

# Early Observations on the Prosecutions of the Business Scandals of 2002-03: On Sideshow Prosecutions, Spitzer's Clash With Donaldson Over Turf, the Choice of Civil or Criminal Actions, and the Tough Tactic of Coerced Cooperation

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*In this article, Professor Oesterle surveys the prosecutorial response to the recent corporate scandals and their attendant public pressure. The article explores a number of shifts in prosecutorial tactics. These include the use of "easier-to-try" charges that are tangential to the core wrongdoing, greater use of simultaneous civil prosecutions, threats of prosecution of the corporate entity to coerce cooperation against employees, and increased involvement of state prosecutors in financial investigations. Professor Oesterle critically examines these developments in considering whether they are positive and necessary given the complexity of these matters or rather an excessive use of government power.*

## I. INTRODUCTION

The revelations of 2002 established a dubious high water mark in this country's history of business scandals. Scores of American companies had been cooking their books. A record 330 publicly-traded companies restated their past earnings disclosures. One of the restatements triggered the largest single bankruptcy proceeding the country had ever seen, another the third largest, and yet another the fourth. The total size of all public companies in bankruptcy set a new high as well. The odor of scandal covered an entire industry,<sup>1</sup> the telecom sector, and permeated its support professionals—lawyers, auditors and accountants, investment bankers, securities analysts, and securities rating agencies.

Trillions of dollars of capital value, much of it held in retirement funds, evaporated. A stunned public, and their elected representatives, called for criminal prosecutions of those responsible.<sup>2</sup> Congress passed a new statute, the Sarbanes-

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<sup>1</sup> See Dale A. Oesterle, *Year 2002: The Year of the Telecom Meltdown*, 2 J. TELECOMM. & HIGH TECH. L. 413 (2003).

<sup>2</sup> Consider an editorial in USA Today, a paper that is fairly close to its readers, stated: Law enforcement must do more than seek some restitution for those harmed by corporate illegality . . . . Executives and other individuals responsible for

Oxley Act of 2002, 15 U.S.C. §§ 7201 et seq., that added new business crimes to the federal code and higher penalties for old ones. Under heavy public pressure, prosecutors, both state and federal, responded with investigations. The investigations have, at the time of this writing, produced a trickle of indictments and a guilty plea or two from some minor players and one CEO.<sup>3</sup>

Public officials and prosecutors ask the public to have patience, but one feels a growing public skepticism over whether top executives responsible for the scandals will see jail time.<sup>4</sup> Also, there is some question as to how many

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breaking laws should be aggressively targeted . . . . Cops can't be in every executive suite, just as they can't be on every street. So law enforcement works when it deters bad behavior. If street thugs know that punishment will be swift and sure, they'll think twice about committing crime. Until corporate executives and their accountants feel the same, there's little to prevent the next Enron.

*Big Crimes? Maybe. Big Punishment? Not Likely*, USA TODAY, Feb. 5, 2002, at 11A; *see also* Clifton Leaf, *Enough Is Enough; White-Collar Criminals: They Lie They Cheat They Steal and They've Been Getting Away with It for Too Long*, FORTUNE, Mar. 18, 2002, at 60 (detailing high profile scandals of the last ten years and concluding that "suite thugs don't go to jail").

<sup>3</sup> As of the writing of this article, the CFO of WorldCom has been charged by the United States Attorney for the Southern District of New York and by the Oklahoma Attorney General, who has also charged the CEO of WorldCom. Fifteen executives of HealthSouth have pled guilty in an investigation by the U.S. Attorney in Birmingham, Alabama. The CEO of HealthSouth has yet to be charged. The CFO of Enron is facing nearly 100 charges in federal court in Houston, Texas; two former CEOs of Enron have yet to be charged. A former treasurer of Enron pled guilty and was sentenced to five years in prison. The founder of Adelphia and his sons have been charged and pled not guilty in federal court in Manhattan. The New York County District Attorney has filed charges against the CEO and CFO of Tyco and the CEO's trial has begun. The founder of ImClone Systems pled guilty to a charge of insider trading and is serving eighty-seven months in jail and must pay a \$4.3 million fine. The CEO of Martha Stewart Inc. has been similarly charged and pled not guilty. A senior investment banker at Credit Suisse First Boston has been charged with obstruction of justice and is on trial, and a senior broker at Bank of America has been charged with larceny and securities fraud. *See generally Where Recent Trials Stand*, USA TODAY, Sept. 29, 2003, at 3B. The only successful prosecution of a CEO to date is the guilty plea of the former CEO of Rite Aid Corp., Martin L. Grass, in federal district court in Harrisburg, Pennsylvania. *See* Mark Scolforo, *Rite Aid Ex-CEO Pleads Guilty*, DESERET NEWS, June 18, 2003, at D10.

<sup>4</sup> The comments of Lou Dobbs on his well-known talk show are typical. On June 9, 2003, he noted that:

Seventy executives in all of corporate America have now been criminally charged, 16 of them from Enron. No one has been sent to jail. It's been 553 days since Enron filed for bankruptcy . . . . Each night we track the efforts of the entire justice system, some 93 United States Attorneys in all, to crack down on corporate wrongdoing. Of the 70 criminal cases we're currently tracking on our corporate crime scoreboard, well over half the cases are in the hands of only three prosecutors . . . . Is it fair to call this a prosecutorial failure? . . . Is there some point at which people are going to become extraordinarily impatient?

*Lou Dobbs Moneyline* (CNN television broadcast, June 9, 2003); *see also* Geoffrey Colvin, *Spare the Rod and Save the Company*, FORTUNE, June 9, 2003, at 46 (complaining about the lack of criminal

convictions are necessary to sate the public's calls for justice. Will a successful prosecution of either or both of L. Dennis Kozlowski<sup>5</sup> and Frank Quattrone<sup>6</sup> do? A recovering stock market may shorten the public's memory and salve its irritation, however.

We have seen business scandal before; they seem to come in waves. The last one was the insider-trading scandal of the 1980s involving Dennis Levine, Michael Milken, Ivan Boesky and Martin Siegel. But the size of the 2002 debacle dwarfs many earlier ones, including the Boesky ring. Each wave of scandal brings new pressures on our criminal justice system, and we learn new lessons, some unwanted. For example, from the insider-trading scandals of the 1980s we learned that pleading guilty to specific charges (often with a promise to testify against others) so as to avoid the risk of conviction for more serious crimes, landed people in jail for longer terms than those given to people who went to trial. Many of those who went to trial went free or settled for minor penalties when prosecutors struggled to prove guilt in the case's complex financial settings.<sup>7</sup>

What new developments have followed the prosecutions of the 2002 scandals? A mid-stream analysis of the prosecutions of those involved in the 2002 business scandals is, of course, premature, but still offers information relevant to our efforts to use criminal prosecutions in response to business scandals. Several themes have emerged—some new, some old with new wrinkles. Those discussed here include: 1) prosecutors' use of sideshow charges; 2) the civil/criminal choice; 3) the federal/state competition in prosecutions; and 4) prosecutors' use of business defendants' Achilles heel, reputation, to extract "cooperation." All four developments reveal a criminal justice system evolving, some say struggling, to ease the difficulty of successfully prosecuting complex financial frauds; at issue is whether the changes are beneficial or problematic. Moreover, all the developments involve significant elevations of prosecutorial power without a corresponding increase in systems of prosecutorial accountability; the effectiveness of existing systems of control will be tested.

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charges over the WorldCom fraud: "[N]o bad guys have gone to jail yet. If the feds want credibility with investors and the public, they need to put some perps behind bars."); Leaf, *supra* note 2, at 60.

<sup>5</sup> Mr. Kozlowski was the high profile CEO of Tyco, well known for his lavish lifestyle. He once held a now infamous \$2 million birthday party for his wife in Sardinia.

<sup>6</sup> Frank Quattrone, an employee of Credit Suisse First Boston, was the most powerful dealmaker in the internet boom.

<sup>7</sup> John Mulheren faced trial based on testimony from Mr. Boesky. Mulheren's conviction for stock parking was overturned on appeal.

## II. PROSECUTORS' USE OF SIDESHOW CHARGES

Prosecutors investigating financial business scandals face a daunting task. These are high-risk cases. The scandals are complex, involve many individuals, and the defendants are wealthy and, generally, clever.<sup>8</sup>

The complexity of the cases has a variety of consequences. First, the government investigation and trial will be long and expensive and necessarily involve the use of high-priced experts. Second, the defense can usually out spend the prosecution by several orders of magnitude, hiring very skillful lawyers, many of whom were once very able prosecutors, and their own, very persuasive, experts.<sup>9</sup> Third, the jury (or judge) may be overwhelmed by the facts. We are asking ordinary citizens to understand and keep in their heads multi-step, convoluted business transactions. Finally, it is invariably very difficult to assign individual fault. These scams are group endeavors, with the involvement of several people at several layers in a hierarchy. Some are following orders, some are responsible, and sorting out who is who under a high standard of proof can be daunting.

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<sup>8</sup> For a general discussion, see Damien Cave, *Lock Up the Analysts and Throw Away the Key*, SALON, May 20, 2002, at <http://www.salon.com>.

<sup>9</sup> See Cave, *supra* note 8 (discussing the comments of Henry Pontell, criminologist at the University of California at Irvine). Consider the following exchange between Lou Dobbs and Jeffrey Toobin, CNN Legal Analyst on Lou Dobbs' talk show, *supra* note 4:

Toobin: [E]ven when you have these flagrant disasters, Enron, WorldCom, Tyco, it's very tough to complete the process, get people actually in jail . . . . [A]s you show in your scorecard every night, zero people are in jail from those companies, and it's been 500-plus days since Enron declared bankruptcy.

Dobbs: Is it fair to call this a prosecutorial failure?

Toobin: I think that we're not quite there yet to say it's failure. Certainly, it demonstrates that when it comes to white-collar crime it's a very slow process, and no one has figured out a way to speed it up very well.

Dobbs: Isn't there a learning curve that should get a little less steep?

Toobin: But when you realize that the standard is proof beyond a reasonable doubt and you're talking about executives who are insulated by several layers of other executives, you know, who have lawyers all around them, you're talking about thousands of documents, simply to accumulate the documents, to look for the wrongdoing, it takes a long time.

Dobbs: Are lawyers out-gunned, out financed, out resourced?

Toobin: There's certainly an element of that. You have, I mean, tremendous legal resources on the other side, and essentially unlimited. Defense lawyers are fond of pointing out that the government has unlimited resources, which in theory they do. But in fact, you know, these U.S. Attorneys, they're not just responsible for prosecuting Enron. They have all the federal crimes in their jurisdiction to prosecute with, you know, a few dozen lawyers. And yes, there is an outgunning that goes on in these big white-collar cases.

These and other factors add up to making prosecutions of business scandals very expensive with a marginal probability of success.<sup>10</sup> Prosecutors can spend most of their budget and time, over an extended period, on one case, only to lose or to otherwise achieve marginal results. Heavy investment in negative or marginal returns is not good for a prosecutor's morale, nor her career.<sup>11</sup>

Even if a case is won, it may be years after the fact. The prosecutors suffer through the public's impatience only to find that the public has forgotten about the case when the verdict appears three or four years later.

Prosecutors' natural response is to favor cases in which investigations are completed quickly and without trial.<sup>12</sup> It is not a new story. Known as "working up the ladder"<sup>13</sup> or the "domino game,"<sup>14</sup> the strategy is straightforward: find a

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<sup>10</sup> "In high-profile cases, perhaps the only thing worse than not bringing the case is bringing the case and losing . . . . It may well be that the public, or the press, or the politicians, are absolutely certain who the bad guys are and certain they should be severely punished. But a moral certainty is not a substitute for having evidence." Ann Davis, *Enron Heat Descends on Smaller Players: Others Enjoy Shade*, WALL ST. J., Dec. 1, 2003, at C1, C11 (comments of David Becker, former general counsel of the SEC and now a lawyer in Washington, discussing the problems of trying complex financial swindles before a jury).

<sup>11</sup> See Cave, *supra* note 8 (comments of Henry Pontell):

Prosecutors must have a firm grasp not just of the law but also of high finance, and they must be willing to fight a well-heeled defendant who can drag out the case. So when a U.S. attorney can bust, say, three prostitution rings in the same time it takes to prosecute one person accused of insider trading, it shouldn't come as a surprise that many prosecutors decide not to bother with the latter. "They only go after the biggest and best cases," Pontell says. "Why else would a prosecutor waste their scarce resources on something with an uncertain outcome? They have to show convictions."

For a discussion of prosecutors' motives, see Edward L. Glaeser et al., *What Do Prosecutors Maximize? An Analysis of the Federalization of Drug Crimes*, 2 AM. L. & ECON. REV. 259 (2000) (noting, among other things, that the decision to prosecute is often influenced by prosecutors' interest in running for higher office); William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 533-39 (2001) (prosecutors respond to public desires). Cf. J. Mark Ramseyer & Eric B. Rasmusen, *Why is the Japanese Conviction Rate So High?*, 30 J. LEGAL STUD. 53 (2001).

<sup>12</sup> See Stuntz, *supra* note 11, at 538.

<sup>13</sup> See, e.g., Mary Flood & Tom Fowler, *The Fall of Enron: Task Force Paces Itself for Results; Enron Probe Got Pleas Via Tenacity*, HOUSTON CHRON., Sept. 11, 2002, at 1 (noting that Enron Task Force is working up the chain of command); *The News with Brian Williams* (CNBC television broadcast, Aug. 21, 2002) (interview of Richard Mintz by Forrest Sawyer). Mintz, a former prosecutor, described the Enron investigation at the time of the Michael Kopper plea in the following terms:

Sawyer: Robert, you're a former federal prosecutor. You know how the game works. You put the squeeze on one guy, and then you try to work your way up the ladder. That's clearly what they're doing here, right?

Mintz: That's exactly right. They're following the well-worn path that prosecutors always use in these types of sophisticated, complex financial fraud cases, which is to find somebody who is vulnerable, find somebody who has got some serious criminal liability, but who also has an insider's view and can

canary; offer the canary immunity or some other deal (a reduced sentence),<sup>15</sup> and use the canary's testimony and a hot document or two to convince successively higher ranking executives that a plea agreement will reduce their jail time.<sup>16</sup> An indignant judge accepting the plea lectures the violator, gives the maximum sentence allowable under the plea bargain, and it makes the news.<sup>17</sup> Most are satisfied, except those pundits that compare the sentence with a more lengthy jail term received by a petty con artist in a contemporaneous prosecution.<sup>18</sup>

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take the government's hand and literally lead them through the complex series of financial transactions.

*Id.* Another common tactic is to use threats of charges against family members as leverage against the primary target of the investigation in plea negotiations. See Flood & Fowler, *supra*, at 1 (describing the Enron Task Force's pressure on both Fastow and Kopper through threats of prosecution against their wives and domestic partners). The charges against Mrs. Fastow, failure to report kickbacks received from participants in the fraudulent transactions, are also an example of a sideshow prosecution. See, e.g., Paul Krugman, *Enron and the System*, N.Y. TIMES, Jan. 9, 2004, at A19 (case is a "fluke"; "system is [not] working").

<sup>14</sup> Mark Curriden, *Domino Effect Could Lead to Series of Enron Pleas; Anderson Deal Expected to Spur Insiders to Talk with Prosecutors*, DALLAS MORNING NEWS, Apr. 12, 2002, at 1D.

<sup>15</sup> See, e.g., Henny Sender & Gregory Zuckerman, *Investment Tips: Behind the Mutual-Fund Probe: Three Informants Opened Up*, WALL ST. J., Dec. 9, 2003, at A1 (describing how the New York Attorney General's office broke the 2003 mutual fund scandal).

<sup>16</sup> See Special Report, *Trial and Error—American Companies*, ECONOMIST, June 22, 2002, at 2 (commenting on then United States Attorney Rudolph Giuliani's use of Dennis Levine to get Martin Siegel, the use of Siegel to get Ivan Boesky, and the use of Boesky to get the "biggest fish," Michael Milken). Recently, Department of Justice prosecutors announced a deal with a division chief in Enron, Michael Kopper. In exchange for cooperation in the investigation, prosecutors agreed to accept a guilty plea entailing a criminal penalty of \$4.3 million and a maximum prison sentence of ten years in jail. See Kurt Eichenwald, *Former Enron Executive Pleads Guilty*, N.Y. TIMES, Oct. 31, 2002, at C1. His cooperation could sweep up a large number of former Enron executives, creating a stable of potential cooperating witnesses. *Id.*; see also *Today* (NBC television broadcast, Aug. 21, 2002) (interview with Jim Stewart by Campbell Brown) (discussing the Kopper plea as "a classic prosecutor strategy to work your way up the food chain, to find a witness lower down who knows a lot about what went on, get him to plead guilty, and then tell what he knows about others on the food chain."). A similar strategy is at work in the case against Qwest and HealthSouth senior executives. See Barnaby J. Feder, *U.S. Takes Dual Actions in Qwest Case*, N.Y. TIMES, Feb. 26, 2003, at C1; Kurt Eichenwald, *Key Executive at HealthSouth Admits to Fraud*, N.Y. TIMES, Mar. 27, 2003, at C1.

<sup>17</sup> A recent example is the judge's sentencing of Samuel D. Waksal, founder and former chief executive of ImClone Systems, to the maximum jail sentence on his plea bargain—seven years and three months—and a fine of several million dollars. See, e.g., Jeffrey L. Seglin, *The Jail Threat is Real. So, Will Executives Behave?*, N.Y. TIMES, July 20, 2003, at BU4. The term exceeded the combined sentences of the 1980s stock swindlers Ivan Boesky and Michael Milken. The federal judge scolded Waksal for his "lawlessness and arrogance." The judge told Waksal that "[t]he harm you wrought is truly incalculable." *Id.*

<sup>18</sup> See Cave, *supra* note 8. Those convicted of crimes for the savings and loan scandal in the 1980s, at the time one of the costliest financial crimes in the country's history, spent an average time of 36.4 months in jail. Michael Milken, the target of the insider trading scandal prosecution in the 1980s, spent only 22 months in jail. Moreover, white-collar criminals of the early nineties could expect to serve their time at minimum-security prisons or halfway houses. By comparison, professor of criminology, Henry Pontell, at the University of California at Irvine, found that a burglar who

Cases that do not fit the pattern because they are too complex and the defense too formidable are likely to be quietly dropped after several years of investigation. But this is also old news. What is new is the increasing use of sideshow prosecutions by prosecutors to sidestep the problem. A sideshow prosecution is one in which the main actors in a very public scandal are indicted not on the essence of the scandal itself but on some other less serious, discrete violations of law that have come to the prosecutor's attention during the scandal investigation.<sup>19</sup> The charges made are easier to prove than charges based on the actual, suspected

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steals \$300 or less goes to jail for 55.6 months and first-time drug offenders suffer an average of 64.9 months of jail time. *See generally* KITTY CALAVITA ET AL., *BIG MONEY CRIME: FRAUD AND POLITICS IN THE SAVINGS AND LOAN CRISIS* (1997) (comparing sentences received by major players in the savings and loan scandal a decade ago with the sentences handed to other types of nonviolent federal offenders).

Times may have changed, however. The increased sentences will land white-collar criminals in more severe prison conditions. *See* Jayne O'Donnell & Richard Willing, *Prison Time Gets Harder For White-Collar Crooks*, USA TODAY, May 12, 2003, at 1A; Ted Landphair, *U.S. Giving Tougher Sentences to White Collar Criminals*, VOICE OF AM. NEWS, May 31, 2003 (describing the United States Justice Department's policy of asking for longer sentences and reporting on John Rusnak and Robert Brennan, who each received seven-plus years in medium security prisons).

<sup>19</sup> Prosecutions based on mail or wire fraud statutes may also be sideshow prosecutions. On the other hand, these statutes present another problem, the creeping criminalization of civil violations. Over the past 130 years, prosecutors have used mail and wire fraud statutes to criminalize an increasing broad array of frauds. *See generally* Shani S. Kennedy & Rachel Price Flum, *Mail and Wire Fraud*, 39 AM. CRIM. L. REV. 817 (2002) (mail and wire fraud statutes used as a first line of defense or stopgap device, permitting the prosecution of newly invented frauds until Congress enacts particularized legislation). *See also* Peter J. Henning, *Maybe It Should Just Be Called Federal Fraud: The Changing Nature of the Mail Fraud Statute*, 36 B.C. L. REV. 435 (1995); Geraldine Szott Moohr, *Mail Fraud Meets Criminal Theory*, 67 U. CIN. L. REV. 1 (1998); Frank P. Andreano, *The Evolution of Federal Computer Crime Policy: The Ad Hoc Approach to an Ever-Changing Problem*, 27 AM. J. CRIM. L. 81 (1999). The use of mail and wire fraud charges to police corporate fiduciary obligations of officers and directors is controversial. *See* Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 954-57 (1993); Peter R. Ezersky, Note, *Intra-Corporate Mail and Wire Fraud: Criminal Liability for Fiduciary Breach*, 94 YALE L.J. 1427 (1985). Most of the critics decry the breadth of the charges, arguing that prosecutors use the statutes to enforce essentially contractual duties without proof of loss or causation. *See* Winter, *supra*, at 956. Some of the criticisms are similar to those against sideshow prosecutions, however:

Since the ultimate object of any investigation is indictment and either plea or trial, federal prosecutors frequently will bring a case relatively unrelated to whatever they originally were pursuing, simply because it is an indictable, triable case. The federal agents who work under the prosecutors also are anxious to turn investigations into actual prosecutions. They may press the prosecutor for indictment of whatever offenses appear to be indictable, even if those offenses have little relation to the initial investigation or involve lesser targets or less serious conduct than originally anticipated.

Ezersky, *supra*, at 1441 (citing Daniel J. Hurson, *Limiting the Federal Mail Fraud Statute—A Legislative Approach*, 20 AM. J. CRIM. L. 423, 433 (1983)). In other words, prosecutors can use mail and wire fraud charges to bring sideshow prosecutions; they are another potential tool to do so.

offense, are less complicated for juries, and can carry significant jail sentences as penalties.

Prosecutors' investigations of the main scandal often uncover several smaller violations committed by the targets of the inquiry. These violations of tax law or document retention are sideshows to the main scandal (which in 2002 was usually some form of lying about financial performance), but are discrete acts and easy to prove at trial.<sup>20</sup> Prosecutors can get immediate results at little cost and low risk and attack the targets of the public's anger to boot. On sentencing, the greater scandal may, and often does, have some impact on the severity of the penalty. Finally, and this is an unfortunate claim if true, some argue that the courts will relax the standards of proof to convict a "big tuna" in such cases.<sup>21</sup>

These sideshow prosecutions are not completely new.<sup>22</sup> They have a long history.<sup>23</sup> Al Capone went to prison for the rest of his life on tax evasion charges—he did not declare the revenue received from a greyhound racetrack in Florida.<sup>24</sup> He was never sentenced for his organized crime activity—the murders, bribery, and illegal trafficking in illicit or stolen goods.<sup>25</sup> But in the past such

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<sup>20</sup> A relative of the tactic, and more defensible perhaps, is when prosecutors take on small transactions in a complex financial fraud case and try the case on the transactions. See, e.g., Davis, *supra* note 10, at C1, C11 (noting that Enron prosecutors are focusing on a "Nigerian barge investment" transaction to convict Andrew Fastow, the Enron CEO for his part in the mammoth Enron financial scandal revealed in 2002; the barge deal boosted Enron's earnings by only \$12 million—peanuts); see also Kris Hudson, *Qwest May Hear from Feds Today*, DENVER POST, Dec. 4, 2003, at A1 (discussing the criminal trial of four executives of Qwest for overstated revenues claimed on a single transaction with the Arizona School Facilities Board).

<sup>21</sup> See Susan B. Bodell, *Catching "Big Tuna": How the Seventh Circuit Finally Reeled in Anthony Accardo*, 47 U. MIAMI L. REV. 1061 (1993); see also Linda S. Eads, *From Capone to Boesky: Tax Evasion, Insider Trading and Problems of Proof*, 79 CAL. L. REV. 1421 (1991).

<sup>22</sup> See Special Report, *supra* note 16 (commenting on "indirect prosecutions" in the United States).

<sup>23</sup> Another example, perhaps, is the indictment of the Chairman of the NYSE in 1962, J. Truman Bidwell, on income-tax evasion charges. Mr. Bidwell was acquitted, but censored by the Exchange for giving large gifts without the NYSE board's permission. See Randall Smith, *Courts Face Biggest Corporate Cases in Years: Former CSFB Banker Quattrone Recalls Excesses of Tech Bubble; Trial Hinges on a Single E-Mail*, WALL ST. J., Sept. 25, 2003, at C1.

<sup>24</sup> For a description of the Capone case, see Eads, *supra* note 21. The IRS in the 30s and 40s was also involved in other high-profile cases: the investigation of the Lindbergh kidnapping, the prosecution of Huey Lond, the Pendergast organization, and the conviction of Irving Wexler (a.k.a. "Waxie Gordon"). See ALAN HYND, *THE GIANT KILLERS* 12–13 (1945).

<sup>25</sup> Chicago boss Anthony Accardo had a similar history. See Bodell, *supra* note 21. The reputed heir to Al Capone's organized crime syndicate in Chicago, he was a brutal man, his weapon of choice was a baseball bat, "Joe Batters." Known as the "Enforcer" and allegedly a trigger man in the St. Valentine's Day Massacre in 1929, he was a principal player in the War of Sicilian Succession in Chicago in the 1930s. He was arrested twenty-seven times on charges of carrying a concealed weapon, gambling, extortion, kidnapping and murder. The closest the authorities came to convicting him was on a charge of filing false tax returns. The Seventh Circuit reversed his jury conviction, citing prejudicial publicity during the trial. He died of natural causes in 1992 at the age of eighty-six and never spent a night in jail.



prosecutions seemed to be less frequent, and there was an air of regret about such practices.<sup>26</sup> At minimum, they seemed confined to a steady trickle of tax evasion charges.<sup>27</sup> No longer.

Prosecutors in complex business scandal cases now seem quite content to turn to sideshow prosecutions very quickly in order to sate public pressure for justice and to avoid the high risks of a main show prosecution. Not only has the frequency of such charges increased, but the types of charges prosecutors use have blossomed from tax evasion to, naming just a few, mail and wire fraud, stock parking and other technical disclosure violations,<sup>28</sup> money laundering,<sup>29</sup> and, the new favorite, obstruction of justice (lying to prosecutors or shredding evidence are examples).<sup>30</sup> There appears to be a new cultural acceptance of the practice.<sup>31</sup>

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<sup>26</sup> The "stock parking" convictions, often overturned on appeal, seemed to this marginal observer to mark a turning point. See, e.g., *United States v. GAF Corp.*, 928 F.2d 1253 (2d Cir. 1991). See generally John C. Coffee, Jr., *The Meaning of Mulheren*, N.Y. L.J., July 25, 1991, at 5; John C. Coffee, Jr., *Developing Law on Stock Parking, Bidder Disclosure*, N.Y. L.J., Sept. 11, 1989, at 39 [hereinafter Coffee, *Developing Law*]. The most sensational of the "stock parking" cases was the prosecution of Drexel Burnham Lambert and its star employee, Michael Milken. See DANIEL R. FISCHER, *PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION* (1995). Drexel pled guilty and paid a \$650 million penalty; Milken settled the government's criminal and civil charges, paying over \$2 billion and serving slightly less than 2 years of a 10-year prison sentence.

<sup>27</sup> See Eads, *supra* note 21, at 1427 n.16.

<sup>28</sup> Technical disclosure violations are to be distinguished from disclosure violations that go to the heart of the scandal, which is often a scheme that involves lying to the public investors about a firm's financial condition. Technical disclosure violations include violations of disclosure obligations that do not go to the heart of the scandal but are minor violations of disclosure provisions. Stock parking, for example, is a failure to disclose ownership of stock held in other companies when required by federal rules. See Coffee, *Developing Law*, *supra* note 26, at 39. Prosecutors bring stock parking cases over the more serious, but harder to prove, insider trading charges that are the basis of the wrongdoing.

<sup>29</sup> Federal prosecutors formally charged Enron CFO Andrew Fastow with securities fraud, wire fraud, mail fraud, bank fraud, conspiracy, and money laundering. The money laundering charge caught the attention of some reporters. See Joseph McCafferty, *Laundry Time*, CFO MAG., Nov. 2002, available at <http://www.economist.com> ("Isn't it usually reserved for big-time drug dealers?"). The laundering charge is based on the allegation that Fastow used his ill-gotten gains to make legitimate purchases, including a home. *Id.* The charge carries a maximum sentence of twenty years.

<sup>30</sup> So long as the government can charge more than one underlying violation and meet the other elements of the Racketeer Influenced and Corrupt Organizations (RICO) statute, it can, and routinely does, include a charge of racketeering. See J. Bradley Bennett, *White Collar Crime, Blue Collar Tactics: A Defense Lawyer's Perspective*, 28 W. ST. U. L. REV. 65, 83 (2000-2001). The Department of Justice Manual encourages the use of racketeering charges to obtain more severe jail sentences. The Department of Justice Manual § 9-110.310(2) (2d ed. 2001).

<sup>31</sup> There are, of course, examples of prosecutors proceeding with some of the complex cases. Two former Tyco International executives are on trial in state court in New York on allegations of looting \$600 million from the company; the founding family of Adelphia Communications Corporation goes on trial in federal court early next year facing charges of financial fraud in the collapse of their company.

There are several prominent examples of sideshow prosecutions in the last two years. First, consider the case of Frank Quattrone.<sup>32</sup> He was one of Silicone Valley's most influential investment bankers during the technology stock boom of the 1990s. Mr. Quattrone ran the technology banking business at CSFB, a unit of Credit Suisse Group. Mr. Quattrone and CSFB were lead underwriters in more tech-stock IPOs than any other firm on Wall Street. We now know that there were serious problems in many of those IPOs: underwriters sought and received various forms of illegal kickbacks in exchange for favorable allocations of "hot" issues.<sup>33</sup> The charge? The United States Attorney in Manhattan charged Mr. Quattrone with obstruction of justice and witness tampering for a single e-mail. Mr. Quattrone forwarded to his entire department a subordinate's e-mail advising that CSFB "clean up those files."<sup>34</sup> The charges do not carry large potential fines and, at most, one to two years of jail time.

Second, consider the case that has been material for many a late-night comedy monologue, Martha Stewart. Ms. Stewart, founder of Martha Stewart Living Omnimedia Inc. allegedly traded ImClone stock on an illegal tip of insider information. The charge? On June 3rd she was indicted for perjury and obstruction of justice, not insider trading. As noted in the *Wall Street Journal*, "[i]n many cases, it can be easier to demonstrate a coverup than the underlying crime."<sup>35</sup> Often overlooked in the public discussion of the case is that the SEC has

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<sup>32</sup> See Smith, *supra* note 23, at C1, C10.

<sup>33</sup> CSFB paid \$100 million to settle charges arising from an investigation by the SEC and the NASD that the bank obtained excessive commissions from about 100 hedge funds in exchange for allocations of IPO stock.

<sup>34</sup> He had received a briefing on an SEC investigation into his firm's IPO activities two days earlier. His lawyers will argue that the e-mail refers only to investment banking documents and not those kept by the firm's traders and capital market executives who oversaw the firm's IPO activities.

<sup>35</sup> Mark Maremont, *In Corporate Crime, Paper Trail Leads to Ink Analyst's Door*, WALL ST. J., July 1, 2003, at A1. The financial press is focusing on an aspect of the Martha Stewart indictment that is not what I would call a sideshow prosecution. See *Kudlow & Cramer* (CNBC television broadcast, Jan. 14, 2003) (comments of Larry Kudlow in an interview with well-known trial attorney David Boies). The indictment charges Ms. Stewart with securities fraud for declaring her innocence to an allegation of insider trading, and thereby, temporarily buoying the stock price of her namesake company. Troubling to the commentators is whether one's public proclamation of innocence should itself be fraud. See David Mills & Robert Weisberg, *Flunking the Martha Test*, WALL ST. J., Jan. 16, 2004, at A10 (arguing no; the authors teach a course on White Collar Crime at the Stanford Law School.) While an intriguing question, and it is discussed below, it is not a sideshow prosecution because to prove the claim, prosecutors must establish the basic charge of financial fraud—in this case that she was guilty of financial fraud—for the public denial to be fraudulent. The charge is better subcategorized under another prosecutor's tactic, that of "piling-on." In "piling-on" a prosecutor subdivides a basic charge of financial fraud into numerous charges so as to increase the offender's exposure to a lengthy sentence and encourage a plea bargain. Prosecutors also commonly use mail and wire fraud charges to "pile-on." Moreover, the many charges increase a prosecutor's flexibility in negotiating tailor-made plea agreements. Andrew Fastow, the Enron CFO, was, for example, charged with ninety-eight counts of various forms of financial fraud. He pled guilty to two. See Kurt Eichenwald, *Ex-Chief Financial Officer of Enron and Wife Plead Guilty*, N.Y. TIMES, Jan 15, 2004, at C9.

charged Ms. Stewart in a companion civil proceeding with insider trading; it is running concurrent with the criminal prosecution.<sup>36</sup> She is, in a sense, “answering” for the basic offense of insider trading.

The third example is, perhaps, the most dramatic. Arthur Andersen, the notorious auditor of Enron and WorldCom, was convicted by a jury on June 15, 2002 of obstruction of justice, a charge only tangentially related to the holes in Enron’s financial statements and not at all related to Andersen’s real offense of undermining financial markets by publishing misleading information. Andersen was ultimately fined a paltry \$500,000, the maximum for the charge.<sup>37</sup> Yet, the prosecution damaged Andersen’s credibility so severely that the firm, one of the largest and most successful accounting firms in the world, closed its doors.<sup>38</sup> The

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<sup>36</sup> See *infra* note 67.

<sup>37</sup> Mary Flood & Tom Fowler, *Enron’s Auditor Is Given the Max*, HOUSTON CHRON., Oct. 17, 2002, at A1.

<sup>38</sup> See Peter V. Letsou, *Why Kill Andersen?*, DAILY DEAL, Apr. 23, 2002 (Andersen was the auditor for more than 2,300 publicly traded companies, roughly 17% of the nation’s total). Eliot Spitzer, the New York State Attorney General, later noted that he thought criminal charges against Andersen had been a mistake and refused to bring such charges against Merrill Lynch. See James Leynse, *Straight Talk for Eliot Spitzer: The New York AG on the Mutual Fund Investigation and Other Issues*, BUS. WK., Oct. 6, 2003, at 129–30:

The consequence of indicting Arthur Andersen was we went from five major accounting firms to four, and 60,000 people were thrown out of work. The indictment was predicated on destruction-of-evidence charges. That destruction of evidence was criminal. However, there was no corporate-wide policy to destroy evidence. Therefore, I felt that if you’re going to indict the entire company and destroy the company, do it for a policy that went to the core of the business.

Eric Holder, former deputy attorney general in the Clinton administration and author of the Holder Memorandum, defended the decision in classic sideshow prosecution terms:

Holder: One of the factors that weighed heavily in favor of the Andersen indictment was the fact that it was a recidivist corporation. It had problems in its interaction with Waste Management some years before.

Montagne: Would a better indictment have focused on Arthur Andersen’s accounting practices, or some version of fraud possibly, which of course is its core business?

Holder: Yeah. That would have been a better indictment. Now the question, of course, is can you come up with the proof in order to come up with an indictment that would survive the challenge and be one that would convince a jury to convict the corporation. Yeah, but I mean, technically, that would be a better indictment, because it goes more to the core of what the corporation does.

Montagne: What is the benefit of indicting the company along with company officials?

Holder: Well, you hold a corporation responsible when a corporation has, as a matter of business decision, decided that it’s going to conduct itself in a certain way. You send a message to the rest of the industry so that you have change, hopefully not only in the corporation, but within the industry itself.

Andersen prosecutorial success, moreover, came with its own warning. Even though the Andersen partner in charge of the Enron audit had pled guilty and agreed to testify for the government, subsequent statements by the jurors reveal that the government nearly lost the case.<sup>39</sup> Even the sideshow prosecutions of financial crimes can be difficult.<sup>40</sup>

The Sarbanes-Oxley Act of 2002, prompted by the corporate scandals revealed in that year, increased substantially the penalties for, among other things, you guessed it, mail and wire fraud, all disclosure violations, and obstruction of justice.<sup>41</sup> The penalties for mail and wire fraud were increased by 400%; obstruction of justice penalties increased 200%.<sup>42</sup> Moreover, the Act adds two new crimes that a prosecutor could use in sideshow prosecutions: CEO and CFO personal certifications of financial reports<sup>43</sup> and retaliation against

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*Morning Edition* (NPR radio broadcast, July 31, 2002) (Interview of Eric Holder by Renee Montagne) (note his use of the word "technically"). Later in the interview Holder took a position against any indictment in the Worldcom case, arguing that the collateral consequences would be too substantial. *Id.* ("If it were to be indicted, it would not be able to get government contracts. It might affect its ability to come out of bankruptcy and pay off shareholders, and obviously have a negative impact on the employees of the corporation.")

<sup>39</sup> See Special Report, *supra* note 16.

<sup>40</sup> Federal prosecutors did have another notable recent success. In early October 2003, a jury in federal court in Harrisburg, Pennsylvania, convicted Rite Aid Corporation's former general counsel of obstruction of justice, witness tampering, and other charges related to a \$1.6 billion accounting fraud in the company. See *Rite Aid Ex-Counsel is Convicted: Guilty Verdict Marks First of Corporate Scandals by a Jury in Current Crop*, WALL ST. J., Oct. 20, 2003, at C8.

<sup>41</sup> The Act increases by four times the maximum penalty for mail and wire fraud, from five to twenty years in prison. The Sarbanes-Oxley Act of 2002, § 903, 18 U.S.C.A. §§ 1341, 1343 (2003) [hereinafter Sarbanes-Oxley Act]. The Act also sets the penalty for conspiracy and attempt to commit fraud as the same as the penalty for the underlying fraud. 18 U.S.C. § 1349. The Act doubled the penalty for securities fraud from ten to twenty years in prison and increased maximum fines from \$1 million to \$5 million. 15 U.S.C. § 78ff(a). In the Act, Congress added three new laws prohibiting conduct that undermines a government investigation. Violations for the three crimes doubled the penalties of pre-Act obstruction charges from ten years to twenty years in prison. 18 U.S.C. §§ 1519, 1512(c)(1), 1520(b).

<sup>42</sup> The Act also mandates the review and, when appropriate, amendment of the Federal Sentencing Guidelines for obstruction of justice and criminal fraud, the new criminal provisions of the Act, and securities fraud offenses. Sarbanes-Oxley Act §§ 805, 905, 1101. When the new Guidelines are promulgated they will contain increased sentences for white-collar criminals whose activities create substantial economic losses. The Sentencing Commission has issued temporary guidelines that raise penalties for frauds involving large sums of money and has called for comments. See Eric Lichtblau, *Panel Clears Harsher Terms in Corporate Crime Cases*, N.Y. TIMES, Jan. 9, 2002, at C1. The Justice Department has criticized the new guidelines in that they do not provide for a more comprehensive overall increase in penalties for all types of fraud. See Eric Lichtblau, *Bush Officials Vowing to Seek Tough Penalties in Wall St. Cases*, N.Y. TIMES, Dec. 19, 2002, at C1.

<sup>43</sup> An executive who knowingly certifies financial statements that do not fairly present the firm's financial condition is subject to a maximum fine of \$1 million and a prison term of ten years. If an executive acts willfully, the maximum penalties are increased to \$5 million and twenty years in prison. Sarbanes-Oxley Act § 906. Whether a certification case is a sideshow prosecution or an attack on the core fraud will depend on the prosecutor's choice of errors in the financial reports. The

whistleblowers.<sup>44</sup> The severity of the maximum prison terms authorized in the Act, averaging twenty years, are comparable to those levied for attempted murder, torture, and sexual abuse of a minor.<sup>45</sup>

Critics of the new penalties question whether raising prison terms will have any effect on business conduct.<sup>46</sup> (In this regard, the Act will be a new focal point for the old argument between the opposing camps of the deterrence and retribution theorists,<sup>47</sup> because the Act is a clear victory for those who believe that the criminal law should exact retribution.) Others charge that the legislation was mere “political pandering” to the public outrage<sup>48</sup> because most of the crimes created by the Act were already crimes under earlier legislation.<sup>49</sup> The critics may be right,

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prosecution of the executives of HealthSouth for violating the certification provision is *not* a sideshow prosecution, for example.

<sup>44</sup> Sarbanes-Oxley Act §§ 806, 1107. Executives who knowingly and intentionally retaliate against whistleblowers are subject to criminal fines and a maximum penalty of ten years in prison. The new crime does not deal with the underlying criminal behavior, nor financial fraud, but instead its aftermath and attempts to cover it up.

<sup>45</sup> See Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 954 n.112 (2003).

<sup>46</sup> See *id.* at 955 (collecting authorities and citing a former SEC official: “If they’re willing to risk five years, they’re going to risk [ten] years.”). The Sarbanes-Oxley Act will, no doubt, dismay law and economics commentators, known as “optimal penalty theorists,” who have argued for two decades that criminal fines can create the same deterrent as jail sentences and at a lower cost. See, e.g., Richard A. Posner, *Optimal Sentences for White Collar Criminals*, 17 AM. CRIM. L. REV. 409, 410 (1980); see also Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395 (1991).

<sup>47</sup> See, e.g., Jennifer S. Recine, *Examination of the White Collar Crime Penalty Enhancements in the Sarbanes-Oxley Act*, 39 AM. CRIM. L. REV. 1535, 1567–68 (2002) (using retributive theory to support the act):

The retributive theory of punishment is that punishment, in whatever form, should be imposed because it is “morally fitting that a person who does wrong should suffer in proportion to wrongdoing.” By contrast, the utilitarian view is that punishment is only justifiable where its outcome has a favorable impact on society . . . . This new law creates the possibility that when a CEO defrauds employees, investors and the government—causing catastrophic losses—that CEO will face a sentence that reflects the enormity of the damage his actions have wrought.

<sup>48</sup> See Stephen Labaton, *Handcuffs Make Strange Politics, You Say? But Not In Washington*, N.Y. TIMES, Aug. 2, 2002, at C1 (describing the public backlash’s effect on Congress and the President); see also Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 46 (2003) (describing the rushed nature of the legislation).

<sup>49</sup> See, e.g., Moohr, *supra* note 45, at 951, 955–56:

The criminal charges brought thus far against Enron executives demonstrate that there was no scarcity of criminal laws “on the books.” . . . [L]ongstanding federal criminal laws, substantial penalties, and increased certainty of punishment did not deter serious business misconduct at an astonishing number of corporations. Wrongdoers were not deterred by the possibility of contact with the criminal justice system’s enforcement agents and mechanisms—judges, prosecutors, police officers, courtrooms, fingerprinting, perp walks, and

but they have missed the point of the Act. The increased prison terms on a multiplicity of indictable charges will make sideshow prosecutions more tempting to prosecutors and, more importantly, will signal a Congressional acceptance and encouragement of the practice.

Moreover, prosecutors' justifications for sideshow prosecutions seem to have diversified. The old, and still very healthy, justification is that such prosecutions are like a shoestring tackle on the one-yard line; prosecutors must use them to put very bad people behind bars when there is insufficient evidence to otherwise convict them of their core offenses. The new justification, fueled by academic literature on "cooperation,"<sup>50</sup> is that such prosecutions aid the prosecutor's overall effort to secure effective cooperation (in exchange for leniency) from those who are under investigation. To a prosecutor, Martha Stewart was much more than an inside trader; she obstructed their investigation. By making an example out of her, future targets of investigations will be more likely to cooperate and less likely to resist.

One can view the development of sideshow prosecutions as inevitable and, perhaps, even healthy given the constraints of a prosecutor's budget,<sup>51</sup> but there is a cost—we lose the public trial, and with it the revelation and condemnation of the core corrupt business practices that attracted the public's ire and the prosecutors' attention.<sup>52</sup> To some, sideshow charges look like what they are: an end-run around the more difficult to prove, yet suspected (and hyped), actual offense.<sup>53</sup> There has been some negative comment. The following is typical talk-show comment on the charge against Martha Stewart: "And it just sticks in one's craw that she's being

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bail hearings. Nor were they deterred by the stigma and societal condemnation that attaches to a felony conviction or even to an indictment. . . . This evidence suggests that penal sanctions alone will not prevent future Enrons.

<sup>50</sup> See *infra* text accompanying note 146.

<sup>51</sup> One could argue that they are preferable to no prosecutions at all. See Leaf, *supra* note 2, at 68 (describing the research of Professor Susan Long at Syracuse University). In a ten-year period from 1992 to 2001, the SEC referred 609 cases to the Justice Department for possible criminal charges, only sixty or so a year. United States Attorneys declined to prosecute in 64% of the cases and obtained guilty verdicts in 76% of the 36% of the cases in which they did prosecute. Only eighty-seven defendants spent a day in jail.

<sup>52</sup> Critics could also note the heavy reliance on prosecutors' case-by-case judgment and the increased variability of treatment given offenders. It would also be difficult to implement a "maximum penalty" direction from the United States Attorney General. See Eric Lichtblau, *Ashcroft Limiting Prosecutors Use of Plea Bargains*, N.Y. TIMES, Sept. 23, 2003, at A1 (detailing a controversial policy directive issued by Attorney General Ashcroft instructing U.S. Attorneys to "seek the most serious charges possible in all cases").

<sup>53</sup> An extraordinary example of a sideshow prosecution comes from the military. The military recently arrested Capt. James Yee, a Muslim chaplain who ministered to the 600 or so prisoners at Guantanamo Bay, Cuba. The government charged him with espionage. When the spy case crumbled, the government charged him with adultery and keeping pornography on his government-owned computer. See Robyn Blumner, *Adultery Charge in Military Case is Hypocritical*, COLUMBUS DISPATCH, Dec. 15, 2003, at A9 ("It is simply not fair or valid to single out Yee for an adultery charge when the list of military transgressors is probably longer than the contrail on a B-52.").

prosecuted for lying about a crime that she was not charged with. It's like they went around the back door because they couldn't find the actual case against her."<sup>54</sup> William Safire, writing in *The New York Times* also questioned whether a protestation of innocence, not made under oath, should be transformed into a charge of "materially misleading federal investigators."

Stewart . . . dared to tell an investors' conference that her sale of stock was perfectly legal and that she was cooperating with investigators. She also proclaimed her innocence in some detail to the *Wall Street Journal*.

That, charges the government, was a crime. Although common sense suggests that mounting a public defense is the natural thing to do for a person being anonymously smeared, the prosecutor reads a sinister motive into her speaking out: She was not trying to salvage her personal reputation but was instead pumping up the price of her company's stock. . . .

Even a world-famous "domestic diva" . . . is entitled to act like a jerk on occasion without risking a charge of criminal conspiracy.

The message this selective prosecution is sending executives is not "don't lie"; rather it is: Don't explain your side to investors or the media lest it land you in court for manipulating your stock. Wrong message.<sup>55</sup>

Moreover, prosecutors can lose these cases as well. The hung jury in the Quattrone case demonstrates that jurors may reject even very basic allegations of financial misbehavior.<sup>56</sup> A *Wall Street Journal* story, after the trial noted:

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<sup>54</sup> *Late Edition* (CNN television broadcast, June 15, 2003) (interview of Mickey Sherman by Wolf Blitzer).

<sup>55</sup> William Safire, *Fight Back; Fight Back, Martha*, N.Y. TIMES, June 12, 2003, at 21A; see also Paul Craig Roberts, *A Comedy of Injustice*, WASH. TIMES, July 17, 2003, at A19:

Mr. Comey indicted Martha because she publicly declared her innocence. . . . Mr. Comey's invented charge ignores the fact that in our legal system a person is innocent until proven guilty . . . Mr. Comey follows up this preposterous charge with another. He indicts Martha for covering up a crime of which she is not accused. . . . [T]he investigation . . . found no basis for a felony charge of insider trading. . . . Regardless of your opinion of Martha, do you want to live under a "Catch-22" legal system like the one Mr. Comey has devised in which a person must incriminate oneself or be indicted for fraud?

<sup>56</sup> See Randall Smith & Kara Scannell, *Inside Quattrone Jury Room, Discord Culminates in Mistrial*, WALL ST. J., Oct. 27, 2003, at A1. The final vote was 8-3 for conviction on two counts and 6-4 for acquittal on a third count. Important to those jurors that voted for conviction was Mr.

Easier can be far from easy. White-collar defense attorneys say the failure of the government to win a conviction against [Quattrone] will give prosecutors pause in a strategy they have employed widely in the string of high-profile scandals that rocked the business world over the past two years: Go for the lesser, seemingly simpler charge, if the big one looks too tricky to try before a jury.<sup>57</sup>

### III. THE PROSECUTOR'S CIVIL/CRIMINAL CHOICE

The development of sideshow prosecutions also suggests more serious questions. Should we understand that business scandals ought to be more appropriately tried in civil prosecutions, where the burden of proof is lower?<sup>58</sup> The fines can still be substantial and other penalties, such as disabling violators from ever again working in their chosen occupations, can be severe. Civil prosecutions could also be tried before expert judges, knowledgeable in accounting and finance.

Or, in the alternative, is our criminal system in need of substantial overhaul to handle such cases? With the increasing use of sideshow charges we may also be getting reform of the criminal system by stealth and misdirection. The sideshow charges provide a method of reducing the elements of a crime, or, in effect, relaxing burdens of proof, and simplifying cases for juries that make the criminal law a more effective weapon in financial fraud cases. One wonders whether a more direct, honest approach to the problems of criminal trials in financial fraud cases would be a more wholesome approach.

Perhaps this is just an academic's pipe dream. The difficulties of reforming our criminal system within presently construed constitutional boundaries (we cannot, for example, create a selective jury pool to empanel sophisticated juries<sup>59</sup>),

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Quattrone's equivocation on whether he had, as head technology—sector investment banker at CSFB, directed IPO allocations of hot issues.

<sup>57</sup> Kara Scannell & Randall Smith, *Quattrone Mistrial May Give Prosecutors Reasons to Hesitate*, WALL ST. J., Oct 27, 2003, at C1.

<sup>58</sup> See, e.g., Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319 (1996) (government prosecutors should use civil rather than criminal actions against corporate entities). For a discussion of burdens of proof, see John Kaplan, *Decision Theory and the Factfinding Process*, 20 STAN. L. REV. 1065 (1968); Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994).

<sup>59</sup> There are constitutional dimensions to many aspects of these prosecutions. See, e.g., Mark D. Hunter, *SEC/DOJ Parallel Proceedings: Contemplating the Propriety of Recent Judicial Trends*, 68 MO. L. REV. 149 (2003) (discussing the problems in simultaneous civil and criminal proceedings against one set of defendants for one set of transactions); Robert G. Morvillo & Robert J. Anello, *White-Collar Crime: Limiting Venue for Business Crime Prosecutions*, N.Y. L.J., Aug. 6, 2002, at 3; David Horan, *Breaking the Seal on White-Collar Criminal Search Warrant Materials*, 28 PEPP. L. REV. 317 (2001) (noting the debilitating effect on a business of a government search warrant that permits or requires possession of all a business's operating records); Amber Harding et al., *Procedural Issues*, 39 AM. CRIM. L. REV. 923 (2002) (focusing on white collar crime litigation); see also Thomas Keifer Wedeles, *Fishing for Clarity in a Post-Hubbell World: The Need for a Bright-*



suggest that we ought to take a fresh look<sup>60</sup> at relying more heavily on civil prosecutions in complex financial scandal prosecutions, both alone or in conjunction with parallel proceedings in criminal court.<sup>61</sup> There are several new provisions in the Sarbanes-Oxley legislation that give the SEC new powers in civil cases. The SEC can not only fine offenders but also can ban them from participating in the financial services industry or from serving on the board of directors of a publicly traded corporation.

There is some evidence that prosecutors are relying more heavily on their civil powers. The SEC is, for example, relying primarily on civil prosecutions in the mutual fund scandals of this year (2003).<sup>62</sup> Eliot Spitzer, the New York

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*Line Rule in the Self-Incrimination Clause's Act of Production Doctrine*, 56 VAND. L. REV. 613 (2003) (discussing the power of the government to compel the production of corporate records by an employee who is asserting a Fifth Amendment privilege).

<sup>60</sup> As noted below, civil prosecutions have been used for financial scandals for some time and their use seems to be on the increase. By a fresh look, I mean a new look at the theoretical justifications of civil prosecution and, something that is currently missing in the literature, a theory of when civil rather than criminal prosecution of financial scandals is socially preferable. If I were asked to develop a theory, I would focus on cases in which indicting financial institutions would destroy them and, yet, in which holding individuals accountable for the acts of an entire institution would be unfair (and hard to slip by juries). This was the basis for the Manhattan District Attorney's Office's decision not to prosecute Enron's biggest bankers: J.P. Morgan Chase & Co. and Citigroup Inc. and its officials. The office settled its investigation for an agreement from the banks to pay a civil fine of \$300 million and to overhaul their internal compliance procedures. Ann Davis, *Enron Heat Descends on Smaller Players; Other Enjoy Shade*, WALL ST. J., Dec. 1, 2002, at C1:

"We determined that our judges and our juries, if asked to evaluate the criminal intention of any particular defendant on trial by himself, would have a very difficult time. The way the corporations that is that projects get divvied up," says John Moscow, deputy chief of the D.A.'s Investigation Division. Mr. Moscow adds that, although outright liars or cheaters should and can be convicted, it is harder to prosecute group activity, particularly when lawyers help execute the deals. "If you have someone who's working hard, and has the opinion of counsel that this is nothing illegal, the conduct of that person and his colleagues, taken together, may constitute what looks like a crime but no particular individual may have provable criminal intent," he says.

<sup>61</sup> Parallel proceedings produce their own unique set of legal problems, however. Concurrent litigation raises significant discovery, constitutional, and strategic issues for both the defendant and the government. See, e.g., Hunter, *supra* note 59; Harding et al., *supra* note 59, at 942-58; *Criminal Probe Stymies SEC's Case Against Health South CEO*, 18 CORP. OFFICERS & DIRECTORS LIABILITY LITIG. REP., No. 23, June 2, 2003, at 6 (describing a federal court's decision to lift an asset freeze imposed on Richard M. Scrusby in the SEC's civil case because he could not examine witnesses in a parallel criminal investigation). In many such cases, however, the civil prosecutions await the outcome of the criminal prosecution. See Harding et al., *supra* note 59, at 944. *Discovery from Former Enron CFO Must Wait for Criminal Case*, 18 CORP. OFFICERS & DIRECTORS LIABILITY LITIG. REP., No. 19, Apr. 7, 2003, at 3 (a federal judge stayed discovery in the civil case against Andrew Fastow until the criminal case was resolved).

<sup>62</sup> See, e.g., Reed Abelson & Riva Atlas, *Regulators' Complaint Outlines Fraud Case*, N.Y. TIMES, Nov. 21, 2003, at C1 (founders of PBHG Funds); Deborah Solomon & John Hechinger, *SEC Takes Heat for Quick Deal with Putnam*, WALL ST. J., Nov. 17, 2003, at C1 (actions against Putnam

attorney general, backed off threats to bring criminal charges against a mutual fund trader when the Office of the Comptroller of the Currency and the SEC convinced him that a forced closing of the firm and civil fraud actions against the firm's executives would be a sufficient remedy.<sup>63</sup> Spitzer also relied on a civil prosecution under the New York Martin Act to sue Merrill Lynch for the recommendations of its securities analysts<sup>64</sup> and to sue Salomon Smith Barney and several of its high profile clients for "spinning" hot IPOs.<sup>65</sup> The prosecution of Invesco is in three civil suits brought by a coordinated effort of the SEC and the state attorneys-general of both New York and Colorado.<sup>66</sup> In the Martha Stewart case the federal government is pursuing parallel proceedings in civil and criminal courts.<sup>67</sup>

The major criticism of such civil prosecutions is that fines thus imposed can be less than the profits actually made from the illegal conduct and that, as such, the fines are merely a "cost" of doing the nefarious business. This involves more than the historic debate over whether civil law is a more appropriate tool than criminal law at "pricing" behavior to force individuals to internalize the costs of their behavior;<sup>68</sup> it is the claim that the civil fines are consistently significantly lower than the profits obtained from the illegal conduct.<sup>69</sup> Jack Grubman settled the

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Investment Management and Morgan Stanley); John Hechinger, Carrick Mollenkamp & David Armstrong, *Civil Charges Are Expected in Fund Scandal*, WALL ST. J., Nov. 3, 2003, at C1.

<sup>63</sup> Riva D. Atlas & Diana B. Henriques, *U.S. Closes Mutual Fund Intermediary*, N.Y. TIMES, Nov. 26, 2003, at C1 (discussing the prosecution of the Security Trust company, an intermediary in the processing of mutual fund trades by pension plans).

<sup>64</sup> John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER, Apr. 7, 2003, at 54.

<sup>65</sup> See, e.g., Charles Pretzlik & Gary Silverman, *Wall Street Under Fire*, FIN. TIMES (London ed.), Oct. 4, 2002, at 19. Spitzer alleged that the investment bank allocated shares in hot (under-priced) IPOs to clients who were CEOs in operating companies and could cause their own companies to direct future investment banking business Salomon's way.

<sup>66</sup> See, e.g., Riva D. Atlas & David Barboza, *Funds Scandal Hits Invesco and Founder of Strong*, N.Y. TIMES, Dec. 3, 2003, at C1.

<sup>67</sup> Because the judge in the civil case has not stayed the case pending the outcome of the criminal case, the parallel proceedings in the Stewart case are producing their share of ticklish legal questions. See, e.g., Kara Scannell, *Stewart Seeks an Unusual Pretrial Advantage*, WALL ST. J., Dec. 1, 2003, at C1 (reporting that Stewart's lawyers are attempting to compel deposition in the civil case to gain access to government information that is not available to them until two weeks before trial in the criminal case).

<sup>68</sup> See, e.g., John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 195 (1991) (arguing that criminal law should prohibit, not price, behavior); see also Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984) (distinguishing sanctions and prices as the basis for legal rules).

<sup>69</sup> See, e.g., Daniel Gross, *Is this Any Way to Punish Fraud?*, THE NEW REPUBLIC, May 19, 2003, at 16:

In virtually every instance, it is worth it for the firms and individuals to pay the fines—because it was worth it for the firms to engage in the sort of behavior that earned the fine in the first place. The \$1.4 billion in fines—which will be

threat of a civil action against him for false stock touting by agreeing to never again work in the industry and paying a fine of \$15 million, less than half of his severance check.<sup>70</sup> The attorney general of Massachusetts has characterized the SEC's settlement of its civil action against Putnam Investments, for example, as a "big hug and a kiss."<sup>71</sup> The criticism seems harsh in light of the fact that any successful civil (or criminal, for that matter) prosecution usually unleashes a wave of private lawsuits ("follow on" suits) led by the country's ablest class action attorneys.<sup>72</sup>

Those skeptical of civil prosecutions punctuate their arguments by decrying the efforts of some defendants in civil suits to seek insurance coverage or tax deductions for settlements of civil prosecutions. Insurance coverage or tax breaks may apply to mitigate the effect of civil fines for both corporate and individual prosecutions.

In years past, public prosecutors could rely on settling civil prosecutions for substantial amounts of money and take credit for redressing corporate wrongdoing. As explained below, payments made by individuals were often reimbursed by the corporation or insurance companies and, if not, were deductible against income for tax calculations. The recent scandals have given renewed attention to indemnification, insurance and tax relief values that have been long appreciated inside corporate boardrooms, but not understood by those on the street corner.

On the corporate level, there is no legal barrier to insurance coverage for civil fines; the only real limit is imposed by the outlines of the contract coverage that insurance companies are willing to write.<sup>73</sup> Credit Suisse First Boston (CSFB), for

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considerably less after taxes and potential insurance collections—amounts to only a tiny fraction of the immense profits companies earned as a result of the corrupt practices for which they are being sanctioned. Morgan Stanley's share of the global settlement amounts to \$125 million (pre-tax). But that amounts to about 0.6 percent of its \$19 billion in 2002 revenues. The ten firms in question probably clocked about \$1.4 billion on a few good days in 1999.

*See also* Emily Thornton, *Wall Street's Fine Mess: How Much Should Brokerages and Banks Pay in Penalties for Their Tainted Research?*, BUS. WK. ONLINE, Dec. 16, 2002 (fines are mere slaps on the wrist unless they are much higher than the \$100 million that Merrill Lynch must pay), available at [http://www.businessweek.com/bsdaily/dnflash/dec2002/nf20021216\\_5177.htm](http://www.businessweek.com/bsdaily/dnflash/dec2002/nf20021216_5177.htm).

<sup>70</sup> Cassidy, *supra* note 64, at 54.

<sup>71</sup> Solomon & Hechinger, *supra* note 62, at C15.

<sup>72</sup> *See, e.g.*, Jeff Chorney, *Wall Street Settlement With Regulators Reveals Practices That May Bring Wave of Private Suits*, MIAMI DAILY BUS. REV., May 6, 2003 (noting that courts have selected Milberg Weiss, the country's most prominent securities class action specialist, to chair a six-firm committee of plaintiffs' counsel in a series of more than 800 actions involving more than 180 initial public offerings underwritten by the large Wall Street investment banks. Experts value the exposure of defendants in the cases at over \$6 billion.). *But see Setback For Investors' Wall Street Lawsuits*, FIN. NEWS, July 6, 2003 (noting that Judge Pollack ruled that investors could not, without better evidence, blame fraudulent analysts' reports from the major investment banks for their market losses).

<sup>73</sup> There are common law contract doctrines on agreements that violate "public policy." Included in this category are insurance agreements that cover intentional or willful wrongdoing. *See*

example, sued its insurer, a unit of Chubb, for \$45 million of a \$100 million settlement with New York's Attorney General over how the firm allocated initial public offerings to favored clients.<sup>74</sup> CSFB's policy coverage excluded "taxes or fines or penalties imposed by law" and CSFB argues that the settlement amounts not specifically identified as a "penalty" are covered by the policy.<sup>75</sup>

Individual executive defendants, barred from seeking indemnification for criminal fines,<sup>76</sup> may seek coverage of civil fines under company indemnification promises and company provided personal insurance (so called "D & O insurance"). Corporate law permits corporations to indemnify directors and officers for expenses (including attorneys' fees), judgments, fines and settlement amounts paid in civil prosecutions on a finding that the defendant "acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the corporation."<sup>77</sup> It is common for corporations to promise executives indemnification to the full extent "allowed by law" and then buy D & O insurance to reimburse the corporation for any such payments. Corporations then supplement the indemnification promise (and its D & O policy surety) with a separate provision in the D & O policies, payable directly to individual officers, that provides coverage exceeding what the law allows for indemnification.<sup>78</sup> The coverage of this supplementing insurance is limited only by what insurance companies are willing to write and corporations are willing to pay.<sup>79</sup>

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Terrence G. Stolly, *Scienter Under the Private Securities Litigation Reform Act of 1995: Unexpected Implications on Director and Officer Liability and D & O Insurance*, 29 CAP. U. L. REV. 545, 586 (2001).

<sup>74</sup> See, e.g., Elliot Blair Smith, *Some Banks Might Seek Insurance Help*, USA TODAY, May 8, 2003, at 3B.

<sup>75</sup> *Id.*

<sup>76</sup> Corporate indemnification for criminal fines is not allowed under state corporate statutes unless "he had no reasonable cause to believe his conduct was unlawful." MODEL BUS. CORP. ACT § 8.51(a)(1)(iii). There is also a general public policy against agreements granting indemnification for criminal activity. See *Globus v. Law Research Serv.*, 418 F.2d 1276 (2d Cir. 1969) (invalidating an underwriter's claim for indemnification from the issuing corporation for 1933 and 1934 Act liabilities).

<sup>77</sup> See, e.g., DEL. GEN. CORP. LAW § 145(a) (2001). The corporation may also indemnify a senior executive in a criminal action only if she "had no reasonable cause to believe [that her] conduct was unlawful." *Id.* If a director successfully defends criminal charges, she may demand indemnification, even if the victory is but a technical escape. See *Perconti v. Thornton Oil Co.*, C.A. No. 18630-NC (Del. Ch., May 3, 2002) (mistrial on charges related to misuse of corporate funds).

<sup>78</sup> See, e.g., DEL. GEN. CORP. LAW § 145(g) (2001) (permitting insurance coverage "whether or not the corporation would have the power to indemnify such person against such liability of this section").

<sup>79</sup> In theory, insurance companies could agree to cover civil fines paid by individual officers when they did not act in "good faith," for example. D & O policies typically include a dishonest, criminal or fraudulent conduct exclusion. See Stolly, *supra* note 73, at 584. Some states also have statutory limits. A New York statute, for example, excludes insurance coverage of liability payments to a director who is adjudicated liable for deliberately dishonest actions or for an illegally obtained personal gain. N.Y. BUS. CORP. LAW § 726(b)(1) (McKinney 2003).

The SEC takes the position that corporate indemnification agreements covering liabilities of directors and officers arising under the Securities Act of 1933 are void as against public policy.<sup>80</sup> Commentators read the policy statement to include the 1934 Act as well.<sup>81</sup> Some states have chafed over the policy.<sup>82</sup> In any event, the SEC policy does not extend to reducing director or officer exposure to federal securities liability through D & O insurance,<sup>83</sup> nor does the SEC object to corporations advancing or reimbursing directors and officers for defense expenses.<sup>84</sup>

Recent scandals show the application of the indemnification and insurance agreements. In *Adelphia Communications*, for example, the former CEO and his three officers/relatives demanded that either the company or its D & O insurance carriers pay the defense costs of personal criminal and civil prosecutions.<sup>85</sup> The demand started litigation between the company and the insurance carriers over who would pay.<sup>86</sup> In a \$22 million settlement with six top Xerox Corporation executives of allegations of accounting fraud, the company (the shareholders that had been defrauded) paid \$19 million of the fines and the executive's legal fees to boot.<sup>87</sup>

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<sup>80</sup> Item 510, Regulation S-K, 17 C.F.R. 229.510 (2003); *see also* Item 512, Reg. S-K, 17 C.F.R. § 229.512(h)(3) (2003). Item 510 requires the disclosure of the SEC position against indemnification in a prospectus when a firm discloses its indemnification agreements with directors. In Item 512, the SEC conditions acceleration of the effective date of the registration statement under the 1933 Act on a disclosure, known as the "Johnson and Johnson formula," that the registrant had been advised of the SEC's position against indemnification, that on a claim for indemnification the corporation will submit the issue to a court "unless in the opinion of its counsel the matter [of indemnification] has been settled by controlling precedent."

<sup>81</sup> *See* JOSEPH W. BISHOP, JR., *THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* § 9.13, at 29 (1982); *see also* *Heizer Corp v. Ross*, 601 F.2d 330 (7th Cir. 1979), *modified*, *King v. Gibbs*, 876 F.2d 1275 (7th Cir. 1989) (dismissing cross-claims for indemnification against Rule 10b-5 liabilities).

<sup>82</sup> Wisconsin, dismissing the SEC policy, has adopted an indemnification provision in its Business Corporation laws that provides that it is the public policy of Wisconsin to permit indemnification against liabilities imposed under federal securities laws. WIS. STAT. § 180.0859 (2002) (adopted in 1987).

<sup>83</sup> *See, e.g.*, SEC Rule 461, 17 C.F.R. 230.461(c) (2003) (insurance against federal securities liabilities is not considered a bar to acceleration of the effective date of a registration statement).

<sup>84</sup> Some claim that the SEC will not block indemnification for settlements of, as opposed to judgments in, federal securities actions. *See* Stolly, *supra* note 73, at 587.

<sup>85</sup> *See In re Adelphia Comm. Corp.*, Civ. Action Number 03-703 (S.D.N.Y. Jan. 28, 2003), *appeal filed*.

<sup>86</sup> The Bankruptcy Court held that the insurance companies should pay \$300,000 per defendant in the first phase of the defense and left the door open for future requests. *Id.*; *see also* *United States v. Weissman*, No. S2 94 Cr. 760, 1997 U.S. Dist. LEXIS 8540 (S.D.N.Y., June 13, 1997) (company bound to pay legal fees through the appeal or any applications for post-conviction relief).

<sup>87</sup> *SEC Wants Execs to Pay Fines Out of Their Own Pockets; Many of Those Facing Penalties Are Covered by Insurance Policies Bought by the Company*, L.A. TIMES, June 17, 2003, at Pt. 3, p.5.

Tax law comes into play as well. Tax deductions are available for the expenses of defending against both criminal and civil actions.<sup>88</sup> At issue is whether a tax deduction is available for payments made to the government as a consequence of the litigation. Corporations may deduct disgorgement payments made in response to civil prosecutions if the payments are not “fines or penalties.”<sup>89</sup> When the New York Attorney General and the SEC were negotiating a settlement with Wall Street brokerage houses over illegal stock touting, a rumor that the firms would deduct two-thirds of the settlement payments caught the attention of Senator Charles E. Grassley, Chairman of the Finance Committee.<sup>90</sup> Senator Grassley asked the SEC to include language in the settlement to prevent the firms from deducting the settlement payments. He also asked the SEC to report to Congress on settlement language and introduced legislation limiting the tax deduction to payments made in restitution to people for harm actually suffered.<sup>91</sup>

Rather than attempt to force an admission by defendants that the settlement was a “penalty,” to force defendants to otherwise admit guilt,<sup>92</sup> or to put other language of characterization in the settlement agreement, the SEC took a simplifying tack. The SEC sought and received binding assurances from settling defendants that they would not seek reimbursement for some or all of the

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<sup>88</sup> *Commissioner v. Tellier*, 383 U.S. 687 (1966) (income tax deduction allowed for expenses incurred in the unsuccessful defense of criminal charges under the Securities Act of 1933).

<sup>89</sup> I.R.C. § 162(f) (2003); I.R.S. Reg. § 1.162-21 (2003). If the payment is “remedial” rather than a “penalty,” it is deductible. See *Middle Atlantic Distributors, Inc. v. Commissioner*, 72 T.C. 1136 (1979). A taxpayer’s repayment to a third party of funds improperly or unlawfully obtained usually will not be a penalty. Senator Grassley believed that the “media coverage today might significantly overstate the after-tax cost and actual burden on Wall Street” if two-thirds of the settlement payments made proved to be deductible. Press Release, Senator Charles Grassley, Statement to Reporters and Editors on Global Settlement (April 28, 2003), available at <http://grassley.senate.gov/releases/2003/p03r04-28.htm>.

<sup>90</sup> Luisa Beltran, *Senators Question \$1.4 Billion Wall Street Settlement*, CBS MARKETWATCH (April 24, 2003). In the proposed \$1.4 billion settlement with the investment bankers, \$487 million in civil penalties was not tax deductible but Senator Grassley was concerned that the \$387 million in disgorgement of profits, the \$432 in million assessments for an independent research organization, and the \$80 million fund for investor education would be deductible.

<sup>91</sup> See Press Release, U.S. Senate Committee on Finance (April 28, 2003). The proposed Government Settlement Transparency Act of 2003 denies a tax deduction of any payments made in settlement of civil prosecutions, including those where there is no admission of guilt or liability. Payments made for restitution to harmed people would remain tax-deductible. A related case involved the agreement of Philip Anschutz to pay over \$4.4 million to charity in settlement of the New York Attorney General’s investigation into Anschutz’s privileged treatment in IPO allocations. When the press reported that Anschutz could take a charitable deduction for the donations, Anschutz quickly replied that he had already exceeded charitable deduction limit with other donations. See *The Anschutz Ransom*, WALL ST. J., May 15, 2003, at A16.

<sup>92</sup> One SEC Commissioner, Harvey Goldschmid, raised the possibility of having defendants admit guilt in the settlements. Most SEC settlements do not require a defendant to admit or deny charges. See Craig Schneider, *SEC May Dump Indemnity Policy* (June 17, 2003), at <http://www.cfo.com/Article?article=9802>.

settlement amounts. In the final \$1.4 billion settlement over illegal stock touting in IPOs, investment banks involved agreed not to deduct the payments made from their income taxes or use insurance to pay those amounts.<sup>93</sup> In the Xerox settlement, noted above, the SEC required the six individuals to agree to pay \$3 million of their own fines rather than be indemnified by Xerox.<sup>94</sup> These harsher settlement bargains and the power of the SEC to seek non-monetary penalties in civil prosecutions, barring an individual from serving as a director or officer in a publicly traded company, for example, have made civil prosecutions a more powerful alternative to criminal prosecutions.

The SEC's tougher stance in civil settlements will reopen the debate over whether there should be limits on insurance against civil fines for companies and tighter limits on indemnification and insurance for civil fines levied on senior executives in publicly traded companies.<sup>95</sup>

In the end, however, our reluctance to rely on civil settlements may stem from a public understanding that jail time for offending executives is the proper penalty.<sup>96</sup> Many are hopeful that jail time will provide a "wake up call" to those in the business community that have lost their ethical moorings.<sup>97</sup>

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<sup>93</sup> See, e.g., *SEC Names Firms for Restitution Fund*, L.A. TIMES, July 19, 2003, at part 3, p. 3; see also Robert Schmidt, *SEC Wants Settlements in Which Defendants Pay Own Fines*, CHIC. SUN-TIMES, June 17, 2003, at 49.

<sup>94</sup> See Schmidt, *supra* note 93.

<sup>95</sup> The new SEC policy "troubled" former SEC enforcement director and federal judge Stanley Sporkin. The change will make it harder for the SEC to settle cases, Sporkin noted, and make insurance less attractive and less valuable to companies. *Id.* The policy considerations of the company and individual situations are distinguishable. Insurance for company payments gives insurance companies an incentive to monitor and evaluate company *bona fides* when deciding whether to insure and for how much. The insurance companies can thus provide an effective private compliance supplement to public prosecutors. When companies indemnify their own officers, however, agency problems complicate the analysis; the officers control the companies that indemnify them. The agency problem supports more stringent controls on the process of indemnification or on the boundaries of the indemnification payments themselves.

<sup>96</sup> The public appetite for criminal prosecutions in corporate fraud cases is often distasteful to academics. Consider the comments of Professor John C. Coffee, Jr., discussing "white collar" scandals of the past several decades:

In general, the public has shown little apprehension about the use of the criminal sanction in these cases, but rather has applauded its use. No one . . . can doubt the attitude of the American public: it has wanted prison sentences imposed—substantial ones. In part, this may simply reflect the public's enjoyment of the spectacle of the once mighty made humble, but the possibility at least exists that those commentators who predicted an erosion in respect for the criminal law if it was used to enforce economic regulations have either overestimated the legal sophistication of the American public or underestimated its appetite for bread and circuses. Possibly, the public is more concerned about being victimized by the underlying offenses, or possibly it simply does not believe that it will be at risk from such prosecutions.

Coffee, *supra* note 68, at 236. Professor Coffee has been a longtime critic of the extensive use of the criminal law in corporate scandal cases. See, e.g., John C. Coffee, Jr., *Paradigms Lost: The Blurring*

Experts in business ethics disagree among themselves on whether the public sentiment is correct. Some call criminal prosecutions a “distraction” and call for a deeper and more enduring cultural resolve against fraudulent conduct;<sup>98</sup> others say jail sentences are a “huge factor” in persuading people to behave ethically in business.<sup>99</sup> All ethics experts, however, are humbled at the lack of success of their corporate ethics compliance programs. Many of the offending CEOs were from companies that had internal ethics programs designed by well-paid ethics experts.<sup>100</sup>

Perhaps the most valuable benefit of the increased threat of criminal prosecution may not be picked up by raw statistics. Lawyers, particularly in-house counsel, have related, off-the-record, that legal compliance advice at the board level, now punctuated by the threat of personal criminal exposure, receives immediate and serious consideration.<sup>101</sup> In short, increased exposure to criminal penalties has led senior executives to put more stock in the firm lawyer’s advice. Business people may chafe over the enhanced role of attorneys in the operation of corporate affairs, but the fact remains that lawyers hold a newly defined position of

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*of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875 (1992); John C. Coffee, Jr., *Hush!: The Criminal State of Confidential Information after McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 AM. CRIM. L. REV. 121 (1988); John C. Coffee, Jr., *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Duties and the Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117 (1981). He argues that “there is a social loss in defining the criminal law so that individuals cannot safely avoid its application.” Coffee, *supra* note 68, at 220. His work builds on two earlier themes in the academic literature. First is the claim that vague or general penal statutes will have a “chilling effect” on legitimate behavior. See Isaac Ehelich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, 2 J. LEGAL STUD. 257, 263 (1974); see also William J. Stuntz, *Substance, Process, and the Civil-Criminal Line*, 7 J. CONT. LEGAL ISSUES 1 (1996). And second is the claim that as more behavior becomes subject to criminal sanctions, less stigma will be attached to criminal convictions. See HERBERT PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* 273 (1968); Henry M. Hart, Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401 (1958); Sanford Kadish, *Some Observations on the Use of Criminal Sanctions to Enforce Economic Regulations*, 30 U. CHI. L. REV. 423 (1963).

<sup>97</sup> See Seglin, *supra* note 17.

<sup>98</sup> See Philip A. Feigin, *Do We Really Have To Do This?*, LAW WEEK COLORADO, June 2003, at 6 (“In my 20 years of fraud investigation I grew to believe that a long prison sentence is of very little deterrent effect to the true criminals, because each one who sets out to defraud believes he or she is smarter than the oafs who got caught before them.”); see also Ken Brown & Ianthe Jeanne Dugan, *Sad Account: Andersen’s Fall From Grace Is a Tale of Greed and Miscues*, WALL ST. J., June 7, 2002, at A1; Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 23 J. CORP. L. 1, 9 (2002).

<sup>99</sup> See Ribstein, *supra* note 98 (comparing the skeptical views of Daryl Koehn, director of the Center for Business Ethics at the University of St. Thomas in Houston, and Ronald F. Thiemann, professor of religion and society at Harvard Divinity School, with the more positive view of Scott Harshberger, an ex-state attorney general and now corporate lawyer).

<sup>100</sup> *Id.*

<sup>101</sup> Conversations with participants in a conference of in-house counsel at the Moritz College of Law in May 2003.



power in all publicly traded firms. When a lawyer tells a board that a proposed course of conduct is, or even may be, illegal, it is an effective, single-vote veto of the decision.

More than ever before, a counseling lawyer had better know her stuff and have some common sense to boot. Among other things, for example, the old days of knee jerk conservative counseling (to be on the safe side) are over. Excessive conservatism in a lawyer's advice will damage the competitive position of a firm. On the other hand, a lawyer who lets things slide and is not right up-to-date on the latest legal rules and requirements can expose the firm to the threat of ruinous criminal prosecutions. Firms will distinguish themselves in the competitive marketplace as never before on the quality of their legal advice.

#### IV. FEDERAL/STATE COMPETITION IN PROSECUTIONS

The uneasy and very public competition between federal prosecutors and those of several states is a notable aspect of the 2002 scandals. The very public tension between the New York attorney general Eliot Spitzer and the two chairs of the Securities and Exchange Commission, Harvey Pitt and his successor William Donaldson, was reported, minute-by-minute, in the financial press.<sup>102</sup> There were a succession of public criticisms,<sup>103</sup> intermingled with statements of cooperation and mutual respect.<sup>104</sup> The low point came when Wall Street institutions succeeded, for a time, in convincing prominent members of the House to propose, and Donaldson to support, legislation to pre-empt some state prosecutions and rule-making.<sup>105</sup> When the mutual fund scandals erupted in 2003, legislators, in

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<sup>102</sup> One of the better pieces done on the clash was John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street*, THE NEW YORKER, April 7, 2003, at 54.

<sup>103</sup> See, e.g., Deborah Solomon, *It's Spitzer vs. the SEC on Mutual Funds*, WALL ST. J., Dec. 19, 2003, at C1; Adrian Michaels, *Feud Between Spitzer and SEC Heats Up: Barely Suppressed Tension Now Spilling Over*, FIN. TIMES (London ed.), July 16, 2003, at 24; Landon Thomas, Jr., *State, Intent on Regulating, Look at Morgan*, N.Y. TIMES, July 15, 2003, at C1.

<sup>104</sup> See, e.g., Eliot Spitzer, *Pitt Call a Truce on Wall St.: Financial Enforcers Vow to Cooperate*, WASH. POST., Oct. 4, 2002, at E1; Riva D. Atlas, *SEC Chief Plays Down Clash with State Attorneys-General*, N.Y. TIMES, Sept. 15, 2003, at C2.

<sup>105</sup> The Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong., (1st Sess. 2003) (Sponsors Richard H. Baker, R-La, Sue W. Kelly, R-NY, Doug Ose, R-Ca, Michael G. Oxley, R-Oh, and Patrick J. Tiberi, R-Oh). The legislation also would prevent states from imposing, among other things, conflict of interest rules on brokerage firms. If the bill had been law in 2002, it would have prevented Eliot Spitzer, the New York Attorney General, from pursuing his investigation into stock analyst conflicts at the major Wall Street brokerage houses that led to ten firms agreeing to pay \$1.4 billion in fines and to institute internal, structural changes to their operations. Spitzer publicly denounced the bill. See Thomas, *supra* note 103. The editorial page of the *Wall Street Journal* supported the bill. See *Curbing Mr. Spitzer*, WALL ST. J., July 24, 2002, at A14 ("Mr. Spitzer should calm down."). The bill was similar to a draft amendment to the Sarbanes-Oxley Act circulated in June of 2002 and pushed by Morgan Stanley. See Gretchen Morgenson, *Bill to Limit Oversight of Wall St. Gains*, N.Y. TIMES, July 11, 2003, at C2. Conspiracy theorists could even claim that Harvey Pitt's final downfall was not his public political failures but his failure to

hearings on the issue, listened to Spitzer charge that the SEC was “asleep at the switch”<sup>106</sup> and had to agree; the legislation was quietly dropped.<sup>107</sup>

Spitzer’s success has led other state attorneys general to be more active as well.<sup>108</sup> Critics of the aggressive enforcement activities of the state attorneys general decry the “balkanization”<sup>109</sup> or decentralization of the country’s securities regulation. The federal government and the states, it is argued, are tripping over each other’s investigations<sup>110</sup> and vying with each other to set industry standards and rules in the settlement of their cases.<sup>111</sup> Companies under investigation argue

“slap down” Spitzer, which angered the powerful institutions on Wall Street. *See, e.g., Sara Hansard, Counting on Pitt’s Successor to Keep Spitzer, et al., at bay; Street to Donaldson: Curb State Watchdogs*, INVESTMENT NEWS, Dec. 16, 2002 (“Wall Street executives were left seething after Mr. Pitt failed to pre-empt or rein in Mr. Spitzer early on in the controversy over stock analysts.”).

<sup>106</sup> Tom Lauricella, *Spitzer Seeks Forfeiture of Some Fund Advisory Fees*, WALL ST. J., Nov. 3, 2003, at C11 (Spitzer made the charge in testimony before the Senate Subcommittee on Financial Management); *see also* Solomon & Hechinger, *supra* note 62, at C15 (describing the SEC failure to act on tips and its failure to find problems in a four month investigation as “embarrassed” by Eliot Spitzer who “stepped ahead” of the agency and uncovered “massive fraud” in the mutual fund industry).

<sup>107</sup> Deborah Solomon, *Zealous States Shake Up Legal Status Quo*, WALL ST. J., Aug. 28, 2003, at A4. The bill did make it through the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and was reported to the full House Committee on Financial Services. *See* Morgenson, *supra* note 105, at C2.

<sup>108</sup> *See* Solomon, *supra* note 107, at A4. Spitzer’s success with the decades old New York Martin Act has led over 20 states to pass or consider their own versions of the federal Sarbanes-Oxley legislation. *Id.*

<sup>109</sup> Richard Baker, the Republican Chairman of the House subcommittee on capital markets, has used the term repeatedly. *See* Joshua Chaffin, *Probe Targets Morgan Stanley: US State Securities Regulators Claims Investment Bank Misled Customers Over Mutual Funds*, FIN. TIMES (London ed.), July 15, 2003, at 15. So did Michael Oxley, chairman of the House Financial Services Committee. *See* Joshua Chaffin, *Determination of a Crusader Brings the Banks to Heel: State Attorney General’s Rise to Prominence*, FIN. TIMES (London ed.), Dec. 21, 2002, at 17; *see also* *Straight Talk From Eliot Spitzer*, BUS. WK., Oct. 6, 2003, at 130 (responding to the charge of balkanization):

We do not want balkanization. That would be bad for capital formation, bad for investors, bad for the economy. Having said that, enforcement has always been distributed among various layers of government. We have federal, state, and local enforcement. That has been the case since the early part of the last century. . . . We have had this duality of enforcement for the past 80 or so years without confusion or dislocation.

<sup>110</sup> The case that has angered federal officials the most seems to be the Okalahoma Attorney General’s criminal prosecution against executives of Worldcom, now MCI. *See* Barnaby J. Feder & Kurt Eichenwald, *A State Pursues WorldCom, and May Hurt the U.S. Case*, N.Y. TIMES, Aug. 28, 2003 at C1; Solomon, *supra* note 107, at A4; *see also* Riva S. Atlas, *SEC Chief Plays Down Clash with State Attorneys-General*, N.Y. TIMES, Sept 15, 2003, at C2; Yochi Dreazen, *States Mull Civil Lawsuits Charging MCI with Tax Fraud*, WALL ST. J., Aug. 29, 2003, at B1 (criticizing the Oklahoma action, as “re-fighting an old battle,” and distinguishing it from Spitzer’s mutual fund investigation, which “opened a new front” on a whistle-blower’s tip).

<sup>111</sup> *See, e.g.,* Amy Borrus & Mike McNamee, *States vs. The Feds: A Fragile Truce*, BUS. WK., Sept. 2, 2003, at 106.

that their exposure to prosecutions by fifty-six state attorneys general (there are fifty states and six territories) with inconsistent restructuring demands is chaotic and hugely expensive.

The claim appears disingenuous in light of the evidence.<sup>112</sup> The power of the state officials, so feared by companies, is generated by their newfound willingness to work together and coordinate their efforts, not their provincialism.<sup>113</sup> The state attorneys general met and divided up responsibility for investigating the investment banks' securities analysts' false stock touting and agreed to share information and resources. Spitzer investigated Salmon, Smith Barney (a division of Citigroup), and Merrill Lynch; Utah took Goldman Sachs; Massachusetts took Credit Swiss First Boston; Alabama took Lehman Brothers; New Jersey took Bear Stearns; Texas took J.P. Morgan Chase; California took Deutsche Bank; and Connecticut, Arizona and Florida took UBS Warburg.<sup>114</sup> This hardly sounds like balkanization. It is the cooperation of the states, not their maverick behavior, that has companies quaking. It is not surprising that many of these banks participated in the \$1.4 billion "global settlement" announced in April of 2003.<sup>115</sup>

Critics also fault the motives of state attorneys general in bringing the cases.<sup>116</sup> The state officials, they argue, are engaging in political grandstanding, trying to further their personal political careers at the expense of careful, planned prosecutions.<sup>117</sup> State attorneys general often run for governor. Moreover, critics

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<sup>112</sup> See, e.g., Allan Sloan, *Reform? Don't Celebrate Yet*, NEWSWEEK, Aug. 4, 2003, at 45 (real reason for beginning legislation is pressure from Wall Street to rein in Spitzer).

<sup>113</sup> See, e.g., *Enemy of the States: Companies are Increasingly Worried by the Growing Power, and Desire, of American's State Attorneys-General to Regulate and Punish Them*, ECONOMIST, Sept. 6, 2003, at 53 [hereinafter *Enemy of the States*].

<sup>114</sup> See *Capitulate or Die*, ECONOMIST, Oct. 5, 2002, at 86.

<sup>115</sup> See Patrice Hill, *Investment Fraud Costs Brokerages; 10 Firms to Pay \$1.4 billion in fines; Hold Billions for Suits*, WASH. TIMES, April 19, 2003, at A1 (The \$1.4 billion includes \$875 million in fines, \$80 million for investor education and \$450 million in seed money for an independent research fund. About \$390 million of the fines was to be returned to investors. The investment banks also agreed to new rules of conduct and to restructure internal compliance systems.).

<sup>116</sup> For a summary of the positions discussed in this paragraph see *Enemy of the States*, *supra* note 113, at 53-54. Spitzer is the target: "From his \$1.4 billion "global settlement" with Wall Street's ten-biggest securities firms in April, Mr. Spitzer wrung nearly \$500 million for state coffers, and invaluable publicity for his blossoming political career—without even detailing quite how the banks were supposed to have broken the law." *Id.*

<sup>117</sup> For a particularly harsh assessment, see Editorial, *Curbing Mr. Spitzer*, WALL ST. J., July 24, 2003, at A14:

Mr. Spitzer had an elaborate theory about how the Street's behavior during the Internet boom amounted to criminal fraud, but he was careful never to test it with actual indictments—perhaps because he didn't want to burn his bridges to New York's biggest industry and most generous campaign contributors. The threat was there, however. CEOs felt more or less blackmailed into agreeing to quasi-regulatory changes that Mr. Spitzer had no business dictating on behalf of the rest of the country.

argue that the state officials have discovered that these cases are a rich new source of revenue in a time when states are strapped for cash. The argument seems to defeat itself at some level as failed prosecutions or prosecutions in which defendants are given “slap-on-the-wrist” penalties are hardly the stuff for political capital. In any event, the evidence that state attorneys general act exclusively with such motives is thin; most believe what they declare when they take their oath of office. Moreover, one hopes that there is room for advancing one’s political career by doing what is right and in the public interest.

While the ideal system would be a single, well-funded, and active federal agency enforcing rules against securities fraud, reality offers different lessons. The SEC was asleep during many of the scandals and too cautious on others. Eliot Spitzer broke the securities analysts’ scandal in 2002,<sup>118</sup> the IPO spinning scandals of 2002,<sup>119</sup> and the mutual fund scandal in 2003;<sup>120</sup> the SEC did not act, even though it had, internally, solid indications of the problems. The state attorneys general have embarrassed the agency, and we are all benefiting as the SEC has been jolted into action.<sup>121</sup> The competition from the states has proven, in fact, to be very healthy. Recent financial scandals have demonstrated that it is too easy for a single federal agency, which is itself a large bureaucracy with problems that all bureaucracies have, to get complacent in its industry oversight and then defensive when scandal breaks.<sup>122</sup> (The SEC has an enforcement staff of over 830 lawyers; Mr. Spitzer has 15 lawyers in his investor protection unit.<sup>123</sup>) That is, the state attorneys general are a needed and healthy check on inevitable bureaucratic indifference by a large federal agency.

There is a legitimate concern over Spitzer’s threats to force, on his own, structural fixes in those industries that are the focus of his investigations. The \$1.4 billion settlement of the securities analysts’ scandal that included structural relief was done in negotiations with the brokerage houses that included significant participation by the SEC.<sup>124</sup> Spitzer’s threats to act on his own stimulated a

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Is there any self-critical capacity at the *Wall Street Journal*? How could Spitzer protect campaign contributions by “blackmailing” potential contributors for \$1.4 billion? What a lapse in critical thinking.

<sup>118</sup> See Spitzer, *supra* note 104, at E1.

<sup>119</sup> *Id.*

<sup>120</sup> See Thomas, *supra* note 103; Tom Lauricella, *Spitzer Seeks Forfeiture of Some Fund Advisory Fees*, WALL ST. J., Nov. 3, 2003, at C11.

<sup>121</sup> For a robust argument along these lines, see Jesse Eisinger, *The Okies Take Over*, WALL ST. J., Aug. 29, 2003, at C1 (“it is [the SEC’s] culture that sets them up for second rate results”).

<sup>122</sup> Consider the remarks of Mr. Spitzer to a reporter on testimony of the SEC chairman, William Donaldson, to the Senate Banking, Housing and Urban Affairs Committee: “We have to destroy this canard that the SEC screwed up because they don’t have resources. . . . It’s a massive army compared to our guerilla fighters—and look what we can do!” Monica Langley, *As His Ambitions Expand, Spitzer Draws More Controversy*, WALL ST. J., Dec. 11, 2002, at A1, A8.

<sup>123</sup> *Id.*

<sup>124</sup> See Hill, *supra* note 115.

coordinated effort that included the SEC. One worries about the limits of his market expertise should he decide to act alone; that is, to act on his own threats. As of this writing, for example, Spitzer has struck out on his own in the mutual fund trading practices scandal to correct excessive mutual fund fees. His settlement talks with Alliance Capital include a demand that the fund reduce its fees.<sup>125</sup> The demand has irked the chairman of the SEC who argued that any change in mutual fund fees should be handled through its rule-making process and that, in any event, “piggybacking” the fee issue on charges of improper trading is “improper.”<sup>126</sup> Once again, however, if the negotiations over fees prod the SEC into action, the investing public may be substantially the better for them.

The scandals of 2002 have taught us that if states are careful not to compromise federal prosecutions with over-inclusive settlements that bind federal prosecutors or grants of immunity from prosecution to the same effect,<sup>127</sup> state attorneys general can offer positive and constructive stimulants to a sluggish federal enforcement effort. Without the prodding of Elliot Spitzer, one wonders how aggressively the SEC would have responded to the 2002 scandals. I am a bit awed by how Spitzer did it: He took on not only the powerful investment banks and brokerage houses of his home jurisdiction in New York (and some of the world’s best paid lawyers), he had to fight the SEC and powerful members of Congress, carrying the investment bank’s water, and the *Wall Street Journal* (the country’s largest newspaper, based in his home jurisdiction) to do it. Amazing.

#### V. LAWYERS ON THE STAND AND OTHER FORMS OF “COOPERATION”

The prosecutions of 2002 remind us in dramatic ways of the power of criminal prosecutions against defendants in the financial industry. In business, particularly in the financial services industry, the accounting industry, or in the practice of business law, the players’ stock-in-trade is, in large part, their reputation for integrity. Some operating businesses that need constant access to the capital markets to survive also live or die on their reputation for financial integrity. In these businesses or professions, an indictment can ruin a firm, or a

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<sup>125</sup> See Christopher Oster & Karen Damato, *SEC, Spitzer Spar Over Terms of Alliance Capital Settlement: Bone of Contention is Lower Fees*, WALL ST. J., Dec. 11, 2003, at C1.

<sup>126</sup> Tom Lauricella, Monica Langley & Susan Pulliam, *Spitzer Gambit May Alter Fund-Fee Debate*, WALL ST. J., Dec. 11, 2003 at C1. When Spitzer agreed to a settlement with Alliance that included a 20% rollback of fees, the chairman of the SEC publicly denounced the fee settlement. See, e.g., Solomon, *supra* note 103.

<sup>127</sup> A state or federal prosecutor’s decision to grant use immunity for testimony binds both jurisdictions. See, e.g., *Kastigar v. United States*, 406 U.S. 441, 448–59 (1972). Moreover, an accepted guilty plea in one jurisdiction is often respected as a terminating event in another. In the state of New York, by statute, a federal guilty plea precludes a follow-on New York prosecution. N.Y. CRIM. PROC. LAW §§ 40.20, 40.30 (2003).

career, well before trial.<sup>128</sup> Trial is unnecessary; the damage is done with the indictment.<sup>129</sup> Vindication, if gained at trial, comes far too late for many in this community.

There are many applications of this basic principle of the prosecutor's raw power over defendants whose stock-in-trade is their business reputation, and we have seen all of them in the prosecutions surrounding the 2002 scandal.

Prosecutors have maximum leverage when threatening charges against financial companies themselves. It has long been true that business organizations may be held criminally liable for the wrongdoing of employees or agents.<sup>130</sup> As far back as 1909, the Supreme Court of the United States noted that, "we see no valid objection in law, and every reason in public policy" to extend criminal liability to corporations.<sup>131</sup> Jail time, of course, is not the object of such prosecutions; criminal fines are all that is possible. But the levy of a criminal fine on a financial institution, which competes and survives on its customer's confidence in its integrity, also threatens the future life of the institution itself. A criminal fine in such a case may be equivalent to a death sentence;<sup>132</sup> at the very least, a criminal fine will have a substantial negative impact on a financial firm's business.<sup>133</sup>

This phenomenon, among others, has led a number of academics over the years to make the claim that criminal prosecutions of business entities generate "unproductive, overdeterrence"<sup>134</sup> that chills legitimate business activity.

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<sup>128</sup> See John Coffee, Jr., "No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment, 79 MICH. L. REV. 386, 425-29 (1980) (discussing adverse publicity problems of a prosecuted company).

<sup>129</sup> See, e.g., *United States v. Regan*, 858 F.2d 115 (2d Cir. 1988) (government threatened pre-trial restraint and forfeiture under RICO of some of the assets of a small investment partnership and then watched in amazement as the firm promptly died; worried investors immediately withdrew their funds and forced the partnership to liquidate).

<sup>130</sup> For an argument against corporate criminal liability, see Fischel & Sykes, *supra* note 58, at 319.

<sup>131</sup> *New York Cent. & Hudson R.R. Co. v. United States*, 212 U.S. 481, 495 (1909). Corporations are criminally liable for any act committed by an employee in the course of such person's employment that is intended to benefit the corporation. See *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972). By contrast, under the Model Penal Code, the prosecution must show that the offense was authorized or performed "by a high managerial agent" acting on behalf of the corporation. See Model Penal Code § 2.07(1)(c) (Proposed Official Draft 1962); see also Kathleen F. Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 RUTGERS L.J. 593 (1988).

<sup>132</sup> See Eric Holder, *Don't Indict WorldCom*, WALL ST. J. EUR., July 31, 2002, at A8.

<sup>133</sup> See generally Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993).

<sup>134</sup> See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994); Fischel & Sykes, *supra* note 58, at 332; Vikramaditya S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477 (1996) (corporate criminal liability is rarely desirable). A new, novel claim is that the prosecution of business entities leads to underdeterrence of corporate wrongdoing as the prosecutions deflect attention from individual managers and executives. See Vikramaditya S. Khanna, *Corporate Crime*

As a consequence of the severity of the effect, a commentator noted as late as 1992 that, “until recently, federal prosecutors rarely made use of this weapon.”<sup>135</sup> No longer. Perhaps spurred on by the United States Sentencing Commission’s 1991 *Federal Sentencing Guidelines*, that feature sentences for corporations,<sup>136</sup> prosecutors now view financial institutions as fair game.

A barely successful criminal prosecution for obstruction of justice sealed the fate of Arthur Andersen, one of the world’s largest accounting firms—the result of account executives on a single account, the Enron audit, shredding documents in a Houston office. Thousands of employees lost jobs, hundreds of clients lost services and the disruption spread worldwide. Drexel Burnham, one of the country’s most active investment banks at the time, did not survive a criminal indictment in the late ’80s.<sup>137</sup>

Prosecutors threatening indictments of business firms threaten their business future, even if the criminal penalties threatened are a small percentage of the firm’s revenue or if the criminal activity was a very minor part of the firm’s overall activities.<sup>138</sup> Firms faced with such threats have very little bargaining power in

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*Legislation: A Political Economy Analysis* (September 2003), at [http://www.bu.edu/law/faculty/papers/pdf\\_files/Khanna V032503.pdf](http://www.bu.edu/law/faculty/papers/pdf_files/Khanna V032503.pdf).

<sup>135</sup> Jed S. Rakoff, *The Corporation as Policeman: At What Price*, N.Y. L.J., Jan. 9, 1992 at 3, 4. See also Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988–1990*, 71 B.U. L. REV. 247 (1991) (noting the dramatic increase in the rate of corporate criminal prosecutions).

<sup>136</sup> U.S. SENTENCING GUIDELINES MANUAL, ch. 8 (1991), 56 Fed. Reg. 22762 (May 16, 1991). For a detailed discussion of the provisions on business entities, see Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205 (1993); Emmett H. Miller III, *Federal Sentencing Guidelines for Organizational Defendants*, 46 VAND. L. REV. 197 (1993). Changes are in the wind. On October 8, 2003, the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines delivered its report to the United States Sentencing Commission. The report contains numerous recommendations. See Press Release, U.S. Sentencing Commission, Panel on the Sentencing Guidelines for Organizations Issues Final Report (Oct. 8, 2003), available at <http://www.uscc.gov/PRESS/re1100803b.htm> (last visited Apr. 2, 2004); see also Julie R. O’Sullivan, *Some Thoughts on Proposed Revisions to the Organizational Guidelines*, 1 OHIO ST. J. CRIM. L. 487 (2004) (discussing the Advisory Group’s report).

<sup>137</sup> Drexel vigorously denied any wrongdoing, steadfastly defended its employees and vowed to fight any charges. Faced with the prospect of a RICO indictment, Drexel pled guilty to six counts of fraud and paid a \$300 million fine. Within months, Drexel had ceased to exist, filing for bankruptcy, liquidating its assets, and laying off over 3,000 employees. See George Anders, *A Shadow of Itself, Drexel Comes Back From Bankruptcy*, WALL ST. J., Apr., 30, 1992, at C1 (detailing the events); see also FISCHER, *supra* note 26.

<sup>138</sup> The Sentencing Guidelines released in 1991 make no allowance for significant reputational loss or loss of the ability to do business after a successful prosecution. Department of Justice guidelines for prosecuting corporations, however, do permit prosecutors to take into account the “collateral consequences” of a corporate conviction. See Elkan Abramowitz & Barry A. Bohrer, *White-Collar Crime, Principles of Federal Prosecution of Business Organizations*, N.Y. L.J., Mar. 4, 2003, at 3. Commentary to the DOJ guidelines acknowledges that “severe consequences to a corporation’s officers, directors, employees and shareholders—many of whom may have been completely uninvolved in and unaware of the criminal conduct and wholly unable to prevent it—may

resisting deals. Those who attempt to take bargaining positions that bluff for trial (“we are innocent”) risk prosecutorial “leaks” that are extremely damaging. The leak of a few e-mails may ruin a career or a company; an indictment may not be necessary.<sup>139</sup> In this regard, the aggressive, calculating use of the media by the New York State attorney general may signal a new era in the prosecution of financial institutions on Wall Street.<sup>140</sup>

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militate against prosecution.” *Id.* Lest prosecutors get too soft, however, the commentary reminds readers that “virtually every conviction of a corporation, like virtually every conviction of an individual, will have an impact on innocent third parties, and the mere existence of such an effect is not sufficient to preclude prosecution of the corporation.” *Id.* See generally Darryl K. Brown, *Third-Party Interests in Criminal Law*, 80 TEX. L. REV. 1383 (2002). The Ad Hoc Advisory Group, reporting in 2003, also did not address this issue. See generally sources cited *supra* note 136.

<sup>139</sup> Eliot Spitzer, the New York State attorney general, published a pile of Merrill Lynch internal e-mails when his negotiations with brokerage firms were stalled. In a matter of days Merrill’s share price plunged. Spitzer threatened to release more. The e-mails disparaged companies on which the firm’s stock analysts had given strong buy recommendations. Within two months, Merrill had agreed to pay \$100 million and its chairman had made a public apology. See Joshua Chaffin, *The Spitzer Settlement: Determination of a Crusader Brings the Banks to Heel State Attorney-General’s Rise to Prominence*, FIN. TIMES, Dec. 21, 2002, at 17. Later some wondered whether Mr. Spitzer had leaked e-mails embarrassing to Sandy Weill, Citigroup’s Chairman and CEO. *Id.* A stock analyst for a Salomon Smith Barney (part of Citigroup), Jack Grubman, alleged in an e-mail that Weill had asked him to upgrade a recommendation on AT&T to win support from the AT&T chairman who sat on the Citigroup board (to block a rival, John Reed, who is now chairman of the SEC and) to get Weill’s recommendation for his children to get into an exclusive pre-school in New York City. Weill made a \$1 million donation to the pre-school and recommended Grubman’s children for admission; the school complied. See Cassidy, *supra* note 64, at 54. Mr. Spitzer denies that his office leaked the e-mail. See *After Hours with Maria Bartiromo*, (CNBC television broadcast, Dec. 16, 2002) (interview with Eliot Spitzer); Cassidy, *supra* note 64, at 54. Weill soon resigned from the boards of both AT&T and United Technologies. Spitzer did reveal the Grubman e-mails formally in his civil suit against Salomon Smith Barney a few months later. Jessica Sommar, *Solly’s Pig’ Out—Spitzer Exposes Grubman’s Smoking Gun E-Mail*, N.Y. POST, Oct. 1, 2002, at 27.

<sup>140</sup> See Cassidy, *supra* note 64, at 54:

One Wall Street executive says he has never seen anything like the media manipulation that took place during the analyst probe. “Nothing compares to this,” he said. “Leaking documents, leaking testimony, leaking the intentions of the regulators. Everything was leaking.” Spitzer’s courting of reporters also irked some of his fellow-regulators, particularly those at the SEC and the NASD, which have a reputation for carrying out investigations discreetly. Spitzer, on the other hand, saw media management as a legitimate and effective tool to build momentum for reform. Unlike the national regulators, who have to deal with Wall Street on an ongoing basis, he saw himself as an independent outsider, whose role was to uncover abuses and remedy them in any way he could.

Spitzer’s example was followed by the Massachusetts Secretary of the Commonwealth, William Galvin, who released damaging internal e-mails from Credit Suisse First Boston. *Id.*; see also Jonathan D. Glater, *Martha Stewart Lawyer Seeks an Inquiry on Possible Leaks*, N.Y. TIMES, July 22, 2003, at C4; Patricia Hurtado, *Who Leaked Martha News?*, NEWSDAY, July 22, 2003, at A14 (Stewart’s lawyers accused the government prosecutors of leaking details about her case to the media before the grand jury had voted on an indictment; they argued that the grand jury may have been



The power and ease of a prosecutorial threat to indict a financial corporation is supplemented by a lighter evidentiary burden for obtaining a conviction of a corporation than of an executive once in trial.<sup>141</sup> This is a seductive package for overworked prosecutors living with a public's outrage over well-publicized, massive financial scandals.<sup>142</sup> Total capitulation to prosecutors by companies under threat of criminal sanction may be the only real business strategy left to save a financial firm's future. A more apt description of the companies' only survival strategy would be the "belly up" approach.<sup>143</sup> Professor Michael Simons has summed the lessons for financial corporations under investigation:

First, a corporation's best hope to avoid indictment is to engage in "super cooperation" that will convince prosecutors of its "good corporate citizenship." Second, that "super cooperation" may be irrevocably hampered if the firm does not quickly change its top management.<sup>144</sup>

Prosecutors have mounted a spirited defense of the technique. Illustrative is the argument of Larry D. Thompson, chair of the President's Corporate Fraud Task Force, in an op-ed piece in the *Wall Street Journal*:

Some have also argued that offering a corporation leniency in return for full and open cooperation with a government investigation is somehow "coercive." I strongly disagree with this notion. While it may not redound to the benefit of corrupt corporate officers, it is always in the corporation's interest to cooperate fully with the government so that matters under investigation can be resolved as quickly and fairly as possible.

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prejudiced by the leaks; the prosecutors responded by implying that the defense counsel could have been the source of the leaks).

<sup>141</sup> See Stephen A. Saltzburg, *The Control of Criminal Conduct in Organizations*, 71 B.U. L. REV. 421, 426-27 (1991) (the prosecution may be able to secure the conviction of a corporation without demonstrating that a particular agent of the corporation is culpable); Elkan Abramowitz & Barry A. Bohrer, *White-Collar Crime Andersen Jury Instruction: A New Collective Corporate Liability?*, N.Y. L.J., July 2, 2002, at 3 (the judge in the Andersen case instructed the jury that it need not be unanimous as to which Andersen employee acted with criminal intent as long as each juror believed at least one employee did).

<sup>142</sup> Consider the comments of an ex-Southern District of New York prosecutor, W. Neil Eggleston: "The problem is if you give prosecutors a tool, they will almost never exercise good judgment in not using it." Vanessa Blum, *Two-Edged Tool: Government Seeks Early Waiver of Attorney-client Privilege, Weighs Cooperation When Charging Corporations*, MIAMI DAILY BUS. REV., Mar. 21, 2003, at A8.

<sup>143</sup> When threatened with an attack by an overwhelming superior opponent in a dog fight, one dog rolls over showing the other its belly in total submission, in an attempt to defuse the attack.

<sup>144</sup> Michael A. Simons, *Vicarious Snitching: Crime, Cooperation, and "Good Corporate Citizenship"*, 76 ST. JOHN'S L. REV. 979, 1017 (2002).

The Justice Department has directed its prosecutors to evaluate the authenticity and completeness of cooperation from corporations under investigation. This is important because it allows the government to conserve its limited resources in investigations where cooperation is meaningful and reflects management's commitment to an acceptance of responsibility for the wrongful conduct at issue. The direction was necessary because some attorneys who appear before the department purporting to represent a corporation are in fact representing the interests of management.<sup>145</sup>

His analysis, which focused solely on results, overlooks the source of the leverage.

A threat to a company in bankruptcy impacts thousands of uncharged, presumably innocent people for the acts of a few senior executives. The firm could survive the indictment of its senior executives, who would be terminated in a reorganization of the firm's management, but it often cannot survive an indictment of the firm itself. Under such circumstances, avoiding an indictment is the only way to survive. The firm's life is in the hands and discretion of a prosecutor. Convincing a prosecutor that a firm is "cooperating" is a firm's only viable strategy. Since an indicted firm is a dead firm, a decision to defend an indictment is suicide. With this kind of power, prosecutors can make very heavy demands on threatened companies.

The Department of Justice has guidelines for prosecuting business organizations that it reissued in 2003.<sup>146</sup> The guidelines include a list of nine factors that prosecutors should consider in reaching a charging decision against a company.<sup>147</sup> The factors are: the nature and seriousness of the offense; the

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<sup>145</sup> Larry D. Thompson, 'Zero Tolerance' for Corporate Fraud, WALL ST. J., July 21, 2003, at A10. Thompson is also the author of the Thompson Memorandum, discussed in the text at *infra* pp. 476-77 and note 146.

<sup>146</sup> See Elkan Abramowitz & Barry A. Bohrer, *Department of Justice Sends Clear Message to Corporate Wrongdoers: An Entity that Pays Lip Service to Cooperation, But that Holds Back in any Significant Way, Will be Denied Credit for Its Efforts*, N.J. L.J., Mar. 24, 2003, at 29 (discussing an internal policy memorandum of the Justice Department written by Deputy Attorney General Larry D. Thompson and dated January 20, 2003 entitled, "Principles of Federal Prosecution of Business Organizations," now known as the Thompson Memorandum, which updates and revises a 1999 Holder Memorandum entitled, "Bringing Criminal Charges Against Corporations"); see also Abramowitz & Bohrer, *supra* note 138, at 3.

<sup>147</sup> The guidelines focus on the decision to prosecute. One can also look at the judge's decision to sentence for a similar consideration of "mitigating factors." This article suggests that any financial firm before a judge for sentencing has already lost. The academic literature on cooperation traces back to the 1991 sentencing guidelines, however. See, e.g., William S. Laufer, *Legal Issues and Sociolegal Consequences of the Federal Sentencing Guidelines: Corporate Prosecution, Cooperation, and the Trading of Favors*, 87 IOWA L. REV. 643 (2002). The sentencing factors do affect a prosecutor's decision to indict however and also will affect pre-prosecution conduct by firms seeking to minimize their exposure to criminal litigation. The United States Sentencing Commission in its 1991 final draft lists as mitigating factors, that an organization has in place an "effective"

pervasiveness of the wrongdoing within the corporation; the corporation's past history; cooperation and voluntary disclosure; corporate compliance programs; offers of restitution and remediation; collateral consequences; the adequacy of prosecuting responsible individuals; and non-criminal alternatives. The general categories sound reasonable, but the devil is in the details.

The most controversial feature of the release is the Department's definition of cooperation.<sup>148</sup> The Justice Department includes as a gauge of cooperation the company's willingness not to invoke the attorney-client privilege and attorney work-product protection.<sup>149</sup> The Department also counts as a negative a company's "protection" of culpable employees. Companies are penalized for assisting, in any way, senior executives under investigation. A company, to be deemed to be cooperating, must work on behalf of the government; it must "find the culprits and turn them in."<sup>150</sup> The Department also notes with disapproval the advancement of attorneys' fees for their defense. Yet, many companies are bound

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compliance program, accepts responsibility for the crime, cooperates with the investigation, or voluntarily reports the offense. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f)-(g).

<sup>148</sup> See Abramowitz & Bohrer, *supra* note 138, at 31. For an overview of the issues inherent in cooperation, see Simons, *supra* note 144, at 979; Laufer, *supra* note 147, at 643.

<sup>149</sup> The waiver is officially voluntary but regarded universally by prosecutors and defense counsel as mandatory. See John Gibaut, *Junior G-Men: Corporate Lawyers Worry that They're Doing the Government's Bidding While Doing Internal Investigations*, 89 A.B.A. J. 46 (Jun. 2003). Corporate lawyers claim that the waiver requirement drives a wedge between a company's employees and its counsel and negatively affects the ability of company counsel to investigate and correct internal problems. See Richard Ben-Veniste & Lee H. Rubin, *DOJ Reaffirms and Expands Aggressive Corporate Cooperation Guidelines*, LEGAL BACKGROUNDER, Apr. 4, 2003, at 11. They also note that a waiver of attorney-client privilege may apply to follow up private litigation. The general counsel of Tyco International testified recently that "I am perfectly happy to give over and waive the attorney-client privilege to the Department of Justice . . . except that it is later going to be used to line the pocket of a rabid plaintiff's bar." Blum, *supra* note 142, at A8. See generally Lance Cole, *Revoking Our Privileges: Federal Law Enforcement's Multi-Front Assault on the Attorney-Client Privilege (and Why It is Misguided)*, 48 VILL. L. REV. 469 (2003). There is heated debate over whether waivers of the privilege for the Department of Justice can be "selective" or otherwise limited. See, e.g., Robert G. Morvillo & Robert J. Anello, *White-Collar Crime: Waiver Issues in Corporate Investigations*, N.Y. L.J., June 3, 2003, at 3 (finding differences among various jurisdictions) (Morvillo is Martha Stewart's defense counsel).

The SEC has also adopted a formal agency policy of granting leniency in exchange for cooperation in civil cases. *In the Matter of Gisela de Leon-Meredith*, Exch. Act Rel. No. 44969, Fed. Sec. L. Rep. (CCH) ¶ 74,986 (Oct. 23, 2001); Report of Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Rel. No. 44,969 (Oct. 23, 2001). The SEC emphasized that the company had "produced the details of its internal investigation, including notes and transcripts of interviews of [culpable employees]; and it did not invoke the attorney-client privilege, work product or other privileges or protections with respect to any facts uncovered in the investigation. *Id.* at 1.

<sup>150</sup> Steve Seidenberg & Tamara Loomis, *DOJ Gets Tougher on Corporations: Revised Guidelines for Bringing a Criminal Case*, NAT'L L.J., Feb. 24, 2003, at A13 (reporting comments of a Washington lawyer who specializes in white-collar defense).

by an employment contract to do so.<sup>151</sup> Must they breach the contract (and lose in a trial for an injunction by the injured executive) to satisfy a prosecutor of their good faith? There are also tales of prosecutors demanding that “cooperating” companies threaten employees with termination if they do not fully cooperate with government investigators, to discourage employees from asserting claims of Fifth Amendment privilege.<sup>152</sup>

Other parts of the guidelines also effectively take away defense choices. According to one factor, a company must have taken “meaningful” remedial measures before indictment. Offers of restitution and employee termination are, of course, public admissions of guilt. Whether they will also affect guilt at trial depends on the whims of a judge applying a technical rule of evidence.

That prosecutors are in the catbird seat in these arrangements is well illustrated by how quickly companies have in fact waived attorney-client (or accountant-client) privileges. The *Wall Street Journal* headline for the Quattrone prosecution on the day that jury selection started was “Quattrone Trial: New Template?”<sup>153</sup> The story underneath highlighted the government’s star witness, David Brodsky, former Credit Suisse First Boston general counsel.

In the past, it was the rare case that brought lawyers to the witness stand. . . . Now, however . . . [c]ompanies wishing to avoid onerous charges and fines are . . . quick to waive attorney-client privilege and force lawyers to cooperate with prosecutors.<sup>154</sup>

CSFB waived its privilege protecting Brodsky’s internal communications when the company learned that Brodsky had e-mailed Quattrone notifying him of the government’s investigation of the company’s IPO practices. Two days later Quattrone forwarded an e-mail to his staff on “cleaning up” their files.

A company’s waiver of the privilege needs to be distinguished from a close but separate situation in which a client uses a lawyer as the spokesperson for a falsehood. If a lawyer relates a lie given by a client, the client can be charged with

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<sup>151</sup> The policy does recognize that some companies are “bound by law” to do so and that compliance with such laws should not be considered a failure to cooperate. This is a shallow distinction. In Ohio, for example, a company, unless it has opted out, must advance expenses; in Delaware, a company may advance expenses on a request and can bind itself to do so *ex ante* by contract. The Justice Department release will cause all states to pass Ohio-type legislation, reducing company flexibility in negotiating employment agreements. Moreover, the Ohio legislation heads in the opposite direction from what the Department wants.

<sup>152</sup> Robert G. Morvillo & Robert J. Anello, *White-Collar Crime: Issues Raised When Rare Techniques are Used by Prosecutors*, N.Y. L.J., Oct. 10, 2002, at 3. A private organization may use economic pressure to extract incriminating statements, unconstrained by the Fifth Amendment. The government cannot.

<sup>153</sup> Laurie P. Cohen, *Quattrone Trial: New Template?*, WALL ST. J., Sept. 30, 2003, at C1.

<sup>154</sup> *Id.*

the fraud, and the lawyer may be subpoenaed to testify against the client at trial. In the indictment filed against Martha Stewart in June of this year, prosecutors referred to her use of her lawyers three times. Prosecutors alleged, for example, that she “caused her attorney to provide” false information to the *Wall Street Journal* in an effort to mislead her shareholders. Ms. Stewart’s defense lawyers have been put on notice that, unless she stipulates that her company lawyers based their statements on her words, the prosecutors will call the company lawyers to the stand.

The power of prosecutors to forge “partnerships” with corporations has earned praise for encouraging businesses to join the government in the battle against corporate corruption.<sup>155</sup> Prosecutors exchange leniency (a decision not to indict the firm) for a corporation’s cooperation in a joint effort to investigate internal corporate fraud.<sup>156</sup> The cooperation of corporations is said to “free the hand of regulators and prosecutors and minimize the cost of compliance.”<sup>157</sup> I find the terminology odd; the terms, “partnership” and “cooperation,” imply corporate consent when the corporation really has no choice in the matter. Coercion is too strong a description, however; this deal that is no deal is just another instance of government regulation by mandate.

The danger of the exchange is not in whether it is voluntary or not, however, but whether, in practice, it will produce more undesirable consequences than advertised benefits. There is a very real question as to whether the exchange will significantly increase the unsavory practice of “scapegoating,” in which corporations find and offer up to prosecutors lower echelon officials in order to save the firm.<sup>158</sup> Middle-managers find, to their surprise, their rights eroded<sup>159</sup> and their futures clouded by their prominence in the press.<sup>160</sup> To their dismay, both prosecutors and their own employer have a huge stake in their public humiliation and incarceration. The prosecutor seeks to relieve public pressure generated by financial scandals; the firm seeks to survive. Whether those truly guilty inside the

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<sup>155</sup> See, e.g., Otto G. Obermaier, *A Practical Partnership*, NAT’L L.J., Nov. 11, 1991, at 13 (“[T]he 93 United States attorneys are good people to be partners with.”). See generally JAY A. SIGLER & JOSEPH E. MURPHY, *INTERACTIVE CORPORATE COMPLIANCE: AN ALTERNATIVE TO REGULATORY COMPULSION* (1988) (history of the government-business cooperation model).

<sup>156</sup> See Laufer, *supra* note 147, at 646.

<sup>157</sup> See *id.* at 646–47.

<sup>158</sup> See, e.g., John C. Coffee, Jr., *Corporate Criminal Responsibility*, in 1 *ENCYCLOPEDIA OF CRIME AND JUSTICE* 253, 260 (S.H. Kadish ed., 1983); Laufer, *supra* note 147, at 663–68; see also Dean Starkman, *Pollution Case Highlights Trend to Let Employees Take the Rap*, WALL ST. J., Oct. 9, 1997, at B10 (corporations under government investigation are turning on their employees to win leniency for themselves).

<sup>159</sup> See Arlen, *supra* note 134, at 833.

<sup>160</sup> Cf. Jon J. Lambiras, *White-Collar Crime: Why the Sentencing Disparity Despite Uniform Guidelines?*, 30 PEPP. L. REV. 459 (2003) (noting the wide sentencing difference among jurisdictions in financial crime cases).

corporation are caught in such cases can be random.<sup>161</sup> There can be no doubt that corporations will try to do this.<sup>162</sup>

The prosecutor's zest for forcing cooperation in financial fraud cases also took an unusual twist in the prosecution of Martha Stewart. Included in the Stewart indictment are charges of securities fraud based on her public declarations of innocence to charges of insider trading.<sup>163</sup> By declaring her innocence of insider trading in an independent company she allegedly affected the value of the stock in her namesake company; that is, she misled her own shareholders. In other words, a claim of innocence by a high profile CEO in a matter unrelated to the company's business has now become securities fraud if the government does not believe the CEO's story. This is taking failure to cooperate with prosecutors to a new level. The tactic raises novel legal and moral questions,<sup>164</sup> but academic debate aside, the threat of the charge undoubtedly substantially increases the potential downside risk of any claim of innocence by a high profile CEO. Prosecutors unwittingly were ignorant of a necessary subtlety of securities law long understood by the courts in

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<sup>161</sup> Senior officials who make the decision for the corporation to cooperate and find a scapegoat may themselves be seeking to avoid prosecution. It is a classic agency problem.

<sup>162</sup> Consider the comments of Eric Holder, the author of the Holder Memorandum, discussed *supra* note 38:

Montagne: How did the corporations react to your memo at the time, back in 1999, and are their CEOs and boards more supportive of it now than they were when you first wrote it?

Holder: . . . I think that when it came out, I think corporations probably didn't think it was the best idea in the world, because we were trying to force prosecutors to consider indicting corporations. Now I think in some ways it's being used as a shield, where corporations are under a greater scrutiny and are holding up the memorandum and saying, "Well, you know, if you apply these factors, we should not be indicted as a corporation." So I think the reaction to it has been mixed.

<sup>163</sup> See the sources cited *supra* note 35.

<sup>164</sup> See Mills & Weisberg, *supra* note 35, at A10:

How did the CEO's claim of innocence threaten that value? Wouldn't the stock value suffer more if she confessed guilt and resigned? And how did the CEO financially gain from the statement—other than in the trivially obvious sense that she avoids financial loss she would suffer if she confessed guilt? . . . Even if prosecutors could somehow finesse the victim/loss issue. . . . It seems bizarre to charge a person with fraud when all she does is publicly proclaim her innocence under a system of justice which [*sic*] requires the state to prove guilt, and which [*sic*] allows defendants to maintain their innocence. After all, a proclamation of innocence, even if it contains a false assertion, is the natural way for a charged person to put the state to its proof.

The authors' claim that there are no shareholder victims is questionable. Anytime stock values do not match firm fundamentals because there is false public information affecting stock prices, there are losers. In this case those who bought the stock during the time period affected by the public denials could be called losers. A better argument would be that the market price was not affected materially by the denial. In any event, the authors' argument on moral problems deserves careful attention.

deciding Rule 10b-5 cases, that not all acts that affect stock price should be actionable.<sup>165</sup>

In the end, the success of the partnership or cooperation paradigm is in the hands of our public prosecutors. Those who have faith in prosecutors claim that prosecutors can reap its benefits and avoid its dangers: prosecutors understand the scapegoating phenomenon and will not bring such cases. We shall see.<sup>166</sup> Even proponents, however, must acknowledge that the approach maximizes prosecutors' power and attendant responsibility.

Yet what system controls the accountability of the prosecutors? Not courts, who rarely see or otherwise get to rule on the results of companies' capitulation to prosecutors' demands.<sup>167</sup> If we are content to give prosecutors this kind of discretionary power to threaten companies with liquidation, which is, in effect, unrestrained by judges or juries, we will have to rely solely on an effective system of professional disciplinary review to catch and deter abuses. As an admitted outsider looking in, I doubt we have such effective systems in place.

Any self-policing disciplinary system operates inside whatever is the professional culture. At the moment, the culture of prosecutors is to seek and use a broad arsenal of weapons against suspected wrongdoers.<sup>168</sup> There seems to be a

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<sup>165</sup> See, e.g., *Lewis v. Chrysler Co.*, 949 F.2d 644 (3d Cir. 1991) (federal securities law disclosure requirements do not require senior executives to publicly admit the culpability of their actions).

<sup>166</sup> See, e.g., Ann Davis, *Enron Heat Descends on Smaller Players; Other Enjoy Shade*, WALL ST. J., Dec. 1, 2003, at C1 (the article describes the prosecution of James A. Brown, a finance specialist at Merrill Lynch & Co., for his role in the Enron scandal). The description has the strong odor of a scapegoat prosecution; he allegedly approved, after initial objections, a "Nigerian barge investment" for Merrill in which the investment bank contributed a measly \$7 million, small potatoes. Brown is charged with, you guessed it, perjury and obstruction of justice, in addition to criminal conspiracy. See Hudson, *supra* note 20, at C8 (discussing the criminal trial of four executives of Qwest for overstated revenues claimed on a single transaction with the Arizona School Facilities Board).

<sup>167</sup> This is the critical difference between an approach that rests on leniency in sentencing and leniency in the decision to prosecute. In theory, judges control sentencing decisions; prosecutors, on the other hand, control the decision to prosecute.

<sup>168</sup> Discussing the development of mail and wire fraud prosecutions for business crimes, Judge Ralph Winter has noted:

In any event, courts acceded to the desire of prosecutors for the creation of amorphous crimes that would allow prosecutors to pursue hard-to-define improprieties—or conduct that was improper only in the eyes of the particular prosecutor—or to pressure individuals thought to possess knowledge of other criminal activities. The creation of these crimes by the federal courts was not, I believe, an unconscious act. Rather, it was in part an act of faith and in part a desire to avoid seeming acquiescence in corrupt conduct. The act of faith was the belief that the effect of the unbounded doctrines they were creating would always be tempered by a prudential exercise of prosecutorial discretion . . . . The culture of prosecutors in these areas of law is to seek rules that are palpably overbroad so that they have a broad arsenal of weapons to use against suspected wrongdoers. . . . They understandably believe that they can be trusted

relentless drive within the profession to increase the discretionary power of individual prosecutors.<sup>169</sup> And one must have a theory of how prosecutors will exercise this newfound power before one can be happy with current trends.<sup>170</sup> I hold the view that even if properly exercised for a while, and we are happy seeing some deserving CEOs go to jail, that over time the lack of accountability and control on prosecutors in financial scandal cases may spell serious problems.

Judge Ralph Winter, an astute and well-positioned observer of prosecutorial conduct and culture has noted, for example:

[U]nchecked power—and it is enormous, raw power—is very troubling in a democratic society. Even if prosecutors are an unusually fair-minded segment of society, at least isolated prosecutorial abuses are inevitable. In busy offices, individual prosecutors may be relatively unsupervised. Moreover, federal prosecutors are trained to be trial lawyers who can get convictions and may be entirely ignorant of the working of capital markets. As well, as demonstrated in the Princeton/Newport Partners case, the Department of Justice may not be able to control individual prosecutorial decisions.<sup>171</sup>

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to limit the application of overbroad doctrine to those who truly are wrongdoers.

Winter, *supra* note 19, at 956–57.

<sup>169</sup> *Id.* at 965.

<sup>170</sup> See the theory of one-time white collar defense lawyer, now federal district court judge, Jed S. Rakoff: “[P]rosecutors are reluctant to bring the criminal law to bear against organizations that appear more rueful than recalcitrant. Simply put, prosecutors tend to view themselves as avenging angels in simple morality plays where evil is banished and social order restored.” Jed S. Rakoff, *Four Postulates of White-Collar Practice*, N.Y. L.J., Nov. 12, 1993, at 3. Not a bad theory.

<sup>171</sup> Winter, *supra* note 19, at 963. In the Princeton/Newport Partners case the government sought pre-trial restraint and forfeiture under RICO of the assets of a small investment partnership to pressure the partners into testifying against partners in an investment bank, Drexel Burnham and Lambert. Nervous investors withdrew their capital from the partnership and forced its liquidation. See David A. Vise, *RICO Goes to Wall St., Racketeer Law's Impact Felt Even Before Verdict in First Case*, WASH. POST, July 30, 1989, at H1. The charges against the partnership did not, under the Department of Justice guidelines, justify the use of RICO. On appeal, the United States Attorney's Office in the Southern District of New York argued that the Department of Justice guidelines were not binding and were wrong. See *United States v. Regan*, 937 F.2d 823, 825 (2d Cir.), *amended* 946 F.2d 188 (2d Cir. 1991). One can take issue with Judge Winter's conclusion that increased prosecutorial discretion has raised the cost of capital in the United States. Winter, *supra* note 19, at 965, 976–77. At the time of the this writing, the amount of corporate fraud now disclosed has shaken the country's capital markets and clearly had a depressing effect on stock prices. One can reasonably believe (as I do), in opposition to the view of Judge Winter, that prosecutors' reinvigorated efforts to hold some accountable for corporate fraud, sobering up those still in office, will have a positive long run effect on the cost of capital in the United States.



## VI. CONCLUSION

It is still early, but there are already lessons from the prosecutions of the 2002 scandals. First, public pressure for fast, splashy results has encouraged sideshow (collateral and technical) prosecutions of high profile personalities and firms. Second, state attorneys general have a significant and important role to play in policing national financial scandals. Third, prosecutors are supplementing or even supplanting criminal prosecutions with easier-to-win civil prosecutions; but the civil prosecutions carry with them the problem of potential fine shifting and avoidance by defendants. And fourth, the tough prosecutor's tactic of coercing the assistance of financial institutions in prosecutions of their employees by threatening indictment of the institutions themselves puts a premium on measured judgments by prosecutors, judgments that may be unreviewed or unreviewable by courts or other supervising authorities. As we have discovered in our securities trading markets, any system that relies too heavily on private institutions' self-policing, with the government as an overseer, is too prone to abuse.



## Addendum

After the editors of the *Journal* finalized the article, a jury convicted Martha Stewart on four counts, all involving obstruction of justice.<sup>172</sup> Before the jury retired, the judge had thrown out the prosecutors' novel charge of financial fraud on her own company's shareholders based on her public claims of innocence. The charges thus turned at that moment into a paradigm sideshow prosecution. She was not convicted of insider trading or any other form of financial fraud. Rather, she was convicted of lying about her actions to federal officials. Whether the actions that she lied about were illegal was not determined and not in issue. The tangential nature of the convictions was not lost on many observers. In a letter to the editor of the *New York Times*, Skip Perry of Atlanta wrote: "I'm no legal expert, but that means she was found guilty of covering up crimes that the government couldn't prove she committed. This is justice?"<sup>173</sup>

The irony of the conviction is that Ms. Stewart engaged in the conduct for which she was primarily convicted, lying to SEC officials, while she had the country's highest paid attorneys—partners at Wachtell, Lipton, Rosen & Krantz, whose average partnership draw per year per partner is close to \$3 million—at her elbow.

A day before going to press, the judge declared a mistrial in the prosecution of two former Tyco International executives, Chief Executive L. Dennis Kozlowski and Chief Financial Officer Mark Swartz. The two were charged with taking over \$600 million in cash from firm coffers, all without authorization of the Tyco Board. The trial lasted close to seven months. There were forty-seven witnesses, many of them testifying on complex accounting and financial matters. One juror said it was "like watching paint dry." A well-publicized jury deadlock was dissolving just as the judge declared a mistrial; one 79-year-old juror, the apparent holdout, had received a threatening letter after her name was published in the national press. Prosecutors vow to try the case again.

Also of interest is the prosecution of four former executives of Qwest Communications in Denver. In the closing arguments, their attorneys claimed that the men were being sacrificed to protect the higher-ups.

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<sup>172</sup> See Kara Scannell & Matthew Rose, *In Stewart Case, Reluctant Jurors Found Guilt After 'Foolish Mistake'*, WALL ST. J., Mar. 8, 2004, at A1. Specifically, she was convicted of two counts of making false statements to government investigators, one count of conspiracy to obstruct justice, and one count of obstructing justice. The jury "felt that she was a smart lady who made a dumb mistake." *Id.* at A6.

<sup>173</sup> Letter to the Editor from Skip Perry, N.Y. TIMES, Mar. 9, 2004, at A26.

