are almost five times their previous levels.” Total sanctions for organizational offenses (which include criminal fines and non-fine sanctions, such as restitution payments, civil and administrative penalties, and private civil liability awards) are also significantly higher, with the percentage increase being about half that for criminal fines. In fiscal 2001, the average fine imposed by federal courts for an organizational offense was $2,154,929. For antitrust offenses, the average organizational fine was even larger. The average antitrust fine was $20,980,184.

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14 *Id.*
15 Increased corporate fines for most federal offenses were authorized under the Criminal Fines Enforcement Act of 1984, Pub. L. No. 98-596, 98 Stat. 3134. The Act increased the maximum penalty for corporate offenders to $100,000 per misdemeanor not resulting in death and $500,000 per felony or per misdemeanor resulting in death. It provided for an alternative maximum fine of twice the pecuniary gain or loss associated with an offense. *Id.* § 6 (codified at 18 U.S.C. § 3571(c) (1988)). Statutory maximum fines for corporate offenders were further increased by the Criminal Fines Improvement Act of 1987, Pub. L. No. 100-185, 101 Stat. 1279. That Act increased the maximum fine for misdemeanors not resulting in death to $200,000. *Id.*, § 6 (codified at 18 U.S.C. § 3571(c)(5) (1988)).
18 U.S. Sentencing Commission, *Sourcebook of Federal Sentencing Statistics* (2001) (Table 52). The average total sanction, taking into account both organizational fines and compelled restitution payments, was $3,345,169. *Id.*
19 *Id.*
large average fines included fraud offenses ($1,900,357), tax offenses ($1,416,802), water pollution offenses ($744,863), and toxic materials offenses ($568,299). The above figures probably do not adequately reflect the severity of fines imposed on larger firms. In a detailed evaluation of seventeen large firms sentenced for non-antitrust offenses during 1989-1990, Professor Cohen found an average fine of $1,581,256. The total sanction for these firms, including all government-imposed sanctions such as criminal fines, restitution payments, administrative penalties, state criminal and civil fines, and cleanup costs, amounted to an average of $5,316,268. Further private settlements with individual victims added average outlays of another $3,235,304, for a total average cost to each defendant organization of $8,551,572.

In evaluating the impact of criminal fines on corporate offenders generally, Cohen concluded that fines are only one part of the total costs imposed on convicted firms. A criminal fine represented, on average, about 31% of the total sanction imposed on defendant firms in 1988. Voluntary and court-ordered restitution accounted for another 31%, administrative settlements and penalties accounted for 28%, and forfeitures, seizures, and other court-ordered sanctions accounted for the remaining 10 percent. Furthermore, corporate convictions were often followed by disqualifications from subsequent government contracting. Debarments and suspensions were imposed in about 25% of government procurement cases and 20% of government program fraud cases.

[c]—The Relationship Between Corporate and Individual Prosecutions

Corporate prosecutions are sometimes but not always accompanied by prosecutions of the individuals who were responsible for the corporate offenses alleged. A study of federal prosecutions from 1984-87 showed that corporate prosecutions were almost evenly split between joint prosecutions of individual and corporate defendants and prosecutions of corporations alone. Among the corporate prosecutions, 48.8% involved no individual co-defendants, 23.8% involved one individual co-defendant and 27.4% involved multiple individual co-defendants. The near majority of cases in which no individuals were prosecuted may be explained by any one of three underlying processes. First, prosecutors may be bringing substantial numbers of corporate cases in which

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20 Id.
23 Id.
24 Id.
organizational liability is based on the collective knowledge and action of multiple corporate employees even though no single employee committed an offense. Such a pattern would be significant, since this type of liability based on the collective knowledge and action represents a form of criminal liability that is unique to organizational actors. Second, prosecutors may be choosing to pursue only corporate principals even though they have the further option to prosecute the individual corporate agents who committed the offenses involved. If this is the case, the frequency of corporate prosecutions involving no individual defendants may reflect evaluations that organizational policies, practices and procedures account for the corporate offenses, rather than the modestly culpable misconduct of individual corporate employees. Third, the large numbers of cases involving only corporate defendants may reflect plea bargaining by corporations to protect key individuals within firms—i.e., the willingness of firms to plead guilty to certain charges if charges against individuals involved in misconduct are withheld.26

Further breakdowns of prosecutions of corporate and individual defendants suggest that prosecutors allocate responsibility for offenses differently for various types of offenses. Prosecutions of corporate defendants only (without parallel prosecutions of corporate employees responsible for the offenses involved) predominate for some types of offenses, perhaps indicating that prosecutors feel that corporate policies and practices often play primary roles in causing these offenses and that individual corporate agents lack sufficient culpability to merit individual prosecution. For example, prosecutions pursuing only corporate defendants are particularly common for regulatory reporting offenses (62.0% of prosecutions involving reporting offenses versus 48.8% for all prosecutions).27 They are also higher than average for environmental crimes (55.6%).

[d]—Prosecutorial Discretion

Charging decisions by prosecutors play important roles in determining the scope of corporate criminal convictions. In the federal system, most corporate charging decisions are made by Assistant U.S. Attorneys located in field offices in federal judicial districts throughout the country. A study of federal prosecutorial discretion conducted by the author and Professor John C. Coffee, Jr. of the Columbia University School of Law has described some of the important features of the charging decisions of these federal prosecutors. The study utilized computerized records maintained by the Justice Department to

26 This type of agreement by a firm to plead guilty to criminal charges in exchange for the government’s agreement not to prosecute individuals involved in a crime is sometimes called a “Westinghouse plea” because it was used to resolve charges against that firm and its employees. See Stewart, *The Prosecutors*, 36 (1987). More recently, this type of plea has been used to shield top corporate executives from embarrassing prosecutions and testimony. See id. at 83 (describing the use of a Westinghouse plea to shield the son of McDonnell Douglas’s chairman and three other individuals from RICO charges).

track the work of Assistant U.S. Attorneys. These records described the handling of criminal matters—defined by the Justice Department as including all investigations on which an Assistant U.S. Attorney spent at least one hour whether or not a case was later filed. The study found that a large fraction of criminal matters considered by Assistant U.S. Attorneys concerned types of crimes often committed in corporate settings. Indeed, white-collar crimes comprised the largest single category of investigations in fiscal 1983, the last year for which data was examined in the study. White-collar offenses (including various types of fraud) accounted for 21% of all investigations, compared with only 9% for drug dealing offenses. Investigations related to government regulatory offenses comprised another 5% of the total, interstate theft investigations comprised 3% and thefts of government property comprised 1 percent. These percentages do not reflect additional antitrust cases handled by prosecutorial staffs outside the U.S. Attorney field offices.

Prosecution rates for these types of offenses indicated that many investigations by Assistant U.S. Attorneys developed into formal charges. By tracking investigations over a four-year period, the study determined the ultimate disposition of new investigations. White-collar crime investigations produced criminal prosecutions 50% of the time, with another 10% receiving other punitive or remedial dispositions including civil sanctions. Of the remaining white-collar crime investigations, 34% were closed out without charges and another 6% were still pending after four years. Prosecution rates for particular types of crimes committed by corporate employees were even higher, including high prosecution rates for government regulatory offenses (82%), interstate theft (55%), and theft of government property (59%).

An examination of the prosecutorial practices in the six U.S. Attorney field offices with the highest numbers of white-collar crime prosecutions showed different prosecution patterns from office to office. This analysis focused on U.S. Attorney field offices in Brooklyn, Chicago, Los Angeles, Manhattan, Miami, and San Francisco. White-collar crime prosecution rates for these offices were generally higher than the national average, suggesting a greater interest or expertise concerning white-collar cases in these large offices. However, prosecution rates varied considerably from office to office. White-collar crime prosecution rates for cases initiated within one year after starting an investigation ranged from 49% of all white-collar crime investigations in Brooklyn, 43% in Los Angeles, 39% in Manhattan and 29% in Miami to 18% in Chicago and fifteen percent in San Francisco. These figures suggest that significant differences exist in the aggressiveness or prosecutorial standards applied to white-collar cases in these different U.S. Attorney field offices.

§ 1.09[3] CORPORATE CRIMINAL LIABILITY

[3]—State Offenses

Corporate prosecutions in state courts have not been studied as carefully as federal prosecutions. However, a survey of prosecutions initiated by District Attorneys in California probably provides a roughly accurate picture of the types of corporate crime prosecutions being brought by state authorities nationwide.\(^{29}\) In this survey, forty-five of California’s fifty-eight District Attorneys described prosecutions of corporate crime in their offices from 1982 to 1987. For purposes of this study, a corporate crime was “any violation of an existing criminal statute by corporate entities and/or by individual business executives that are committed on behalf and for the benefit of a corporation (or any other form of business association, such as a partnership).” While this definition of corporate crime extended the study to some individual prosecutions, under standards for corporate criminal liability in California and most states, these crimes committed by individuals for corporate benefit were ones that probably would have supported corporate criminal liability had prosecutors chosen to target the corporations involved. Thus, this study identifies the types of offenses that are likely candidates for corporate prosecutions by authorities in California and other states.

For purposes of this study, District Attorneys were asked to describe their levels of corporate prosecutions within numerical ranges. The descriptions of the study’s results here take a conservative view of the results and assume that actual levels of corporate prosecutions were at the lower ends of each of the ranges reported. Overall, the study identified a total of 411 corporate crime prosecutions. These were mostly for financial crimes (53%), with a substantial component of environmental offenses (36%) and workplace safety crimes (10%).

Most of these prosecutions were apparently concentrated in a few District Attorneys’ offices. Over the five years covered by the study, many offices reported ten or fewer corporate crime prosecutions in some crime categories. Sixty-two percent of the offices reported ten or fewer prosecutions for corporate financial crimes, 81% reported this few environmental crime prosecutions, and 98% reported this few workplace safety prosecutions. Most of the corporate prosecutions were concentrated in offices reporting relatively large numbers of corporate prosecutions. Eighty-one percent of all financial crime prosecutions were in sixteen offices reporting ten or more, 59% of the environmental crime prosecutions were in eight offices reporting ten or more, and 26% of the workplace safety prosecutions were in a single office reporting ten or more. This paints a picture of an elite group of prosecutors, presumably in the state’s large urban centers, who account for most corporate crime prosecutions under California laws.

Several additional studies of state prosecutions confirm that corporate crime is a high priority among local prosecutors. In a survey of 419 District

\(^{29}\) This study is described in California Department of Justice, N. 28 \textit{supra}, at 53-59; Benson et al., "District Attorneys and Corporate Crime: Surveying the Prosecutorial Gatekeepers," 26 Criminology 505 (1988).
Attorneys by the National Institute of Justice, most state prosecutors indicated that their offices had commenced a corporate prosecution within the prior year.\(^{30}\) The majority of these cases involved economic crimes, with nearly half of the respondents indicating that their offices had initiated at least one consumer fraud case and a third reporting that they had initiated at least one false claim or insurance fraud case. Environmental offense prosecutions were also common, with 31% of the District Attorneys responding indicating that their offices had commenced such an action.

Many of the respondents in this survey felt that corporate prosecutions are on the rise. Over 25% observed that corporate prosecutions had increased during their tenure in office. About 25% felt that this trend would continue, while only 1% predicted a decrease in such cases.\(^{31}\)

State prosecutors cite deterrence as the main rationale for their emphasis on corporate prosecutions. Corporate prosecutions are viewed as a means to achieve widespread deterrence at a minimum cost in an era of increasingly scarce prosecutorial resources.\(^{32}\) In the words of one prosecutor:

> I’ve prosecuted maybe 50 murders, and I’ve never deterred a street murder. I’ve... prosecuted one industrial murder, and I think we’ve deterred a whole lot of people... So even with a lack of resources, one corporate prosecution is much more valuable than one street crime prosecution.\(^{33}\)

A further study of state prosecutors’ attitudes confirmed that deterrence of corporate crimes is a high priority, but that state prosecutors’ assessments of appropriate corporate indictments and penalties are influenced by the scope of voluntarily initiated corporate law compliance efforts.\(^{34}\) Fifteen of sixteen state Attorneys General responding to a survey of state prosecutors’ practices\(^{35}\) indicated that corporate law compliance programs would influence prosecutors not to indict firms with such programs, but instead to pursue misconduct as a regulatory violation.\(^{36}\) In addition, many of the Attorneys

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\(^{31}\) *Local Prosecutors and Corporate Crime*, N. 30 supra, at 1-2.


\(^{33}\) *Id.* at 5.


\(^{35}\) While sixteen Attorneys General responded substantively, twelve additional Attorneys General indicated that they could not provide substantive responses to the survey insofar as office policies prohibited comment on any potential enforcement action. *Id.*

\(^{36}\) Nine state Attorneys General (from Arkansas, Illinois, Minnesota, Nebraska, Nevada, New Hampshire, North Dakota, Oregon, and Wyoming) stated that the
General reported that corporate law compliance measures would affect the severity of penalties sought when corporations are indicted.

[4]—Economic Crime Patterns

In a study of economic crime patterns completed in 2005, the PricewaterhouseCoopers consulting firm found fraud and other economic crimes to be important and growing problems for companies across the globe.37 PricewaterhouseCoopers based its analyses on 3,634 interviews with senior executives in 34 countries. The executives contacted included a large component of respondents (52%) who were members of their companies’ executive boards. Many of these executives (43%) were responsible for financial aspects of their companies’ performance. This section summarizes these executives’ perceptions of economic crimes affecting their corporations, as collected and analyzed in the PricewaterhouseCoopers study.

[a]—Crime Levels

The 2005 crime survey found that 45% of the companies surveyed reported being subject to one or more significant economic crimes during the previous two years. This reflected an eight percentage point increase over levels found in a previous 2003 survey. Increased fraud levels were found in every region. In most regions, the fraction of companies reporting significant fraud incidents in 2003-2005 was between 40% and 50%. The exception was in Africa, where 77% of companies reported fraud incidents.

These levels of economic crimes reflected dramatic increases over 2003 levels in certain regions. In Western Europe, the fraction of companies reporting fraud increased thirteen percentage points, while in Central & Eastern Europe the increase was twenty-one percentage points. PricewaterhouseCoopers analysts attributed these increases to a number of factors, including 1) elevated amounts of fraud being committed, 2) the tightening of market regulations in many countries and a resulting increase by companies in their efforts to demonstrate regulatory compliance and good governance by reporting more incidents of fraud, 3) the introduction of more stringent controls and risk management systems enabling companies to detect more incidents of fraud, and 4) a decrease in the stigma attached to reporting fraud to regulators and other public officials.

Larger companies were particularly prone to incidents of fraud according to the PriceWaterhouseCoopers study. While only 36% of the small companies surveyed reported suffering from an incident of fraud in the two years preceding the study, 62% of large companies reported fraudulent activities during the same period. For purposes of the study, “small companies” included those with less than 200 employees nationally and “large companies” were those with more than 5000 employees nationally.

The study’s authors attributed the susceptibility of large companies to fraud to such factors as 1) greater opportunities for fraud in large companies due to the anonymity and unaccountability of employees in the larger and more complex organizations of large companies and the tendency of employees in these settings to view fraud as “victimless crimes,” 2) the number and complexity of transactions undertaken in large companies, 3) better fraud detection systems in larger companies which increase their chances of detecting fraud, and 4) increased legal standards and threats associated with the international operations found in many large companies. Large companies reported that, despite the sophistication of fraud prevention systems and other control practices, the complexity of their organizations and the extent of their business activities meant that they still had insufficient controls in place, leading to a high number of fraud incidents.

The stability of the companies surveyed and their business surroundings also appeared to influence their levels of fraud incidents. The survey authors felt that this phenomenon reflected the adage that “opportunity makes the thief.” They found that where company executives considered their firms to be in a dynamic period of change, their companies were 20% more likely to suffer fraud than were companies in which their executives perceived themselves as being in a stable period.

The crime survey found substantial levels of fraud incidents across various industries and in both regulated and unregulated contexts. Percentages of companies reporting fraud in particular industries were as follows: retail & consumer (60%), financial services (50%), telecommunications (47%), chemical (46%), services (45%), construction (43%), energy (including mining and utilities) (42%), pharmaceuticals and biotech (42%), automotive and aerospace (41%), manufacturing (41%), and technology (38%).

[b]—Types of Crimes

Companies reporting incidents of fraud and other economic crimes suffered an average of eight incidents over the two years covered by the Price-WaterhouseCoopers study. The most commonly reported crimes involved asset misappropriation (with 62% of the companies surveyed reporting at least one such incident) and false representations offenses (47%). In part, the high levels of these sorts of offenses reported by companies may be related to the fact that these offenses are among the easiest types of fraudulent behavior to detect because they involve the taking of items with a defined value. Other types of crimes which were reported by a substantial fraction of the companies surveyed included financial misrepresentation offenses (24%), corruption and bribery (24%), insider trading (4%), money laundering (7%), and counterfeiting, including counterfeit product marketing (25%).

(Rel. 7)
Incidents of corruption and bribery showed regional variations. These offenses were most commonly reported in the countries within South & Central America, Africa, and Asia-Pacific. The authors of the study speculated that, within the developing economies of many of these countries, corrupt practices may be more often be viewed as accepted practices in conducting business than in countries with more developed economies. In contrast, companies in the more developed and regulated regions of North America and Western Europe did not report high levels of corruption & bribery but did report substantial levels of financial misrepresentation.

[c]—Victim Losses

If they were the victims of “tangible frauds” such as asset misappropriation, false representation, or counterfeiting offenses, corporations in the PriceWaterhouseCoopers study were asked to characterize the amounts of their losses. These types of crimes caused average losses of $1,732,253 between 2003 and 2005 to each of the companies that reported loss figures. This amounts to total losses by the companies surveyed of in excess of $2 billion.

More than 10% of the small companies reporting loss figures indicated that they had lost more than $1 million in the two years covered by the study. In addition, 6% of large companies reporting fraud losses revealed that they had lost in excess of $10 million through asset misappropriation, false representation, and counterfeiting offenses.

[d]—Civil and Criminal Penalties

Fraud offenses and other economic crimes which are undertaken by corporate employees for corporate benefit can produce substantial fines and other penalties for their companies. Civil penalties imposed by regulators, particularly those imposed for securities fraud and other violations of securities laws, can have a crippling impact on the finances of the companies involved. A survey by PricewaterhouseCoopers of litigation initiated by the United States Securities and Exchange Commission (SEC) in 2004 found that 120 accounting-related securities litigation cases were filed against companies having stock registered on United States exchanges. Twenty of these cases also involved some form of criminal investigation, usually by the federal Department of Justice (“DOJ”). These levels of penalty-oriented securities cases and criminal investigations followed several years of actions by regulators and prosecutors at similar levels. PricewaterhouseCoopers found that accounting fraud formed the basis for 117 SEC suits and fifteen criminal investigations in 2003, 161 SEC actions and forty-three criminal investigations in 2002, and 107 SEC suits and thirteen criminal investigations in 2001.

Penalties resulting from these types of legal actions are on the rise. According to a PricewaterhouseCoopers survey of SEC and DOJ civil and criminal litigation:

“In 2004 SEC and DOJ civil and criminal money penalties and disgorgement sanctions reached all-time highs. Yet, one SEC Commissioner has remarked that the SEC will consider imposing even higher amounts
of penalties in future settlements! During fiscal 2004, some of the more impressive amounts of penalties and disgorgement sanctions imposed by the SEC and/or the DOJ included: the $2.25 billion penalty, the largest in the SEC’s history, against WorldCom; $388 million of restitution penalties—paid to a “Fair Funds for Investors” account—in a combination of cash and company securities, imposed on Computer Associates International; $120 million in penalties levied against Royal Dutch Shell; and other substantial fines and penalties imposed on, among others, Merrill Lynch, Deutsche Bank Securities, Bristol-Myers Squibb, Gemstar—TV Guide International, Symbol Technologies, and Lucent Technologies. As the SEC and DOJ ratchet up the fines, penalties and disgorgement sanctions imposed against companies and individuals, the private securities litigation plaintiffs bar, and private securities class action plaintiffs (including institutional lead plaintiffs) take heed and factor such information into their own settlement demands.”

[e]—Collateral Damage

A substantial portion of the firms reporting incidents of fraud and other economic crimes in PricewaterhouseCoopers’ 2005 study reported substantial collateral damage to their firms from these crimes. A full 40% of the respondents reported significant collateral damage to their firms from economic crimes beyond the direct damage associated with financial losses and offense penalties. Among those firms suffering collateral damage, the types of damage reported included adverse impacts on the companies’ brand reputation (43%), business relations (42%), and staff morale (54%).

Smaller companies suffered greater collateral damage from offenses than larger ones. Among small companies, 51% reported significant intangible damage compared with 39% of larger companies. The authors of the PricewaterhouseCoopers study felt that the large impact of fraud on smaller firms was unsurprising because “[w]ith a smaller work force and client base, a negative reaction from either of these segments in response to a fraud, combined with its impact upon the brand and reputation, can have a critical—and sometimes fatal—effect on the business.” As to types of crimes tending to cause serious collateral damage, firms cited insider trading (62%), corruption and bribery (49%), and counterfeiting (49%) offenses. The authors of the PricewaterhouseCoopers study saw somewhat different reasons for the large size of the collateral damage from these three types of offenses, reasoning that:

40 Id. at 12.
“In the case of insider trading, this is not surprising since it damages the integrity of a company and those involved in its financing.

“The high level of damage associated with corruption & bribery is also not surprising, given the intense recent media coverage in this area.

“As for counterfeiting, any company can face serious threats to its brand and its business relations if fake goods enter the marketplace—but this can be particularly damaging to those companies involved in the manufacture of products with health and safety implications.”

Other types of offenses identified by companies as causing collateral damage included financial misrepresentations (44%), false statements offenses (41%), asset misappropriation offenses (32%), and money laundering (15%).

In general, most companies reported that greater collateral damage resulted from incidents of fraud that became the focus of media attention and public concern than from fraud which only became known to the limited community of a company’s business partners and clients. This suggests that companies affected by internal misconduct may be more concerned about collateral damage due to heightened regulatory pressures and weakened investor support following widely publicized misconduct than about the loss of future business opportunities due to increased mistrust on the part of business partners and clients who learn about less broadly publicized misconduct.

[5]—Case Study: Financial Consequences of the BP Oil Well Blowout

The financial consequences to BP PLC (BP) of corporate offenses associated with the oil well blowout and subsequent oil spill at BP’s Deepwater Horizon drilling platform in the Gulf of Mexico illustrate the enormous financial costs to corporations that can be at stake in incidents of corporate crime. The blowout, oil spill, and subsequent false statements by BP resulted in charges against BP by both the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). In late 2012, the company reached agreements with both federal agencies resolving these charges. The agreements called for payments by BP totaling $4 billion to resolve the criminal charges brought by the DOJ and an additional $525 million to resolve charges brought by the SEC. The company was also suspended from

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[41] Id. at 13.


receiving future federal contracts until such time as federal contracting officials were convinced that BP could serve as a responsible federal contractor,\footnote{See Letter from Richard A. Pelleter, EPA Suspension and Debarment Official to Robert Dudley, Group Chief Executive, British Petroleum PLC (Nov. 28, 2012), available at http://www.corporatecrimereporter.com/wp-content/uploads/2012/11/bpdebar.pdf (letter notifying BP of debarment) (last visited on Dec. 21, 2012); EPA, News Release: “BP Temporarily Suspended from New Contracts with the Federal Government” (Nov. 28, 2012), http://yosemite.epa.gov/opa/admpress.nsf/d0cf6618525a9ef885257359003fb69d/2aaf1c1dc80c969885257abf006d9fb0!OpenDocument (last visited on Dec. 21, 2012).} threatening the company with large future reductions in federal contract payments. These government-induced financial consequences do not take into account further amounts paid to compensate victims of physical and economic injuries following the oil well blowout.

The company’s own accounting of the projected financial consequences of the criminal misconduct and resulting blowout suggested that the costs would be staggeringly large and potentially injurious even for an enormous company such as BP. In a public statement following its resolution of criminal and SEC charges in November 2012, BP summarized the overall financial hardships to the company as follows:

The aggregate amount of the resolution is approximately $4.5 billion, with payments scheduled over a period of six years. As of the end of September 2012, BP’s financial statements recorded a charge taken against pre-tax income in relation to the accident and oil spill of $38.1 billion. This charge included $525 million provided for the SEC settlement. Today’s resolution is expected to result in an increase of approximately $3.85 billion to the $38.1 billion charge taken against income as of the end of September. BP’s financial statements as of the end of December 2012 will reflect this additional charge, as well as any other adjustments arising during the fourth quarter. It is anticipated that the cash outflows can be met within BP’s current financial framework.”\footnote{BP PLC, Press Release: “BP Announces Resolution of All Criminal and Securities Claims by U.S. Government Against Company Relating to Deepwater Horizon Accident” (Nov. 15, 2012), available at http://www.bp.com/genericarticle.do?categoryld=2012968&contentId=7080497 (last visited on Jan. 5, 2013).}

Adding the two charges noted in this statement produced a total projected loss to BP of approximately $41.95 billion. However, the company had some help in offsetting these losses. It successfully sought offsetting contributions to damage payments from other companies involved in the Deepwater Horizon drilling platform (in some cases through active pursuit of litigation against these companies). BP noted in its November 2012 statement that it had received significant contributions towards reimbursement of its costs related to the blowout from four other companies involved in the Deepwater Horizon drilling operations:

“BP has previously secured contributions toward response and compensation costs from the co-owners of the Macondo well, Anadarko ($4 billion)
and MOEX ($1 billion), and from contractors who worked there, including Cameron ($250 million) and Weatherford ($75 million). 46

Even taking these offsetting contributions of approximately $5.325 billion into account, BP’s projected losses due to the company’s criminal misconduct leading to its well blowout and oil spill were a staggering $36.625 billion ($41.95 billion minus $5.325 billion). This enormous loss figure does not even take into account possible further harms to BP from BP’s impaired reputation and reduced product sales to government entities and private customers.

To place this projected loss figure of $36.625 billion in perspective, BP’s net profits after taxes for 2011 (as stated in the company’s annual report) were approximately $26.1 billion, up from approximately $16.6 billion in 2009. 47 While these last figures suggest that BP is generating sufficient new funds to survive the Deepwater Horizon incident, they also indicate that the company could not survive many (if any) additional incidents of this type. Thus, the ultimate lesson of the BP oil well blowout and subsequent corporate losses is that criminal misconduct and its aftermath can be a “life threatening experience” even for giant concerns such as BP.

46 Id.

§ 1.10 A New Perspective: Evaluating Corporate Crime as a Manageable Defect in Corporate Performance

What is lacking in most descriptions of corporate crime is a coherent explanation of what makes it corporate—that is, why certain crimes by corporate employees and other corporate agents should be attributed to their firms. While many observers have argued that an element of managerial fault in conjunction with employee offenses provides an appropriate reason to link such offenses to corporations, there has been little agreement about the sort of managerial fault that will suffice. Some commentators would limit corporate crimes to instances of fault on the part of high-level managerial agents. Others would extend the notion of corporate crime to include all cases where managerial policies or practices affirmatively furthered employee offenses. However, even this last view of managerial fault may be too narrow in that it fails to take into account managerial capabilities to prevent offenses. This section describes the rudiments of a definition of corporate crime that turns on the adequacy of management efforts to understand and minimize legally defective corporate performance.

As a logical complement to the view that corporations—and, by implication, corporate managers—have duties to promote lawful behavior in corporate operations, it is possible to think of crimes committed by corporate employees in the course of corporate activities as instances of legally deficient or “defective” corporate performance. The overall quality of corporate performance concerning law compliance depends on the extent to which firm managers and employees minimize legally significant defects in corporate performance.

Conceiving of corporate crimes in this way offers several advantages over alternative conceptions of such crimes as products of crime-promoting policies or practices. First, it recognizes the often unpredictable link between actions initiated by managers and resulting crimes by corporate employees while not absolving managers of all responsibility for those crimes. Although many of the criminal consequences of corporate policies and operating practices are not foreseeable, they are often detectable and controllable through active monitoring and curative responses.

Second, the characterization of corporate crime as a defect in corporate performance suggests the type of tools available to corporate managers to detect and combat corporate crime. For example, performance quality management techniques developed by Professor W. Edwards Deming and others suggest several useful approaches. These techniques are based on the notion that quality in corporate performance often cannot be achieved merely through care by corporate managers in the selection of actions to be taken by corporate agents. Rather, high-quality performance is a product of carefully chosen employee actions coupled with careful evaluations of variations in the quality of resulting performance and adjustments to eliminate or minimize systemic sources of performance defects. These same performance quality improvement techniques can help firms detect and eliminate operating practices and procedures that lead to illegal conduct in the course of corporate affairs.
Third, the interpretation of corporate crime as a defect in corporate performance suggests a new set of standards for measuring corporate culpability and liability for the crimes of corporate agents. Culpability standards turning on the efforts of managers to prevent and minimize crimes by corporate agents have several clear advantages over alternative tests. First, an emphasis on the crime prevention responsibilities of corporate managers provides a useful descriptive framework for identifying deficient management practices that led to offenses, establishing a systematic means to study those offenses and to learn lessons about how to prevent similar misconduct in the future. Second, tests turning on efforts to prevent legally defective corporate performance can be used to define a workable standard for evaluating the criminal liability of corporate offenders. Under an illegal defect measure, corporate criminal liability would turn on due care by corporate managers in monitoring and eliminating illegal conduct by corporate employees. This due care assessment establishes a workable liability standard since it turns on managers’ use of techniques for reducing performance defects that are well known from other corporate applications. Third, an illegal defect standard will articulate corporate liability tests in terms that corporate managers can understand, thereby increasing the likelihood that managers will take the steps necessary to avoid liability. Criminal standards that withhold corporate liability if managers exercise due care to prevent illegal conduct by corporate employees will encourage corporate managers and employees to use their managerial talents, group knowledge, and organizational resources in the service of minimizing illegal conduct and victim losses.

[1]—Components of a Performance Defect Interpretation of Corporate Crime

[a]—Viewing Managers as Potential Architects of Corporate Law Compliance

The interpretation of corporate crime as a form of defective corporate performance starts from the premise that many top corporate managers are not sources of corporate offenses, but are rather personally disinterested or hostile towards corporate offenses. As nonparticipants in most offenses, they can be enlisted as architects of corporate law compliance. The fault of their firms in ensuing corporate offenses can be gauged from the sufficiency of top managers’ efforts to minimize corporate offenses.

There are ample signs that many top corporate managers possess the attitudes necessary to make this system work. First, contrary to popular belief, few top executives actively encourage illegal behavior within their firms.¹

¹ Of course, many decisions by top executives do promote illegal conduct at lower corporate levels in unexpected ways. For example, pressures by executives for high sales performance can lead to heightened levels of price-fixing by corporate subordinates. See, e.g., Sonnenfeld & Lawrence, “Why Do Companies Succumb To Price-Fixing?” Harv. Bus. Rev., p. 145, 149-150 (July-Aug. 1978) (sales performance pressures from higher corporate levels were an important cause of price-fixing
Most recent corporate crime has not been “crime in the suites” involving top executives, but instead has been initiated by middle- and low-level managers within corporate organizations. Aside from incidents involving illegal political contributions, top executives have only rarely been implicated in corporate crimes. A study of seventy-three executives convicted of antitrust violations showed that 55% were middle managers, 25% were at a vice-presidential level, and only 20% were top executives in their firms. Top executives are probably responsible for an even smaller fraction of illegal conduct in areas like environmental pollution and worker safety where middle- and lower-level managers tend to exert exclusive control over corporate activities.

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offenses in the folding-box industry). However, the chain of causation from top executives to low-level offenders is remote, and the influence of decisions by top executives on decisions to commit crimes at low corporate levels is only indirect. See Coffee, “No Soul to Damn: No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment,” 79 Mich. L. Rev. 386, 397 (1981) [hereinafter Corporate Punishment].


“Except for cases hinging on illegal political contributions—once a way of life in many corporations and rarely investigated or prosecuted prior to Watergate—the chief executive is seldom personally implicated. Typically, even the executives running the guilty subsidiary or division disavow any knowledge of the wrongdoing below.” Ross, “How Lawless Are Big Companies?” Fortune, pp. 56, 64 (Dec. 1, 1980). Cf. Whiting, “Antitrust and the Corporate Executive” (pts. 1-2), 47 Va. L. Rev. 929, 48 Va. L. Rev. 1, 15-18 (1961-1962) (no involvement by senior executives was discovered in extensive investigations of price-fixing in the electrical equipment industry during the 1950s).

Clinard & Yeager, Corporate Crime, 279 (1980); Clinard et al., Illegal Corporate Behavior, 206 (1979).

“The most shocking safety and environmental violations [by corporations] are almost exclusively at the product level of decisions at lower managerial levels.” Corporate Punishment,” N. 3 supra, at 397; accord Clinard & Yeager, Corporate Crime, 279 n.7 (1980); Clinard et al., Illegal Corporate Behavior, 206 (1979).
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Second, there is strong evidence that many top executives are interested in eliminating corporate crimes by subordinates. For example, this interest in preventing offenses was found in a study of attitudes of top executives regarding price-fixing in the folding-box industry. After interviewing forty top executives, Harvard Business School professors Jeffrey Sonnenfeld and Paul Lawrence concluded that:

(Text continued page 1-59)
[O]ur interviews with the senior people in these companies left us without a shred of doubt about the sincerity and completeness of their personal commitment to legal compliance. In fact, the top people we spoke to in the major forest products companies desperately want to know how and why they got on the wrong side of the law so that they can be sure it never happens again.\footnote{Sonnenfeld & Lawrence, “Why Do Companies Succumb To Price Fixing?” Harv. Bus. Rev., pp. 145-146 (July-Aug. 1978).}

Other studies have also found that corporate managers view unethical fellow managers as troublesome, disreputable figures who are a detriment to their firms.\footnote{See Simpson, “Corporate-Crime Deterrence and Corporate-Control Policies: Views from the Inside,” in White-Collar Crime Reconsidered, 289, 294 (1992).}

Third, even if many top managers would not otherwise have a personal interest in minimizing crime within their corporate organizations, current criminal laws and sentencing standards give corporate managers substantial reasons to pursue law compliance as a means to further the financial interests of their firms. Criminal liability standards reward firms whose managers act as public trustees and affirmatively seek to reduce criminal conduct in the course of corporate activities. These rewards include greatly reduced corporate sentences for crimes committed by employees and—in cases where preventive efforts are commensurate with crime risks—the possible avoidance of corporate charges and liability altogether.

In addition, some statutes impose a personal duty on top corporate managers to ensure criminal law compliance by subordinates. These duties arise under what is commonly termed the “responsible share” doctrine of executive liability. A corporate executive is deemed to have a responsible share in crimes by subordinates—and is held liable for those crimes—if the executive has sufficient authority to prevent the crimes, has knowledge that crimes may be underway, and fails to act to prevent the crimes. This type of liability creates strong incentives encouraging top corporate executives to stop or prevent criminal conduct within their organizations once they gain notice that the conduct is underway or about to occur.

[b]—Measuring Corporate Fault and Liability

Given that many top executives have values and motivations making them potential supporters of corporate law compliance, a useful fault measure for gauging corporate criminal liability can be constructed under which corporate liability turns on the adequacy of top executives’ efforts to prevent corporate offenses. Under such a standard, corporate criminal liability would be imposed where top executives have initiated or continued corporate activities without taking accompanying steps to minimize corporate offenses and an offense by a corporate employee occurs during the activities. In most fault assessments, blameworthy conduct is not necessarily a deviation from pre-
vailing conduct, but rather a deviation from desirable or meritorious conduct. Desirable or meritorious conduct by firms, as seen from a public perspective, involves the completion of corporate business activities through as few incidental offenses as possible. A firm may be said to be at fault when corporate managers do not pursue this desirable behavior. This fault measure treats crimes by corporate agents as corporate performance defects and assigns fault to corporations and their managers for failures to minimize these defects.

[c]—Evaluating Corporate Crimes as Defects in Corporate Performance

The characterization of corporate crime as a form of defective corporate performance suggests some new ways to study corporate crime. First, sources of corporate crime can be identified from features of corporate policies and practices that promote crimes by corporate agents. These include choices by corporate managers to pursue illegal conduct or to authorize such conduct by subordinates. They also include actions authorized by corporate managers with foreseeable illegal consequences. Managerial actions knowingly promoting employee offenses also include the ratification or acceptance of corporate benefits from an offense, at least where that ratification or acceptance occurs in a way that suggests managerial approval for further illegal conduct. All these are managerial actions that increase illegal conduct by corporate agents in foreseeable ways. As such, they are systemic sources of illegal conduct and sufficient bases for finding corporate fault in crimes by corporate agents.

However, management actions promoting offenses do not exhaust the systemic sources of corporate crimes. Seemingly innocent corporate practices may contribute to corporate offenses, yet have few characteristics that would indicate a likelihood of illegal consequences when the practices are authorized by corporate managers. For example, strong pressures and rewards for high sales totals are a traditional, valuable part of incentive systems for corporate sales employees; yet, at some pressure levels or in some competitive situations, these sales incentives are sources of price-fixing, fraud, and bid-rigging offenses.9

The point at which such potentially legitimate managerial techniques will lead to corporate crimes may not always be predictable when the techniques are initiated. Hence, the authorization of strong sales incentives by corporate managers will not provide a basis for ascribing fault to the managers or their corporations under most circumstances. Some reasonable means to predict criminal consequences will generally need to be present before managers and their firms can be blamed for later crimes by employees.

Yet, the line between generally proper processes producing legitimate and illegitimate employee conduct will sometimes be revealed as those processes

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are applied. Instances of illegal conduct resulting from generally proper management techniques may be noticeable if corporations actively monitor corporate activities to identify illegal conduct. Hence, there is a range of offenses resulting from normally proper corporate practices that firms can prevent through careful efforts to monitor corporate affairs and to initiate changes in operating practices when management receives reports hinting at illegal conduct. To fail to hold firms accountable for these offenses, at least from the point when reasonable monitoring would have detected them, is to allow firms to escape liability for preventable offenses.

Offenses for which corporations should be held accountable under this standard involve features that would inform a reasonably inquisitive observer of the need for further inquiry into the likelihood of illegal conduct by firm employees.

[2]—A Taxonomy of Corporate Crime in Terms of Performance Defects and Prevention Methods

An analysis of crimes by corporate employees which categorizes corporate crimes based on the management methods and errors that led to the offenses can define a useful taxonomy of corporate offenses. Each offense category and mechanism in this taxonomy represents the target of a corresponding set of corporate crime prevention methods.

Legal defects in corporate performance—that is, crimes committed by corporate agents in the course of corporate affairs—are related to three types of management failures. First, management techniques can direct employees to commit intended or foreseeable offenses. Second, management processes may inadequately inform employees about conduct required for law compliance or fail to motivate employees to pursue that conduct. Third, management responses to detected illegal conduct or offense risks may involve insufficient adjustments of corporate operations to reduce the likelihood of further offenses. These three managerial sources of offenses define three corresponding categories of corporate crime. A fourth category of offenses includes those that could not have been prevented through reasonable managerial measures and that were therefore unavoidable offshoots of legitimate corporate activities. This section will present a taxonomy of corporate crime in terms of these four offense categories.

[a]—Offenses Resulting from Management Misdirection

Some offenses by corporate employees are products of instructions given by corporate managers with the understanding that compliance with the instructions will entail illegal conduct. Given that the resulting offenses could be prevented by the reasonable alternative of limiting managerial instructions to legitimate ends, the attribution of these crimes to corporations based on managerial fault seems well supported.

The same is true where managers demand legitimate conduct or results from subordinates if the managers can reasonably foresee that the conduct or results will be achieved through illegal means. Here, the fault of the managers is the failure to exercise reasonable foresight about the probable
consequences of their instructions. This degree of fault—while probably not
enough to hold the managers personally liable for the resulting misconduct—
is a sufficient reason to attribute resulting offenses to errors in the management
of the firm and to impose corporate criminal liability for those offenses.

[b]—Offenses Resulting from Inadequate Provisions for
Law Compliance

A corporation has a variety of means to promote law compliance by cor-
porate employees. These measures involve techniques for informing employ-
ees about the conduct necessary for law compliance, methods for motivating
employees to undertake this conduct, selection processes employing and
advancing only those individuals whose past activities indicate a likelihood
of future job performance within legal bounds, and control processes that
identify poor performance related to law compliance and trigger responsive
changes. Offenses resulting from managers’ failures to take these sorts of
steps reflect inadequate efforts by managers to minimize offenses when
authorizing and encouraging related business activities. Because of this sort
of managerial neglect, these offenses are properly characterized as corporate
offenses.

[i]—Inadequate Identification of Compliance Behaviors

Corporate offenses sometimes result from the failure of employees to
appreciate that their conduct is illegal. Offenses involving such mistaken
assessments often reflect failures of firm managers to adequately organize
information and decision systems to bring employees needed guidance about
how to conduct corporate activities lawfully. These failures typically involve
one or more of the following types of organizational deficiencies:

(1) work allocations that do not identify the corporate employees or
other agents who are responsible for undertaking or coordinating
predictably necessary compliance activities;

(2) authority hierarchies that fail to identify persons or groups who will
resolve possible conflicts between legal requirements and other
aspects of corporate performance;

(3) assigned work activities that are so extensive or complex that
employees do not have time or resources needed to identify and
complete legally significant tasks;

(4) operating rules, practices, or procedures that do not identify legally
mandated actions and require such actions as a matter of corporate
policy; or

(5) failures to plan for predictable compliance conduct, including spec-
fications of (a) the circumstances when legally significant tasks
will be undertaken; (b) the information, persons, and materials
needed to complete these tasks; (c) scripts for particular actions to
be taken in completing the necessary tasks; (d) schedules that must
be met in completing the tasks; and (e) inspection or completion cri-
teria for recognizing successful performance of the tasks.
[ii]—Failures to Properly Reward and Motivate Employees

Corporate rewards for employee performance tend to encourage offenses when those rewards are distributed without regard for the quality of employees' law compliance efforts. Where corporate rewards do not diminish with poor law compliance efforts by employees, then a firm sends a message that these efforts are unimportant. Exceptionally good efforts to assure law compliance may be difficult for corporate managers to identify and evaluate; therefore, positive rewards for exceptional compliance efforts may be rare. However, poor compliance efforts resulting in offenses or behavior approaching or promoting illegal conduct often can be identified. These should be followed by significant reductions in compensation and employment status for the individuals involved. Where this pattern of rewards is not maintained, both an offender and his or her co-workers may be reinforced in the belief that illegal conduct is acceptable performance, leading to further offenses.

[iii]—Failures to Properly Select or Advance Employees

The values and attitudes of individual employees toward law compliance can play important roles in promoting or restricting illegal conduct in corporate operations. These values and attitudes can be partially determined by employee selection and advancement practices. As in the distribution of corporate rewards, desirable compliance attitudes and values may be difficult to identify for purposes of hiring and advancement decisions. Persons meriting selection or advancement on the basis of desirable attitudes about law compliance often will be indistinguishable from other persons. Hence, it may be difficult to preferentially select employees with desirable compliance values or attitudes. However, it will sometimes be possible to demote, dismiss, or avoid promoting individuals having poor regard for law compliance when this sort of attitude is revealed through misconduct during their employment. Companies that fail to make these sorts of negative responses to poor compliance performance risk both sending a signal that compliance is unimportant and advancing persons who are unconcerned about compliance into positions of substantial corporate power.

[iv]—Failures of Control Measures

Control measures are steps by firm managers to define desired corporate performance, articulate measurable indicators of that performance, monitor the attainment of the desired performance through these indicators, and reevaluate and adjust corporate operations where desired performance is not achieved. Control methods encompass periodic monitoring or auditing of performance characteristics, detailed investigations of serious performance failures, and comprehensive quality assessments in key performance areas. Where employee actions and behaviors promoting law compliance can be specified in advance, these same control measures can be used to maintain and improve law compliance by corporate employees. These techniques can be particularly effective concerning corporate compliance with positive
duties where the conduct required by a statute or regulation (for example, the filing of certain reports or the maintenance of chemical discharges below certain levels) defines desirable performance in concrete terms and establishes obvious benchmarks for monitoring corporate performance. Offenses stemming from a detectable failure of corporate employees to undertake foreseeably necessary compliance actions are, in effect, products of corporate indifference to the control of employee actions within recognized legal boundaries.

[c]—Offenses Resulting from Poorly Organized Offense Responses

Even where corporate managers take seemingly proper steps to direct and motivate employees towards lawful conduct, offenses may still result. The implications of an offense committed under these conditions are sometimes uncertain. The offense may be one involving corporate circumstances that are likely to be repeated, suggesting a need for improvements in law compliance measures to avoid repeat offenses. Alternatively, the offense may simply reflect abnormal conduct by a particular employee that is unlikely to be repeated in later corporate operations. These two types of offenses stem from common (i.e., systemic) sources and special (i.e., personal) circumstances respectively.

A thorough response to a corporate offense needs to evaluate both these possible sources. First, corporate managers and legal specialists need to determine which of these types of sources was involved in the offense. Second, once the sources of an offense are identified, managers need to consider and implement reasonable improvements in operating practices that will help avoid or prevent similar violations in the future.

[i]—Distinguishing Common and Special Causes of Corporate Offenses

Differences between common and special causes of offenses by corporate employees may be difficult for corporate managers to perceive. Special causes include unusual circumstances in corporate operations or the private lives of employees. A special cause of an offense might include, for example, extreme pressure on a particular employee to support a sick family member and a corresponding willingness to engage in illegal acts to avoid the loss of the employee’s job. Such circumstances might be important sources of a given offense, yet be so rare that corporate systems to deal with them are not justified.

By contrast, common causes of offenses relate to features of corporate systems and practices that operate repeatedly. Management policies or practices are systemic sources of crimes by corporate agents if it is foreseeable, given the information revealed by an offense, that they will encourage individuals to commit further crimes or permit further preventable offenses. Offenses having such systemic sources can only be minimized through systemic changes in corporate compliance methods. While, as will be discussed below, not every type of offense with systemic sources will be preventable,
the mistaken attribution of systemically caused offenses to the abnormal conduct of individual employees will only leave the real causes of the offenses unaddressed. The result may be other offenses that could have been avoided.

(ii)—Responses to Offenses from Special Causes

It may seem that offenses due to special causes merit little response by corporate managers since these offenses stem from abnormal circumstances unlikely to be repeated. However, this is not always true. While changes in underlying corporate operating techniques may not be justified, changes in corporate information gathering and internal reporting practices may still be warranted. Such changes should be considered after an offense if improved information practices would have better detected the unusual circumstances or employee behavior that led to the offense and permitted the offense to have been prevented or stopped at an earlier stage. This is often the case in instances of corporate crime. Fellow employees of an individual offender often will have witnessed his unusual behavior or preliminary criminal activities and had an opportunity to inform company managers at a point when the offense could be prevented or stopped. Alternatively, performance indicators (such as a jump in pollution releases measured in plant operations) may have been available that would have revealed the offense if those indicators had been carefully monitored, even if the underlying offense mechanisms or causes could not have been anticipated.

(iii)—Responses to Offenses from Systemic Causes

If the analysis of an offense suggests a systemic source, meaningful reforms should identify and address that source. The types of improvements that may be useful will depend on the systemic source involved. If the offense was committed by employees who knew that their conduct was illegal, greater direction toward behaviors necessary for law compliance would probably not prevent other similar offenses. However, increased law compliance control measures aimed at employees like the offender and greater monitoring of corporate performance related to the offense may be justified.

However, if the corporate offense resulted from the offender’s lack of knowledge that her conduct was illegal, a different set of changes in corporate operations deserves consideration. Law compliance can be improved in these circumstances through new rules, practices, and procedures directing employees towards lawful conduct in corporate activities, more extensive planning of compliance-related practices, and greater consultations with legal professionals to identify potentially illegal conduct before actions are selected. Several other systematic changes can also help to ensure that legal requirements are met in future corporate operations, including:

(1) alterations in legal environments, such as changes in business activities to eliminate legally constrained lines of business;
(2) lowering of performance demands to make performance goals more clearly attainable without resort to illegal methods;
(3) creation of self-sufficient operating groups to oversee legally restricted corporate activities through the direct involvement of relevant
specialists (often lawyers) capable of ensuring that legal requirements are properly understood and considered in decision making; (4) investment in information systems to increase oversight of employees’ legally risky performance by corporate superiors; and (5) creation of lateral relations across corporate hierarchies that help operating employees call on the expertise of legal specialists to identify legal constraints and to formulate lawful corporate responses.

Research on corporate organization techniques suggests that these methods comprise the full range of techniques that corporate managers can use to improve a specific aspect of corporate performance such as law compliance. Evaluations of corporate offenses should determine if these sorts of improvements would have been likely to have prevented or cut short the offenses. If so, the improvements will usually be worthwhile changes in corporate law compliance systems. The failure to evaluate and institute such changes following offenses will indicate management fault concerning subsequent offenses that could have been prevented.

[d]—Additional, Unpreventable Offenses

There are two reasons why a particular offense committed by a corporate employee while carrying out his corporate duties may warrant no response by corporate managers. First, the offense may be a product of special, concealed circumstances peculiar to the individual offender and, therefore, unlikely to be repeated by other employees and unlikely to be detected at a useful point by improved corporate processes. This is another way of saying the offense was committed by an employee whose actions were so unusual that they do not warrant further preventative measures for the future. Second, the misconduct may stem from systemic sources, but the law compliance monitoring and analysis procedures needed to properly detect and eliminate offenses emanating from those sources may be unreasonably expensive in light of the type of law compliance improvement that would be achieved.

(i)—Offenses by Rogue Employees

Some offenses by corporate employees are not preventable through reasonable efforts by corporate managers. These offenses are ones that both (1) stem from special sources which are unlikely to be repeated and (2) involve concealed actions which are not reasonably identifiable, in whole or in part, through detection at an early stage when further illegal actions could be prevented. Persons committing these sorts of unusual, surprising offenses are properly thought of as rogue employees—that is, employees gone bad in rare, unpredictable ways.

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While these types of offenses certainly exist, corporate managers probably overestimate their frequency. In assessing defective corporate performance generally (not just in the context of illegal conduct), corporate managers are often not very adept in distinguishing between common and special sources of defective performance. Corporate managers may be overly eager to attribute a corporate offense to special causes such as the unpredictable actions of a rogue employee. Attributing an offense to mistakes of an individual employee gets corporate managers “off the hook” and avoids the condemnation they and their firm might receive if an offense were linked to systemic features of management policies or practices. It may also lessen pressures for burdensome changes to reform corporate operating practices.

Yet, there will always be some unpredictable offenses undertaken under abnormal circumstances that corporate managers could not have done a better job in avoiding or detecting. These offenses simply cannot be tied to managerial fault. Our legal system may need to develop corporate criminal liability standards which ensure that corporations are not held accountable for such offenses. Alternatively, if we embrace a system of vicarious corporate liability for all employee offenses undertaken for corporate benefit, the fairness and legitimacy of that system may depend on there being only a small fraction of employee offenses and instances of corporate criminal liability that fall into this category lacking managerial fault.

[ii]—Offenses from Justifiably Tolerated Systemic Sources

Under the approach described here, corporations should be accountable and criminally liable for offenses in the course of company activities that managers could have prevented through reasonable adjustments to corporate practices. The reasonableness of adjustments to law compliance efforts will turn on the cost of additional crime prevention measures in comparison with the public injuries that the additional measures are likely to prevent. Where additional compliance efforts would cause more social harm than they prevent, they are unreasonable. This approach assumes that the permissible level of criminal conduct incident to corporate activities is zero, subject only to the limitation that small amounts of crime must be tolerated to avoid even larger costs to society of preventive measures. This standard accepts that there are a few corporate offenses that should be tolerated in the public interest. If the only effective crime prevention methods concerning a particular type of offense by corporate employees will entail net social costs—not counting a firm’s internal costs to carry out the preventative measures—corporate managers are justified in failing to take preventive steps and they and their firm should bear no fault when an offense of this sort results.

[3]—The Role of Compliance Programs in Corporate Criminal Law

In an opinion issued in 2006, federal district court and United States Sentencing Commissioner Ruben Castillo eloquently described the role and importance of corporate law compliance programs in criminal law.
enforcement. Judge Castillo’s opinion in United States v. Caputo\textsuperscript{11} examined the importance of compliance programs in the context of the sentencing of two individual defendants who, as part of their efforts to cover up criminal activities at their firm, manipulated the leadership and content of their company’s compliance program to ensure that their illegal activities and those of others would not be interfered with. In explaining why these actions indicated that the defendants’ offenses were especially serious, Judge Castillo described the positive impact that a properly run law compliance program should have on corporate law compliance and, hence, why the defendants’ knowing frustration of their company’s compliance program efforts provided evidence that their offenses involved substantial culpability and deserved a harsh sentence.

The Caputo case involved charges against two individual defendants, Ross A. Caputo and Robert M. Riley, who were both directors of AbTox, Inc., a medical device manufacturer. Caputo was also the President and Chief Executive Officer (CEO) of the company and Riley was its Vice President of Regulatory Affairs and Chief Compliance Officer. While Caputo was one of several corporate CEO’s who had been tried and convicted based on their activities as corporate leaders, Riley was to that point one of only a few Chief Compliance Officers ever tried and convicted in federal court. After an eight week jury trial, both defendants were convicted of nineteen criminal counts including conspiracy (one count), fraud (one count), mail fraud (three counts), wire fraud (three counts), and the introduction of an altered or misbranded device into interstate commerce (seven counts). Judge Castillo’s remarks concerning the significance of law compliance programs in criminal law enforcement were presented in the context of a sentencing memorandum explaining the basis for the sentencing of Caputo and Riley following these convictions.

The convictions in Caputo arose out of the marketing of a particular medical device by AbTox. AbTox’s business concerned essentially a single product: the AbTox Plazlyte sterilizer, which it marketed to hospitals across the country for use in sterilizing reusable medical devices. As a manufacturer of medical devices, AbTox was subject to regulation by the U.S. Food & Drug Administration (FDA) under the 1976 Medical Device Amendments to the Federal Food, Drug, and Cosmetic Act.\textsuperscript{12}

Under this legislation, any new medical device to be introduced into commerce in the United States after 1976 requires the approval of the FDA. Beginning in about November 1990, AbTox began seeking FDA clearance for its sterilizer. The sterilizer submitted to the FDA was a gas plasma sterilizer, with a one cubic foot sterilization chamber, and employing a 10% peracetic acid mixture as its principal sterilant. AbTox interacted with the FDA for four years, providing data intended to show that the described sterilizer was as safe and effective as ethylene oxide (“EtO”), the prevailing means of low temperature sterilization for medical instruments.

\textsuperscript{11} United States v. Caputo, 456 F. Supp.2d 970 (N.D. Ill. 2006).
\textsuperscript{12} 21 U.S.C. § 360k.
Judge Castillo described the defendants’ activities during this period as follows:

“During the pre-market notification process, AbTox engaged in different forms of fraudulent conduct. Adverse test results were, for the most part, withheld from FDA reviewers, while favorable results achieved under the same test protocols were disclosed. FDA reviewers testified at trial that the information withheld was material. Caputo and Riley both played a significant role in withholding test data. Both of them were kept informed of test results on an almost daily basis. Caputo signed the first FDA submission—known jokingly among the scientific staff at AbTox as the ‘submission of omissions’—while Riley was editor-in-chief of the various submissions and also AbTox’s primary contact with the FDA.”

At some point in the process, the defendants decided that instead of selling the small, one cubic foot sterilizer, for which there was no viable market, they would develop and sell a larger sterilizer. The larger sterilizer had different design and engineering characteristics. However, the defendants did not seek a separate approval for marketing the alternate design. In 1994, the FDA issued a clearance letter authorizing the marketing of the smaller sterilizer for use under limited circumstances. This posed serious problems for the defendants:

“The clearance letter left the defendants with two seemingly insurmountable marketing problems. First, there was no real market for the one cubic foot sterilizer that the FDA had cleared, because it was simply too small to be of practical use in a hospital setting. Second, there was no real market for the unapproved six cubic foot sterilizer if sold within the scope of the clearance; that is, limited to flat stainless steel instruments without lumens or hinges. Hospitals already had a fast, affordable, safe, and effective method of sterilizing stainless steel instruments in steam, and non-stainless steel instruments requiring low temperature sterilization, such as endoscopes, were not within the scope of AbTox’s marketing clearance.”

Faced with this choice, the defendants proceeded to market the larger sterilizer as if it were covered by the FDA’s approval letter and misrepresented the types of uses authorized by the FDA approval. Hospitals that bought the company’s sterilizer believed that they were purchasing an approved model. They began to use the units for a wide variety of sterilization practices and encountered equipment breakages and other problems. Eventually, a number of patients suffered eye injuries due to procedures performed on them with improperly sterilized instruments. Despite being informed of these problems, the defendants continued to market AbTox’s sterilizer and concealed company test results that would have indicated that

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13 Caputo, 456 F. Supp.2d at 973.
14 Id.
deficiencies in their device had probably caused the unusual eye injuries occurring at hospitals with the sterilizer. Additional eye injuries occurred after these results were concealed.

Judge Castillo summarized the defendants’ criminal activities as follows:

“[D]efendants Caputo and Riley effectively carried out a bait and switch scheme on the FDA and its customers, obtaining clearance on one sterilizer but using the clearance to sell another. The defendants continued to sell the large uncleared sterilizer, in defiance of law and FDA directives, through a pattern of falsehoods and deception, until the company shut down sales operations on April 7, 1998, under pressure from the FDA. In the meantime, AbTox had illegally sold 168 adulterated sterilizers in the United States, causing an intended loss in excess of $16 million.”

Following an extensive analysis of this conduct under the federal sentencing guidelines, Judge Castillo sentenced Caputo to a ten-year prison sentence and Riley to a six-year sentence. His analysis emphasized that the defendants’ conduct had involved “a prolonged, massive fraud upon the FDA and relevant hospitals by marketing an illegal sterilizer that ultimately put the general public at risk.” He also pointed out that the offense had produced serious adverse impacts on the public, with twenty-five patients at five hospitals having been identified as having suffered significant corneal problems after ocular surgeries performed with instruments sterilized in the illegal AbTox sterilizer. In addition to these substantial health risks, the defendants’ offenses had serious financial consequences. Testimony at trial indicated that 144 U.S. hospitals purchased and paid for 167 uncleared units of AbTox’s sterilizer. The total amount of their purchases was over $17 million.

As part of his analyses of the seriousness of the defendants’ offenses, Judge Castillo emphasized the importance of their failures to implement a meaningful law compliance program at AbTox to ensure adherence to medical device requirements and FDA regulations. These failures to address law compliance through appropriate corporate operating systems were particular serious given the significant public health risks at stake. Judge Castillo reached the following conclusions regarding the defendants’ failures to meet their obligations to establish and operate meaningful corporate law compliance systems:

“Among the pertinent policy statements issued by the Sentencing Commission are the Amended Organizational Sentencing Guidelines. At the tenth anniversary of the Sentencing Guidelines for Organizations, the U.S. Sentencing Commission announced its intention to form an advisory group to review the effectiveness of the Guidelines. 66 Fed.Reg. 48306, 48306-07 (Sept. 19, 2001). The Sentencing Commission asked the advisory group to focus on the Organizational Guidelines definition of an effective compliance program. U.S. Sentencing Commission, News Release (Feb. 21, 2002). In April 2004, the Sentencing Commission

\[\text{15} \quad \text{Id. 456 F. Supp.2d at 978.}\]
\[\text{16} \quad \text{Id. 456 F. Supp.2d at 982.}\]
approved revisions to the Sentencing Guidelines for Organizations, pursuant to the recommendations of the advisory group. These revisions, which became effective on November 1, 2004, emphasize that an organization must both promote an organizational culture that encourages ethical conduct and exercise due diligence to prevent and detect criminal conduct. See § 8B2.1, United States Sentencing Guidelines. The Guidelines set forth the following compliance requirements:

1. Standards and procedures to prevent and detect criminal conduct;
2. Adequate resources and authority for the program;
3. Personal screening related to the goals of compliance;
4. Training in the standards and procedures at all levels;
5. Non-retaliatory internal reporting systems;
6. Periodic auditing, monitoring and evaluation of the program’s overall effectiveness;
7. Incentives and discipline to promote compliance and ethical conduct; and
8. Reasonable, responsive and preventive steps upon detection of a violation.

By any measure, AbTox’s system of corporate compliance was a total failure from top to bottom. Caputo and Riley both bear primary responsibility for this failure. In this case, Caputo selected Riley to serve as AbTox’s Chief Compliance Officer for all the wrong reasons. Caputo knew that he could manipulate and dominate Riley based on his prior personal and business experiences with him. Riley did not have any real training as a compliance officer. Riley had received an MBA from Northwestern University, specializing in marketing, before beginning work in the healthcare industry.

Corporate compliance officers are very much today’s corporate “fire personnel.” They are often the company’s “first responders” and must focus on both proactive and reactive efforts to be effective. Proactive efforts need to emphasize the complimentary goals of crime prevention and corporate ethical behavior. Reactive efforts measure how well a corporation reacts when it learns that questionable and potentially illegal corporate conduct has occurred. The defendants’ behavior in this case turns the concept of corporate compliance on its head. Caputo and Riley subverted the standard compliance goals to ensure that AbTox could proceed with its illegal marketing scheme in direct violation of FDA regulations. Measured by any standards, Riley’s actions as AbTox’s Chief Compliance Officer were woefully and criminally inadequate. The evidence at trial showed that he continually failed to act to prevent the ongoing illegal marketing of AbTox’s only commercially viable sterilizer. Instead, the evidence showed that Riley aided and abetted Caputo’s illegal marketing plans. Riley chose to use whatever regulatory expertise he had to further, shield, and cover up the offenses proven at trial. Riley totally failed to self report any adverse scientific or healthcare results of the sterilizer to the FDA. Riley also willfully participated in the submission of numerous
misleading regulatory filings with the FDA. All of Riley’s actions were taken at the behest and with the approval of Caputo.17

Judge Castillo’s consideration of compliance program abuses as part of his sentencing analysis suggests several important points about the role of compliance programs in criminal law enforcement. First, the adoption of a substantial compliance program that at least meets the standards for such programs specified in the federal sentencing guidelines may be treated as minimally adequate management conduct in a wide variety of criminal law enforcement settings. This view is especially likely to be adopted in business contexts like that in Caputo where the public’s interest in preventing offenses and associated health risks is particularly strong. Second, substantial departures from the compliance program management standards of the sentencing guidelines may be seen as evidence of a disregard for law compliance or even an intent to conceal offenses, either of which may affect culpability assessments for corporate leaders who are responsible for compliance program deficiencies. Third, where corporate leaders are convicted of offenses—even offenses that do not relate directly to their operation of their company’s compliance program—their conduct with respect to such a program may bear upon evaluations of their state of mind and the seriousness of their criminal activities. If convicted corporate leaders are also responsible for major compliance program deficiencies, their offenses may be treated as being particularly serious because they were committed as part of a broader pattern of disregard for law compliance or with a plan to conceal the offenses by weakening compliance program efforts that might otherwise have revealed the offenses.

While the compliance program standards in the federal sentencing guidelines were developed primarily to be used in corporate culpability assessments conducted as part of corporate sentencing analyses, these same standards can also be used to determine if corporate managers have been flagrantly irresponsible in their failures to pursue law compliance in their companies. Where, as was the case in Caputo, convicted corporate managers have taken no meaningful steps to pursue the types of compliance program activities specified in the sentencing guidelines as responsible measures to prevent organizational offenses, then it is reasonable to reach the conclusion that Judge Castillo apparently accepted in Caputo and to find that the individuals involved intended to conceal and perpetuate their offenses. In these circumstances, failures of corporate leaders to take steps to implement a compliance program may lead to particularly harsh individual sentences.

Thus, for both a corporation and its leaders, the scope and quality of compliance program activities can influence sentencing courts’ characterizations of the seriousness of criminal misconduct and determinations of appropriate criminal penalties. Sentencing assessments and other legal analyses that characterize the culpability of corporate leaders in light of whether the leaders have deviated from the law compliance promoting roles specified for

17 Id. 456 F. Supp.2d at 984-985.
corporate executives in the federal sentencing guidelines’ standards for compliance programs seem likely to expand in the future. Evaluations of conduct by corporate leaders under the compliance program criteria of the sentencing guidelines will probably be extended from the individual sentencing context addressed by Judge Castillo to other types of liability analyses where the attitudes of the corporate leaders about law compliance are relevant. In these settings, failures of corporate leaders to take reasonable steps to implement systemic corporate practices for promoting law compliance will provide evidence of the leaders’ ongoing indifference towards law compliance and their corporate duties. In extreme cases, this type of indifference may even be seen as evidence of an intent to conceal the types of illegal conduct that reasonable compliance program activities would have been likely to reveal and resolve.
§ 1.11 Case Studies in Corporate Misconduct: Corporate Accounting Fraud

Few types of corporate offenses have had as much public notoriety and corporate impact as financial fraud in corporate accounting. Following major corporate scandals involving Enron, Worldcom, and several other major American companies, Congress instructed the federal Securities and Exchange Commission (“SEC”) to conduct a study of corporate accounting fraud offenses committed by publicly traded concerns. The results of this study provide detailed descriptions of the illegal accounting and financial reporting practices that devastated a broad range of large companies in the late 1990s and early 2000s and the types of corporate personnel who played key roles in these corporate offenses.1

This subsection profiles the types of corporate misconduct found by the SEC in its study of accounting fraud offenses and the penalties imposed for that misconduct. It also identifies some of the key company employees involved in the offenses scrutinized by the SEC and the penalties applied to these corporate insiders in addition to the imposition of corporate penalties.

[1]—Characteristics of SEC Enforcement Actions

The characteristics of the SEC’s efforts to enforce federal securities laws reveal some features of that agency’s enforcement priorities and suggest what will often be parallel criminal case selection criteria of federal prosecutors. Hence, the enforcement actions described here provide valuable information on future administrative actions by the SEC and criminal prosecutions by the Department of Justice.

Under the provisions of the Sarbanes-Oxley Act of 2002, the SEC was required to conduct a study of its enforcement actions regarding publicly traded companies. The SEC’s study covered enforcement actions during the five years from July 31, 1997 through July 30, 2002 (the “study period”). The SEC found that its enforcement actions in this period concerned the following types of corporate fraud and misconduct.

During the study period, the SEC filed 515 enforcement actions for financial reporting and disclosure violations arising out of 227 Division of Enforcement investigations (referred to hereafter as “enforcement matters”). The 515 actions targeted 869 named parties, including 164 entities and 705 individuals. During the study period, enforcement actions involving financial reporting violations or fraud increased from ninety-one in the first year of the study to 149 in the last year of the study. Of these 515 actions, 186 were federal civil actions and 329 were administrative proceedings. Of the 869 named parties, the SEC charged 593 with fraud in connection with the reporting violations, including 511 individuals and eighty-two entities.

The SEC brought the greatest number of actions in the area of improper revenue recognition: 126 of the 227 enforcement matters involved such conduct, including the fraudulent reporting of fictitious sales, improper timing of

(Text continued on page 1-69)
These offenses involved inaccurate disclosures in Management’s Discussion and Analysis (“MD&A”) sections of periodic corporate disclosure filings with the SEC. Additionally, twenty-three enforcement matters involved improper accounting related to mergers and other business combinations.

A further group of 137 enforcement matters studied by the SEC involved miscellaneous other accounting and reporting misconduct. Some of the most common types of misconduct in this group (with their associated numbers of enforcement matters) were as follows:

<table>
<thead>
<tr>
<th>Other Accounting and Reporting Issues</th>
<th>Number of Enforcement Matters Involving Each Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inadequate Disclosures in MD&amp;A and Elsewhere</td>
<td>43</td>
</tr>
<tr>
<td>Failure to Disclose Related Party Transactions</td>
<td>23</td>
</tr>
<tr>
<td>Inappropriate Accounting for Non-Monetary and Roundtrip Transactions</td>
<td>19</td>
</tr>
<tr>
<td>Improper Accounting for Foreign Payments in Violation of FCPA</td>
<td>6</td>
</tr>
<tr>
<td>Improper Use of Off-Balance Sheet Arrangements</td>
<td>3</td>
</tr>
<tr>
<td>Improper Use of Non-GAAP Financial Measures</td>
<td>2</td>
</tr>
</tbody>
</table>

In approximately 10% of the enforcement matters studied by the SEC, the accounting or disclosure issue was reflected in financial statements that were included in a corporate stock issuer’s registration statement filed with the SEC in connection with an Initial Public Offering of stock (“IPO”).

[2]—Types of Corporate Misconduct Involving Accounting Fraud

[a]—Improper Revenue Recognition

The SEC found that illegitimate revenue recognition was the most commonly present type of accounting fraud in the enforcement actions it reviewed. Of the 227 enforcement matters studied, 126 involved improper revenue recognition. These enforcement matters broke down as follows: 106 involved fraud charges (Section 17(a) of the Securities Act of 19333 (“Secu-

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2 These offenses involved inaccurate disclosures in Management’s Discussion and Analysis (“MD&A”) sections of periodic corporate disclosure filings with the SEC.

§ 1.11[2] CORPORATE CRIMINAL LIABILITY

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[62x638]§ 1.11[2] CORPORATE CRIMINAL LIABILITY

1-70

rities Act”)) and/or Section 10(b) of the Securities Exchange Act of 1934\(^4\) ("Exchange Act"), with the balance involving reporting, books and records and/or internal controls violations (under Sections 13(a), 13(b)(2)(A) and (B), and/or 13(b)(5) of the Exchange Act). Based on the misconduct leading to the 126 enforcement matters involving improper revenue recognition, ninety-four issuers restated their financial statements.

The following table summarizes the types of improper revenue recognition found by the SEC in their examination of the Commission’s enforcement actions:

<table>
<thead>
<tr>
<th>Improper Recognition Practices</th>
<th>Number of Enforcement Matters Involving Each Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improperly Timed Revenue Recognition</td>
<td>81</td>
</tr>
<tr>
<td>Fictitious Revenue</td>
<td>80</td>
</tr>
<tr>
<td>Improper Valuation</td>
<td>21</td>
</tr>
</tbody>
</table>

The SEC found that senior management was implicated in 104 of the 126 enforcement matters involving revenue recognition. Specifically, the SEC found that fifty-five Chairmen of the Board, seventy-five CEOs, seventy-seven Presidents, eighty-one CFOs, twenty COOs, ten CAOs, and twenty-two VPs of Finance were charged in such enforcement matters. In addition, the Commission charged forty Controllers based on their involvement in these enforcement matters.

[b]—Improper Expense Recognition

The SEC found that 101 of the 227 enforcement matters it studied involved improper expense recognition. These enforcement matters involved a wide range of abusive practices, typically aimed at improperly understating or deferring expenses and thereby overstating a company’s net income.\(^5\) The charges associated with these abuses included seventy-eight cases involving fraud charges (under Section 17(a) of the Securities Act and/or Section 10(b) of the Exchange Act), with the remainder involving non-fraudulent reporting, books and records and/or internal controls violations (under Sections 13(a), 13(b)(2)(A) and (B), and/or 13(b)(5) of the Exchange Act). In the seventy-eight cases that involved fraud, the SEC charged 290 parties with committing fraud in connection with reporting violations.


\(^{5}\) One practice identified by the SEC as involving improper expense recognition leading to illegal revenue reporting by public companies involved setting up “cookie-jar” reserves which an issuer can use to create the appearance of revenues which meet earnings expectations. By setting “cookie-jar” reserves in one quarter (and initially overstating expenses) and improperly netting those excess reserves against expenses in future periods, a company can create a false impression of its actual income in these periods. See SEC, “Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002,” at 13, available at http://www.sec.gov/news/studies/sox704report.pdf.
The following table summarizes the types of improper expense recognition incidents identified in the SEC’s study:

<table>
<thead>
<tr>
<th>Improper Expense Recognition Practice</th>
<th>Number of Enforcement Matters Involving Each Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to Record Expenses or Losses via Improper Capitalization/Deferral or Lack of Accrual</td>
<td>49</td>
</tr>
<tr>
<td>Overstating Ending Inventory Values to Reduce Cost of Goods Sold</td>
<td>25</td>
</tr>
<tr>
<td>Understating Bad Debts or Loan Losses</td>
<td>19</td>
</tr>
<tr>
<td>Improper Use of Restructuring and Other Reserves</td>
<td>17</td>
</tr>
<tr>
<td>Failure to Record Asset Impairments</td>
<td>5</td>
</tr>
</tbody>
</table>

The SEC’s study found that senior managers were implicated in seventy of the 101 enforcement matters involving expense recognition. Specifically, the SEC charged thirty-two Chairmen of the Board, forty-seven CEOs, forty-six Presidents, fifty-four CFOs, sixteen COOs, eight CAOs and eighteen VPs of Finance in cases involving improper expense recognition. The Commission also charged thirty Controllers for violations based on improper expense recognition.

In connection with the 101 enforcement matters that the SEC identified as being related to improper expense recognition, seventy issuers restated their financial statements.

[c]—Improper Accounting Regarding Business Combinations

The SEC also identified twenty-three enforcement matters in which companies used improper accounting in connection with business combinations. These actions involved improper valuation of assets, improper use of merger reserves, and premature merger recognition. Some companies also failed to disclose the liabilities associated with a business combination. Of the twenty-three enforcement matters related to business combinations, seventeen involved fraud charges (under Section 17(a) of the Securities Act and/or Section 10(b) of the Exchange Act), with the remainder involving reporting, books and records and/or internal controls violations (under Sections 13(a), 13(b)(2)(A) and (B), and/or 13(b)(5) of the Exchange Act). The misconduct involved in these twenty-three enforcement matters caused seventeen issuers to restate their financial statements.

The following table summarizes the types of accounting abuses found by the SEC in connection with business combinations:
The SEC found that senior management was implicated in fourteen of the twenty-three enforcement matters involving improper accounting for business combinations that were examined in the Commission’s study. Specifically, the SEC found that seven Chairmen of the Board, eight CEOs, nine Presidents, one COO, eight CFOs, and one VP of Finance were charged in such enforcement matters. In addition, the Commission charged two Controllers based on their involvement in the misconduct leading to these enforcement matters.

[d]—Other Types of Improper Activities

The SEC found that several other types of accounting and reporting abuses also led to substantial numbers of the enforcement actions examined in the Commission’s study. These additional abuses included inadequate disclosures in a company’s period Management Discussion and Analysis (“MD&A”) disclosures or elsewhere in the issuer’s filings, failures to disclose related party transactions, improper accounting for non-monetary and roundtrip transactions, improper accounting for foreign payments in violation of the Foreign Corrupt Practices Act (“FCPA”), the improper use of off-balance sheet arrangements to conceal debt, and the improper use of non-GAAP financial measures. Of the 227 enforcement matters studied by the SEC, 137 included one or more of these types of violations. These 137 matters involved 104 fraud charges (under Section 17(a) of the Securities Act and/or Section 10(b) of the Exchange Act) and the remainder involved reporting, books and records and/or internal controls violations (under Sections 13(a), 13(b)(2)(A) and (B), and/or 13(b)(5) of the Exchange Act).

The following table summarizes the types of accounting abuses found by the SEC other than improper revenue and expense reporting and improper practices in connection with business combinations:

<table>
<thead>
<tr>
<th>Improper Accounting Practice</th>
<th>Number of Enforcement Actions Involving Each Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inadequate Disclosures in MD&amp;A and Elsewhere</td>
<td>43</td>
</tr>
<tr>
<td>Failure to Disclose Related Party Transactions</td>
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<tr>
<td>Improper Accounting for Non-monetary and Roundtrip Transactions</td>
<td>19</td>
</tr>
<tr>
<td>Improper Accounting for Foreign Payments in Violation of the FCPA</td>
<td>6</td>
</tr>
</tbody>
</table>
Improper Use of Off-Balance Sheet Arrangements 3
Improper Use of Non-GAAP Financial Measures 2

[3]—Persons Involved in Misconduct

The SEC’s study also profiled the corporate insiders involved in the cases the Commission evaluated. The study revealed that the majority of the persons held responsible for the securities law violations leading to SEC enforcement actions were members of the defendant corporations’ senior management. The study found that 157 of the 227 enforcement matters studied by the SEC involved charges against at least one senior corporate manager. In these enforcement matters, charges were brought against seventy-five Chairmen of the Board, 111 Chief Executive Officers (“CEOs”), 111 Presidents, 105 Chief Financial Officers (“CFOs”), twenty-one Chief Operating Officers (“COOs”), sixteen Chief Accounting Officers (“CAOs”), and twenty-seven Vice Presidents (“VPs”) of Finance.

In addition, the study determined that the SEC brought charges against eighteen auditing firms and eighty-nine individual auditors. The SEC found that violations by auditors were not limited to any particular size of auditing firm. Violations by auditors resulted largely from auditors failing to gain sufficient evidence to support a corporate stock issuer’s accounting methods, failing to exercise an appropriate level of skepticism in responding to red flags, and failing to maintain independence.

As part of its study, the SEC provided several specific examples of misconduct at different corporate levels that led to enforcement actions by the agency. The examples cited by the Commission and the SEC’s interpretation of the misconduct involved were as follows.

Although the vast majority of cases the Commission has brought stemmed from conduct by top-level executives, the financial reporting violations have involved numerous individuals at all levels both inside and outside of the issuer. Some of the violative conduct involved customers and shareholders of issuers and some involved the outside auditors. . . . The individuals associated with issuers were charged with accounting violations relating to a variety of conduct ranging from the most egregious misappropriation of corporate assets/funds to financial misstatements arising from poor management and loose controls.

This section outlines a few key cases that highlight the roles played by individuals in various levels of authority, both inside and outside of issuers, who were involved in accounting schemes.

1. Senior Management

Many cases involved schemes by senior management to create the appearance that the company would meet analysts’ expectations or to artificially increase the value of the company’s stock.
Case highlights

- **Enron Corporation**—The Commission has charged two former senior ranking Enron officials with fraud in one of the largest accounting scandals in history. The Commission alleged that the company’s former CFO and another high-ranking Enron official engaged in a complex scheme to create an appearance that certain entities that they funded and controlled were independent of the company, allowing the company to incorrectly move its interest in these companies off its balance sheet. The Commission alleged that these transactions were designed to improve the company’s financial results, and to misappropriate millions of dollars representing undisclosed fees and other illegal profits.\(^6\) In its November 8, 2001 Form 8-K filing, Enron announced its intention to restate previously issued financial statements dating back to 1997. On December 2, 2001, Enron filed for Chapter 11 bankruptcy protection.

- **Sunbeam Corporation**—The Commission filed actions against five former officers (the CEO and Chairman, principal financial officer, Controller, and two vice-presidents) of the company alleging that they engaged in a scheme to fraudulently misrepresent the company’s results of operations in connection with a purported “turnaround” of the company. The Commission alleged that the company’s Principal Accounting Officer and Controller created inappropriate accounting reserves, known as “cookie-jar” reserves, to increase the company’s reported loss for 1996 and inflate income in 1997, thus contributing to the false picture of a rapid turnaround. In 1998, the officers took increasingly desperate measures to conceal the company’s mounting financial problems by, among other things, deleting certain corporate records to conceal pending returns of merchandise.\(^7\) On or about November 12, 1998, the company filed amended financial statements covering the period October 1, 1996 through March 31, 1998.

- **Waste Management, Inc.**—The Commission alleged that the company’s top officers, including the former Chairman and CEO, President and COO, Executive Vice President and CFO, Vice President, Corporate Controller and CAO, Senior Vice President, General Counsel and Secretary, and VP of Finance, fraudulently manipulated the company’s financial results to meet predetermined earnings targets. The Commission’s complaint alleged that because the company’s revenues and profits were not growing quickly enough to meet targets, these senior officers improperly resorted to eliminating or deferring current period expenses to inflate earnings, using a mul-

\(^7\) SEC, Accounting and Auditing Enforcement Release No. 1395 (May 15, 2001).
titude of improper accounting practices to achieve their objectives.\(^8\) On or about March 31, 1998, the company filed amended financial statements covering the period January 1, 1992 through September 30, 1997.

Several cases against senior management involved accounting fraud (often accompanied by failure to disclose related party transactions) stemming from the siphoning off of company funds for the executives’ own personal use.

**Case highlights**

- **Adelphia Communications Corporation** ("Adelphia")—The Commission sued the company’s former CEO and Chairman and his sons alleging, among other things, that they made fraudulent statements and omissions in order to cover up the family’s secret and extensive personal use of Adelphia funds to purchase luxury homes in Colorado, Mexico and New York City, build a golf course, purchase timber rights to land in Pennsylvania, buy stock and pay off margin calls.\(^9\) ... On June 25, 2002, the company and certain of its subsidiaries filed for bankruptcy.

- **Tyco International Ltd.**—The Commission alleged that three top executives—the CEO, CFO, and Chief Legal Officer—failed to disclose to shareholders the multi-million dollar loans from the company that they used for personal business ventures and investments, and to purchase yachts, fine art, estate jewelry, luxury apartments and vacation estates. These senior officials also allegedly failed to disclose benefits such as a rent-free $31 million Fifth Avenue apartment, the personal use of corporate jets, and making charitable contributions in their personal capacity.\(^10\) On December 31, 2002, Tyco filed amended financial statements and disclosures covering the period October 1, 2000 through June 30, 2002. On December 31, 2002, Tyco filed amended financial statements and disclosures covering the period October 1, 2000 through June 30, 2002.

- **Rite Aid Corporation**—The Commission alleged that the former CEO, CFO and Vice Chairman engaged in a scheme to overstate income by massive amounts. In addition, the Commission alleged that the CEO sought to enrich himself at the expense of failing to disclose both his personal interest in leased property for Rite Aid store locations and several transactions where he funneled $2.6 million from Rite Aid to a partnership that he and a relative controlled.

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\(^8\) SEC, Accounting and Auditing Enforcement Release No. 1532 (March 26, 2002); Securities and Exchange Commission, Accounting and Auditing Enforcement Release No. 1410 (June 19, 2001).

\(^9\) SEC, Accounting and Auditing Enforcement Release No. 1599 (July 24, 2002).

\(^10\) SEC, Accounting and Auditing Enforcement Release No. 1627 (Sept. 12, 2002).
The Commission’s complaint also charged that he fabricated minutes for a Finance Committee meeting that never occurred in connection with a corporate loan transaction. On three separate occasions during 1999 and 2000, Rite Aid filed amended financial statements relating to this matter.

2. Mid-Level Management

The [SEC’s study] found that the Commission brought actions against 83 mid-level management employees, such as corporate controllers and division and subsidiary level officers and controllers. Many of these employees participated in fraudulent schemes at the direction of senior management. Occasionally, the Commission has sued employees for independent conduct that has resulted in the misstatement of issuer financial statements.

Case highlights

- **WorldCom, Inc.—** The Commission alleged that two accountants who worked in the company’s General Accounting Department, along with their supervisors, participated in a fraudulent scheme directed and approved by WorldCom’s senior management. The Commission alleged that these individuals made or caused to be made entries in WorldCom’s books, which improperly decreased certain reserves to reduce line costs, causing the overstatement of pre-tax earnings by $828 million and at least $407 million in two consecutive quarters. The Commission also alleged that these individuals made and caused to be made entries in WorldCom’s books, which improperly capitalized certain line costs for five quarters, resulting in an overstatement of WorldCom’s pretax earnings by approximately $3.8 billion. . . .

- **Aurora Foods Inc.—** The Commission alleged that principal financial officers of two divisions of the company, at the direction of its senior management, engaged in a scheme to under-report trade promotion expense. These individuals moved large portions of trade promotion expenses to accounts receivable, thus concealing them from the auditors. On or about April 14, 2000, the company filed amended financial statements covering the period April 1, 1998 through June 30, 1999.

- **Seaboard Corporation**— The Commission found that the Controller of a division of the company booked improper entries in that division’s books and records over several years that overstated the deferred farming cost asset and understated farming expense. After

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12 SEC, Accounting and Auditing Enforcement Release No. 1585 (June 27, 2002); SEC, Accounting and Auditing Enforcement Release No. 1658 (Nov. 5, 2002).
discovering that the entries were improper, she deliberately undertook to conceal the errors through other improper entries and adjustments. On or about August 28, 2000, the company filed amended financial statements covering the period January 1, 1997 through March 31, 2000.

3. Counsel

[During the study period, the Commission] charged 14 attorneys (11 General Counsel and three outside counsel) for participating in financial reporting violations.

Case highlights

- **FLIR Systems, Inc.**—The Commission brought a settled action suspending an attorney from practicing before the Commission based on willful violations of the securities law. The Commission found that, in connection with FLIR’s scheme to overstate earnings, the General Counsel signed two management representation letters to the company’s outside auditors. Among other things, these letters failed to disclose the conditional nature of the transactions and of his personal involvement in the negotiations. The General Counsel had been involved in the negotiations in the transactions and knew that the buyer had no obligation to purchase the product. FLIR restated its 1998 and 1999 financial statements three times in 2000 and 2001 to correct these misstatements.

- **Livent Inc.**—The Commission alleged that Livent’s General Counsel, along with its senior management, orchestrated and implemented a fraudulent scheme to, among other things, inflate revenues reported by the company in financial statements filed with the Commission. In furtherance of this scheme, the counsel drafted and finalized a number of agreements, and actively dealt with the legal representatives of the counter parties in the negotiation and finalization of these agreements. The Commission also alleged that counsel and company officers concealed the agreements from the company’s auditors in order to improperly record revenue from the transactions and inflate the company’s revenues. On or about November 18, 1998, the company filed amended financial statements covering the period January 1, 1996 through March 31, 1998.

- **Sunbeam Corporation**—The Commission filed a settled administrative action against the former General Counsel of Sunbeam, based on his participation in drafting of certain press releases in connection with the company’s fraudulent misrepresentations of its pur-

15 SEC, Accounting and Auditing Enforcement Release No. 1670 (Nov. 21, 2002).
ported “turnaround.” On or about November 12, 1998, the company filed amended financial statements covering the period October 1, 1996 through March 31, 1998.

- **Latin American Resources, Inc.**—The Commission filed an action alleging that the company’s outside counsel falsified documents and caused others to omit or state material facts to the company’s accountant in connection with the company’s financial statements which allegedly made false claims that the company owned Brazilian agricultural plantations comprising 95% of its company’s assets. Latin American Resources did not file amended financial statements relating to this issue.

4. Customers

[During the study period, the Commission] charged eleven individuals employed or otherwise related to customers of issuers and two customers (entities) for participating in fraudulent accounting schemes. The [SEC’s study] found that these customers were most frequently involved in fictitious sales transactions or side letters designed to falsify revenue.

Case highlights

- **Manhattan Bagel, Inc.**—In addition to charging the President and Chairman of the company’s subsidiary, the Commission sued three employees of customers of the company’s subsidiary. The Commission alleged that the customers’ employees aided and abetted a fraudulent scheme designed to inflate the company’s net income by falsely confirming to the company’s auditors that their employers had made significant purchases, when, in fact, the purchases had never been made. On or about September 30, 1996, the company filed amended financial statements covering the period January 1, 1996 through March 31, 1996.

- **Aura Systems, Inc.**—In addition to charging the issuer, a wholly owned subsidiary and several former officers, the Commission issued a settled cease-and-desist order against individuals from one of the company’s customers for making circular wire transfers that allowed the company to record “payments” from fictitious sales. Aura did not restate its financial statements relating to this issue.”

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20 SEC, Accounting and Auditing Enforcement Release No. 1571 (June 7, 2002); SEC, Accounting and Auditing Enforcement Release No. 1575 (June 11, 2002).
[4]—Developing Characteristics of Corporate Offenses: Changing Patterns of Corporate Financial Reporting Fraud

Two studies of corporate financial reporting fraud by researchers working on behalf of the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) provide important insights into the changing sources and consequences of corporate crime. In an initial study covering fraud committed in 1987-1997 and a follow up study regarding fraud from 1998-2007, the COSO researchers examined financial reporting practices investigated by the United States Securities and Exchange Commission (“SEC”) and the characteristics of the companies involved. Each of the incidents examined in these studies involved allegations by the SEC of improper practices leading to an Accounting and Auditing Enforcement Release (“AAER”) concerning the company investigated. While the COSO studies focused on financial reporting offenses by public companies, many of the insights reported in these studies carry over into other types of corporate crimes as well. This subsection summarizes the findings of these two studies, with emphasis on the changes in corporate crime characteristics found by researchers for the two periods covered by these studies.

[a]—Financial Reporting Fraud in the Early 1990s

In their initial study of financial reporting fraud in the late 1980s and early 1990s, COSO researchers found that reporting fraud involved mostly smaller companies in which resources were often strained and financial controls were especially weak. The researchers identified nearly 300 companies involved in alleged instances of fraudulent financial reporting investigated by the SEC between 1987 and 1997. They then randomly selected 204 companies for detailed studies of the companies and the fraudulent activities investigated by the SEC.

Key findings in this study of reporting fraud incidents dating from 1987 to 1997 included the following:

1. Companies in which individuals committed reporting fraud generally were small, with few listed on the New York or American Stock Exchanges;

2. Fraudulent activities often involved executives at the very top of the corporate organizations investigated, with the CEO of the organizations involved in 72% of the cases;

[25] Id. at 1.
[26] Id.
3. Audit committees and boards in the companies involved in fraud were frequently especially weak. In most cases, the audit committees rarely met and the companies’ boards of directors were dominated by insiders and others with significant ties to the companies.\[^{27}\]

4. Company founders and board members frequently owned significant portions of the companies investigated for financial reporting fraud.\[^{28}\]

5. Companies frequently suffered significant adverse consequences following incidents of financial reporting fraud, including bankruptcy, significant changes in ownership, and delisting by national exchanges.\[^{29}\]

6. Individuals involved in financial reporting fraud also suffered highly adverse consequences. Individual senior executives were targets of class action law suits and SEC actions that resulted in civil damage liability and penalties imposed on the executives personally. A significant number of individuals were terminated or forced to resign from their executive positions. A few individuals eventually served prison sentences or paid criminal fines.\[^{30}\]

The fraudulent reporting practices investigated by the SEC typically involved large dollar amounts and long-standing conduct ingrained in company activities. The researchers summarized the characteristics of the fraudulent activities of the companies as follows:

Cumulative amounts of frauds were relatively large in light of the relatively small sizes of the companies involved. The average financial statement misstatement or misappropriation of assets was $25 million and the median was $4.1 million. While the average company had assets totaling $533 million, the median company had total assets of only $16 million.

Most frauds were not isolated to a single fiscal period. Most frauds overlapped at least two fiscal periods, frequently involving both quarterly and annual financial statements. The average fraud period extended over 23.7 months, with the median fraud period extending 21 months. Only 14 percent of the sample companies engaged in a fraud involving fewer than twelve months.

Typical financial statement fraud techniques involved the overstatement of revenues and assets. Over half the frauds involved overstating revenues by recording revenues prematurely or fictitiously. Many of those revenue frauds only affected transactions recorded right at period end (i.e., quarter end or year end). About half the frauds also involved overstating assets by understating allowances for receivables, overstating the value of inventory, property, plant and equipment and other tangible assets, and recording assets that did not exist.\[^{31}\]

\[^{27}\] *Id.*
\[^{28}\] *Id.*
\[^{29}\] *Id.*
\[^{30}\] *Id.* at 7.
\[^{31}\] *Id.* at 6.
Financial Reporting Fraud After 2000

A second look at financial reporting fraud after 2000 by COSO researchers produced a somewhat different picture of the firms and practices leading to such fraud.\textsuperscript{32} This study examined 347 companies involved in alleged instances of fraudulent financial reporting during the ten-year period between January 1998 and December 2007. The COSO researchers compared their findings with the insights gained from the earlier COSO study of corporate reporting fraud completed in 1999.

Overall, the COSO researchers found that the number of incidents of fraud increased modestly over the number for the period of their prior study, but that the average dollar amount involved in each incident of fraud was much larger. The researchers summarized these findings as follows:

During the ten-year period 1998-2007, the SEC alleged fraud involving 347 companies as described in 1,335 AAERs. In comparison, the 1999 COSO study spanned 11 years of SEC fraud investigations in which nearly 300 frauds were described in nearly 700 AAERs. . . . In addition, while the incidence of SEC fraud cases increased somewhat from 1987-1997 to 1998-2007, the magnitude of individual fraud cases increased markedly. . . .\textsuperscript{33}

The increases in both mean and median sizes of fraudulent reporting were large:

For the period 1998-2007, the total cumulative misstatement or misappropriation was nearly $120 billion across 300 fraud cases with available information (mean of nearly $400 million per case). This compares to a mean of $25 million of misstatement or misappropriation per sample fraud in COSO’s 1999 study. While the largest frauds of the early 2000s skewed the 1998-2007 total and mean cumulative misstatement or misappropriation upward, the median fraud of $12.05 million in the present study also was nearly three times larger than the median fraud of $4.1 million in the 1999 COSO study. Thus, the magnitude of the fraud problem has increased in the past decade.\textsuperscript{34}

The most common fraud techniques in 1998-2007 involved improper revenue recognition, followed by the overstatement of existing assets or capitalization of expenses. Revenue frauds accounted for over 60% of the cases, versus 50% in 1987-1997.\textsuperscript{35}

The COSO researchers also found that the size of the companies involved in significant financial reporting fraud was much larger in recent years than in the early 1990s. The companies allegedly engaging in financial statement


\textsuperscript{33} Id. at 2.

\textsuperscript{34} Id. at 3.

\textsuperscript{35} Id. at iii.
fraud in 1998-2007 had median assets and revenues of just under $100 million, compared with median assets and revenues of under $16 million for the companies alleged to have engaged in fraud in 1987-1997.\footnote{Id. at iii.}

Top level executive involvement, already high in incidents of financial reporting fraud in 1987-1997, was even more prevalent in 1998-2007. In 89 percent of the cases in which the SEC alleged financial reporting fraud, the SEC named the CEO and/or CFO of the company involved as a participant in the fraud, up from 83 percent of cases in 1987-1997.\footnote{Id. at iii.}

Changes in outside auditors may have contributed to the rise in financial reporting fraud cases after 2000. Twenty-six percent of the firms with fraud allegations in 1998-2007 changed auditors between their last clean financial statements and their last fraudulent financial statements, whereas only 12% of firms without fraud allegations switched auditors during that same time. Sixty percent of the firms with fraud allegations that changed auditors did so during the fraud period, while the remaining 40% changed in the fiscal period just before the fraud began.\footnote{Id.}

Although the COSO researchers suspected that differences in board characteristics and practices would be present for firms with and without fraud allegations, few such differences were found. Characteristics such as percentages of inside directors, numbers of board meetings, percentages of company ownership held by board members, and large share blocks held by outside parties were not significantly different for companies with and without fraud allegations.\footnote{See id. at 20-25.}

The researchers found that several types of adverse corporate consequences followed incidents of financial reporting fraud. Immediate adverse impacts of these incidents were often reflected in corporate stock prices. The COSO researchers found that initial press accounts of an alleged fraud resulted in an abnormal stock price decline of an average of 16.7% in the two days surrounding the news announcement. News of an SEC or Department of Justice investigation resulted in an abnormal stock price decline of an average of 7.3%.\footnote{Id. at iii.}

Long-term negative consequences of financial reporting fraud were reflected in several types of adverse corporate developments. Companies targeted by SEC allegations of financial reporting fraud in 1998-2007 suffered bankruptcies, delistings from stock exchanges, and material asset sales following discoveries of the fraud at rates much higher than companies without such allegations.\footnote{Id. at iii.}

[c]—Lessons from the COSO Studies

At least four important lessons can be drawn from the changes in corporate misconduct found in the two COSO studies profiled here. First, despite
substantial public attention in highly visible corporate incidents such as those involving Enron and Worldcom, effective internal mechanisms for preventing corporate financial reporting fraud are still not in place in many companies and a substantial number of serious incidents of fraud continue to proceed. The need for improved practices—and for diligence in reviewing the continuation and sufficiency of present practices—is confirmed by the findings of substantial levels of misconduct in the most recent COSO study. While this study focused on financial reporting fraud, there is no reason to believe that corporate crime prevention practices are any more effective in other criminal areas. Indeed, given the substantial number of internal and external control measures aimed at preventing financial reporting fraud, there are reasons to believe that the track record of public companies in preventing financial reporting fraud should be better than that in preventing other types of misconduct. The substantial levels of financial reporting fraud still found suggests that continuing levels of other types of corporate misconduct may be even higher and the need for preventive practices in these other areas even greater.

Second, the substantial increase in the size of the dollar amounts typically involved in financial reporting fraud—and the corresponding increase in the seriousness of these offenses—further indicates the need for improved and expanded crime prevention measures such as corporate compliance and ethics programs. These programs can help to prevent offenses (and avoid the financial losses these offenses entail), while also helping to reduce corporate penalties when some offenses still slip through. As more and more is at stake in corporate offenses like financial reporting fraud, the economic case in favor of expenditures on corporate compliance and ethics programs is correspondingly stronger.

Third, the involvement of increasing large (and increasingly complex) companies in financial reporting fraud indicates the importance of wide ranging and systematic efforts to ensure the accuracy of financial records and the completeness of financial reporting across widely distributed corporate operations. The diversity of financial records and information sources that are combined in the reports of a large public company imply equally large challenges in ensuring the integrity and accuracy of those reports. Only equally elaborate corporate information gathering standards, information reporting, and audits will be sufficient for companies relying on diverse information sources to responsibly ensure compliance with financial reporting requirements. Once again, the need for systematic law compliance practices in large corporate organizations is clear. To the extent that law compliance in other intricate legal areas (such as environmental or anti-money laundering law compliance) depends on detailed attention to finely stated requirements in diverse settings, systematic law compliance practices will also be valuable for large organizations in these additional legal areas.

Fourth, the frequent involvement of top executives in financial reporting fraud indicates the need for independent checks and balances limiting senior executives’ actions regarding financial reports. Placing a key executive in the sole position of reporting on or characterizing important financial information simply invites corrupt misreporting for personal advantage or overly-
favorable misreporting to avoid reputational harm or embarrassment in revealing poor corporate performance. Outside, disinterested parties should be used to check the accuracy of financial reporting by senior managers as a matter of regular and unavoidable corporate practice. This sort of reliance on outside fact finding will not only tend to detect and stop high-level financial reporting fraud and other corporate misconduct, but the very involvement of such fact finding and the likelihood that it will detect misconduct at high levels should deter some misconduct before it even begins.

(Text continued on page 1-79)
§ 1.12 Patterns in Corporate Law Compliance and Ethical Conduct

Developing patterns of corporate misconduct in the form of illegal or unethical behavior by corporate employees are difficult to measure, particularly from the outside of the affected firms. However, the best systematic reviews in this area to date are the National Business Ethics Surveys conducted by the Ethics Resource Center (ERC).\(^1\) These surveys involve a series of national polls of business employees at all levels. The surveys are aimed at understanding employees’ views about ethics and compliance in their workplaces. The ERC surveys are important not only because of the scope of employees surveyed each year (the 2007 study alone involved 1,929 respondents in business workplaces), but also because the surveys have been conducted for a number of years (the 2007 study was the fifth in the series) and can therefore provide some longitudinal perspective on changes in employee behaviors over time. Overall, the ERC’s studies seek to “track the views of employees at all levels to reveal real-life views of what is happening within organizations and the ethics risks they face”\(^2\) and to detect changes in these ethical practices and risks over time.

The ERC’s surveys provide a number of helpful indicators to corporate executives and counsel about where to look for problems in compliance and ethics programs, as well as specific steps that companies have used successfully to solve compliance problems and to promote law compliance and ethical behavior. This section summarizes some of the key findings of the ERC’s National Business Ethics Survey completed in 2007.

[1]—The Compliance and Ethics Climate

The ERC found that levels of ethical misconduct in business settings were very high in 2007 and back at pre-Enron levels. During the year prior to being contacted in the survey, more than half of the employees surveyed saw ethical misconduct of some kind in their workplaces.

The ERC found that misconduct levels correlated with weak compliance and ethics practices. The ERC measured several types of ethical weaknesses in business workforces, including:

• Employees’ lack of satisfaction with information from top management;
• Employees’ lack of trust that top management will keep promises and commitments;
• Employees’ lack of satisfaction with information from supervisors;
• Employees’ lack of trust that supervisors will keep promises and commitments;
• Employees’ lack of trust that coworkers will keep promises and commitments; and

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\(^1\) The most recent edition of the Ethics Resource Center’s National Business Ethics Survey is available as a free download (upon registration) from https://www.ethics.org/research/nbes-order-form.asp.

\(^2\) Id.
• Rewards for employees who are successful, even if it is through questionable means.

The ERC survey found that, as workplaces have more of these features, employees in the workplaces are more and more likely to witness unethical conduct in the workplaces. Indeed, in workplaces with four or five of these characteristics, over 90 percent of employees reported witnessing unethical conduct in the year prior to their responses in the study.

[2]—Absence of Employee Reporting

The ERC found that many employees do not report the unethical conduct that they observe, meaning that business managers can not act to reduce the improper conduct. The responses that employees do undertake vary, but do not generally support management solutions to ongoing ethics and compliance problems. More than one-third of the employees who saw misconduct chose to address the misconduct themselves rather than making an official report of the misconduct through company channels. Forty percent of the persons who saw misconduct did not report the misconduct officially because they would have had to report the misconduct to the person involved. Another 25 percent were not aware of any mechanism to report misconduct anonymously. Hotlines were surprisingly ineffective as means to receive misconduct reports. Most employees preferred to speak with someone with whom they had a prior relationship such as a supervisor or ethics officer. Only 3 percent indicated that they would prefer to report misconduct through a hotline.

[3]—Concerns About Futility and Retaliation

Many employees who were aware of misconduct had significant concerns about the futility of reporting the misconduct or about the possibility that they would be targets of retaliation if they made reports. Most employees (54 percent) who did not report misconduct they witnessed had doubts that their reports would make a difference. More than a third (36 percent) of non-reporting parties feared retaliation.

Interestingly, more employees feared retaliation than experienced it. Only one in eight employees reported experiencing some form of retaliation for reporting misconduct. The widespread fear of retaliation no doubt discourages many employees from reporting, while those few who do report are further discouraged from additional reporting by significant levels of actual retaliation.

[4]—Elements of Successful Compliance and Ethics Programs

The ERC survey found that compliance and ethics programs tended to be most effective if the programs had all of the following characteristics:

• Employees are willing to seek advice about ethics questions that arise;
• Employees feel prepared to handle situations that could lead to misconduct;
• Employees are rewarded for ethical behavior;
Employees in the company are not rewarded for success obtained through questionable means; and
Employees feel positively about their company.

Unfortunately, only 25 percent of the employees surveyed indicated that their company’s compliance and ethics programs had all of these features.

[5]—Enhancing Law Compliance: Building an Ethical Culture

The Ethics Resource Center’s survey looked at whether companies adopted ethical cultures in which employees were encouraged to act ethically and lawfully based on company values rather than because of deterrence and sanctioning by authority. The ERC felt that four elements shape ethical culture: ethical leadership, supervisor reinforcement, peer commitment to ethics, and embedded ethical values. They defined these features as follows:

1. Ethical leadership: tone at the top and belief that leaders can be trusted to do the right thing.
2. Supervisor reinforcement: individuals directly above the employee in the company hierarchy set a good example and encourage ethical behavior.
3. Peer commitment to ethics: ethical actions of peers support employees who ‘do the right thing.’
4. Embedded ethical values: values promoted through informal communications channels are complementary and consistent with a company’s official values.”

The ERC’s survey found that only nine percent of companies in the United States today have strong ethical cultures as measured from these features.

[6]—Ethical Culture Promotes Law Compliance

The ERC found strong ethical cultures promoted law compliance in several ways, including decreasing misconduct, increasing the likelihood of reporting, and reducing retaliation against employees who reported misconduct. Twenty-four percent of employees observed misconduct in strong ethical cultures, while 98 percent observed misconduct in weak ethical cultures. Three percent of employees working in companies with strong ethical cultures experienced retaliation when they reported misconduct, compared to 39 percent in weak cultural environments.

[7]—Complimentary Impacts of Ethical Cultures and Compliance Programs

The ERC study found that both ethical corporate cultures and well-implemented compliance programs significantly promote corporate law compliance, but in different ways.

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3 Id.
The ERC determined that the strength of a company’s ethical culture was the single most important factor in reducing misconduct. The ERC found that well-implemented ethics and compliance programs reduced misconduct slightly, but that effective ethical cultures reduced misconduct to roughly one-third to one-half of the rates in companies with weak ethical cultures.

By contrast, ethics and compliance programs had the greatest impacts on the reporting of misconduct. The ERC found that misconduct reporting rates are much higher among employees in companies that have well-implmeneted ethics and compliance programs.

Given these different types of impacts, the ERC concluded that companies wishing to maximize the impacts of their efforts to prevent misconduct should seek to implement both ethical cultures and well-constructed compliance and ethics programs.

[8]—Recommendations for Program Improvements

Based on its findings about the types of business practices that influence levels of misconduct and reporting, the ERC formulated a number of recommendations for company managers and boards of directors. The ERC indicated that a company can make progress in its efforts to ensure lawful and ethical behavior by:

1. Ensuring that measures to create an ethical culture are in place;
2. Pushing ethical leadership down to the mid-management and supervisory level;
3. Recognizing that employees are not reporting many types of misconduct through company hotlines and that hotline statistics summarizing reported misconduct are telling only part of the story regarding internal corporate misconduct;
4. Informing employees about the outcome of reports of misconduct to reassure them that actions were taken based on the reports, that management appreciates their reports, and that the employees will not be targets of retaliation;
5. Creating tangible incentives for upholding ethical standards and for exhibiting other types of ethical courage; and
6. Elevating ethics and compliance professionals to real standing within companies.
§ 1.13 Conclusion

Corporate crime reflects complex behavioral patterns and managerial influences. By (1) initiating criminal conduct; (2) creating pressures that produce foreseeable, but unintended offenses; (3) making inadequate provisions for law compliance in tasks and resources assigned to individual employees; or (4) failing to investigate, understand, and react to past offenses and misconduct, corporate managers can play a number of culpable roles in crimes committed by corporate employees. Corporate crime definitions that attribute employee offenses to firms based on the involvement of managerial fault should not take too narrow a view of relevant managerial errors. To do so will produce a picture of corporate crime that overlooks many offenses which firm managers failed to prevent despite reasonable opportunities to do so.