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**“NO SOUL TO DAMN: NO BODY TO KICK”:
AN UNSCANDALIZED INQUIRY INTO
THE PROBLEM OF CORPORATE
PUNISHMENT†**

*John C. Coffee, Jr.**

Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?¹

Edward, First Baron Thurlow 1731-1806

The Lord Chancellor of England quoted above was neither the first nor the last judge to experience frustration when faced with a convicted corporation.² American sentencing judges are likely to face a similar dilemma with increasing frequency in the near future, for a number of signs indicate that corporate prosecutions will become increasingly commonplace.³ At first glance, the problem of corporate punishment seems perversely insoluble: moderate fines do

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1. *Quoted in* M. KING, PUBLIC POLICY AND THE CORPORATION 1 (1977). One version, probably apocryphal, reports that the Lord Chancellor then added in a stage whisper, “[a]nd, by God, it ought to have both.” H.L. MENCKEN, A NEW DICTIONARY OF QUOTATIONS ON HISTORICAL PRINCIPLES FROM ANCIENT AND MODERN SOURCES 223 (1942).

2. Long before Baron Thurlow’s time, ecclesiastical courts had responded to corporate misbehavior by imposing the decree of excommunication. This probably represents the first occasion on which the anthropomorphic fallacy that the corporation was but an individual misled courts. It was not the last. In the thirteenth century Pope Innocent IV forbade the practice of excommunicating corporations on the unassailable logic that, since the corporation had no soul, it could not lose one. He thus became the first legal realist in this area.

3. Between 1976 and 1979, 574 corporations were convicted in the federal courts. See Orland, *Reflections on Corporate Crime: Law in Search of Theory and Scholarship*, 17 AM. CRIM. L. REV. 501, 501 n.4 (1980). A comprehensive review by the editors of *Fortune* magazine has found that 11% of the 1,043 major corporations it surveyed were involved in a “major delinquency” between 1970 and 1980 (a term it defined to include five crimes — bribery, criminal fraud, illegal political contributions, and price-fixing or bid-rigging antitrust violations — regardless of whether the enforcement proceeding was brought in the form of a criminal or a civil action). See Ross, *How Lawless Are Big Companies?*, FORTUNE, Dec. 1, 1980, at 56, 57. The extraordinary media attention given to the unsuccessful prosecution of the Ford Motor Company for manslaughter for allegedly failing to correct known defects in the design of its Pinto model may hasten this trend toward greater use of the criminal sanction. *State v. Ford Motor Co.*, No. 5324 (Ind. Super. Ct., filed Sept. 13, 1978). Other straws are also blowing in the wind. See Courie, *Justice Maps Out Criminal Approach For Health, Safety*, Legal Times of Wash., Feb. 11, 1980, at 1, col. 1.

not deter, while severe penalties flow through the corporate shell and fall on the relatively blameless.⁴ Nonetheless, this Article will submit that there are ways both to focus the incidence of corporate penalties on those most able to prevent repetition and to increase the efficiency of corporate punishment without employing *in terrorem* penalties.

This assertion may be greeted with polite indifference since an obvious and simpler alternative to pursuing new forms of corporate penalties is simply to prosecute the individual executive and ignore the corporate entity. The case for such an individual focus to corporate law enforcement is strong,⁵ but it is not unqualified. This Article will argue that law enforcement officials cannot afford to ignore either the individual or the firm in choosing their targets, but can realize important economies of scale by simultaneously pursuing both.⁶

Because this Article's arguments are interwoven, a preliminary roadmap seems advisable. First, Section I will examine three perspectives on corporate punishment and will develop several concepts in terms of which corporate penalties should be evaluated. Although this analysis will suggest several barriers to effective corporate deterrence, Section II will explain why a sensible approach to corporate misbehavior still must punish the firm as well as the individual decision-maker. Section III will then evaluate three proposed ap-

4. This Article will refer to the tendency for fines imposed on the corporation to fall on others who are not culpable as the "overspill problem." It has, of course, been noted before. See MODEL PENAL CODE § 2.07, comment at 148 (Tent. Draft No. 4, 1955) (noting that use of punitive fines amounts to imposition of "vicarious criminal liability" on "a group ordinarily innocent of criminal conduct" — *i.e.*, the stockholders). This same concern that punitive penalties would fall on innocent parties has surfaced in civil actions. See *Roginsky v. Richardson-Merrell, Inc.*, 378 F.2d 832, 841 (2d Cir. 1967) (punitive damages not imposed because they would penalize innocent parties). Obviously, this "overspill" problem is not unique to the criminal law context and arises any time severe penalties appear necessary to achieve deterrent aims. Thus, the remedies here suggested are equally applicable in civil cases where the problems discussed in this Article inhibit adequate deterrence.

5. The author has summarized these arguments elsewhere. See Coffee, *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions*, 17 AM. CRIM. L. REV. 419 (1980).

6. These economies of scale derive not only from the obvious fact that both the corporation and the individual defendants can be prosecuted on the basis of the same evidence and often at the same trial, but also from the dynamics of plea bargaining under which all defendants have an incentive to implicate each other in return for a sentencing concession. See, *e.g.*, Dorfman, *Justice Thwarted: The \$2.4 Million Tipster*, NEW YORK MAGAZINE, Feb. 13, 1979, at 13 (detailing settlement agreement under which former general counsel of Gulf and Western Inc. pleaded guilty and received probation in return for cooperation and testimony against his corporation); Pound, *Ex-Frito-Lay Official Pleads Guilty in Plot to Corner Peanut Oil Market*, N.Y. TIMES, Oct. 17, 1980, at 19, col. 1 (similar facts); Kiernan, *MacDonnell Plea Bargain Fell Through*, WASH. POST, June 10, 1980, at D6, col. 4 (tentative agreement for corporation to plead guilty in return for dismissal of charges against individuals rejected by corporation's founder).

proaches: (1) the "equity fine," (2) the use of adverse publicity, and (3) the fuller integration of public and private enforcement.⁷ In addition, it will consider whether anything is gained by prosecuting the corporation in a criminal, as opposed to civil, proceeding. Finally, Section IV will look beyond remedies designed to increase deterrence to the possibility of incapacitative sanctions. This latter inquiry is promoted by recent judicial decisions and legislative proposals that permit courts to place corporations on probation.⁸ Interesting questions are thus presented: Can an organization be rehabilitated? If so, what goals should the sentencing court pursue and what remedies can it realistically implement?

This essay is written as Professor Alfred Conard nears retirement from a long and distinguished career. The thesis advanced herein is not necessarily one Professor Conard would agree with, but its attempt to establish connections between the distant fields of corporate and criminal law follows the tradition of an inter-disciplinary approach to problems of corporate behavior which he has long trail-blazed. Like W. Somerset Maugham's character who could keep his attention on both the moon and the sixpence, Professor Conard has shown the ability to move from theory to practice. This essay will attempt to do likewise, moving first from a theoretical overview to a consideration of practical remedies which the sentencing court might employ.

I. PERSPECTIVES ON CORPORATE PENALTIES: WHY SANCTIONS FALL SHORT

The literature on corporate sanctions sometimes seems to consist of little more than the repeated observation that the fines imposed on convicted corporations have historically been insignificant.⁹ True as this point undoubtedly is, it is also a short-sighted critique. It ignores both the judiciary's reasons for declining to impose more severe penalties and the possibility that a monetary penalty sufficiently high to deter the corporation may be infeasible or undesirable. Once

7. These approaches could be at least partially implemented by the judiciary under its current powers, without new legislative authorization. See notes 197-200 *infra* and accompanying text.

8. These cases, discussed at note 173 *infra*, are analyzed in Note, *Structural Crime and Institutional Rehabilitation: A New Approach to Corporate Sentencing*, 89 YALE L.J. 353, 368 n.92 (1979).

9. See, e.g., Geis, *Deterring Corporate Crime*, in CORPORATE POWER IN AMERICA 182-97 (R. Nader & M. Green eds. 1973); Geis, *Criminal Penalties for Corporate Criminals*, 8 CRIM. L. BULL. 377, 381 (1972); Note, *Increasing Community Control Over Corporate Crime — A Problem in the Law of Sanctions*, 71 YALE L.J. 280, 285 n.17 (1961).

these possibilities are considered, the problem of corporate criminal behavior becomes radically more complex. Three independent, but overlapping perspectives each suggest that monetary penalties directed at the corporation will often prove inadequate to deter illegal behavior. In order, this Article will survey the field from the perspectives of the neo-classical economist, the organization theorist, and the public policy specialist who is concerned that the costs of punishment may exceed the benefits of deterrence.

A. *The Deterrence Trap*

Our first perspective flows directly from the application of the economic theory of deterrence to an empirical premise. Economists generally agree that an actor who contemplates committing a crime will be deterred only if the "expected punishment cost" of a proscribed action exceeds the expected gain.¹⁰ This concept of the expected punishment cost involves more than simply the amount of the penalty. Rather, the expected penalty must be discounted by the likelihood of apprehension and conviction in order to yield the expected punishment cost. For example, if the expected gain were \$1 million and the risk of apprehension were 25%, the penalty would have to be raised to \$4 million in order to make the expected punishment cost equal the expected gain.¹¹ One may well question the adequacy of this simple formula when applied to individual defendants, because the stigmatization of a criminal conviction constitutes an additional and severe penalty for the white-collar defendant.¹² But this loss of social status is a less significant consideration for the corpo-

10. See Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). For a shorter exposition of this view, see R. POSNER, *ECONOMIC ANALYSIS OF LAW* 165-67 (2d ed. 1977).

11. See R. POSNER, *supra* note 10, at 167. Here \$4 million times 25% exactly equals, and cancels out, the \$1 million expected gain.

Some recent commentators have sought to apply this formula to corporations through a penalty system in which the fine is set equal to the expected gain times a "non-detection factor/multiplier." See Note, *Deterring Air Polluters Through Economically Efficient Sanctions: A Proposal for Amending the Clean Air Act*, 32 STAN. L. REV. 807, 818-19 (1980). Such a proposal makes sense where the risk of detection can be measured and is found to be relatively high (as was apparently the case, *id.* at 815), but this Article will argue that our ability to so escalate cash penalties is limited, both because it is bounded by the corporation's available financial resources, and because such penalties impose externalities on the public and thus face judicial nullification.

12. Some research suggests that stigmatization is the chief deterrent for middle-class offenders. See Nagin & Blumstein, *The Deterrent Effect of Legal Sanctions on Draft Evasion*, 29 STAN. L. REV. 241 (1977). Although the article deals specifically with draft evaders, the authors speculate that their findings may have generalized relevance to most forms of white-collar crime. See note 107 *infra* and accompanying text.

rate entity, and we are thus forced to rely largely on monetary sanctions.

The crux of the dilemma arises from the fact that the maximum meaningful fine that can be levied against any corporate offender is necessarily bounded by its wealth.¹³ Logically, a small corporation is no more threatened by a \$5 million fine than by a \$500,000 fine if both are beyond its ability to pay. In the case of an individual offender, this wealth ceiling on the deterrent threat of fines causes no serious problem because we can still deter by threat of incarceration. But for the corporation, which has no body to incarcerate, this wealth boundary seems an absolute limit on the reach of deterrent threats directed at it. If the "expected punishment cost" necessary to deter a crime crosses this threshold, adequate deterrence cannot be achieved. For example, if a corporation having \$10 million of wealth were faced with an opportunity to gain \$1 million through some criminal act or omission, such conduct could not logically be deterred by monetary penalties directed at the corporation *if the risk of apprehension were below 10%*. That is, if the likelihood of apprehension were 8%, the necessary penalty would have to be \$12.5 million (*i.e.*, \$1 million times 12.5, the reciprocal of 8%). Yet such a fine exceeds the corporation's ability to pay. In short, our ability to deter the corporation may be confounded by our inability to set an adequate punishment cost which does not exceed the corporation's resources.¹⁴

The importance of this barrier (which this Article will call the "deterrence trap")¹⁵ depends on whether rates of apprehension for corporate crimes are typically low. Although there are exceptions, most corporate crimes seem highly concealable. This is so because, unlike victims of classically under-reported crimes (such as rape or child abuse), victims of many corporate crimes do not necessarily know of their injury. The victim of price-fixing may never learn that he has overpaid; the consumer of an unsafe, toxic, or carcinogenic

13. See Block & Lind, *Crime and Punishment Reconsidered*, 4 J. LEGAL STUD. 241, 242-43 (1975).

For an increasing number of corporations, the wealth boundary may be reached at a surprisingly low level. See Emshwiller, *Plunging Power: Big Financial Problems Hit Electrical Utilities; Bankruptcies Feared*, Wall St. J., Feb. 2, 1981, at 1, col. 6.

14. To be sure, the corporation's resources include more than its immediately available liquid assets, since the corporation can borrow and the fine can be deferred through installment payments. But, it seems a safe premise that financial institutions will be reluctant to lend substantial amounts to finance the payment of a penalty by a recently convicted corporation, particularly where civil damage actions may follow quickly on the heels of the conviction and where the initial conviction may trigger further investigations and disclosures of misbehavior.

15. The term "deterrence trap" is used because this problem has many of the same characteristics as the "liquidity trap," a problem familiar to students of macroeconomic analysis.

product typically remains unaware of the hazards to which he has been exposed. Even the government or a fellow competitor may rarely discover the tax fraud or illegal bribe which has cost it a substantial loss in revenues.

The ability to conceal corporate crime has been little noticed by economists, in all likelihood because they have often been preoccupied with the antitrust context. Yet the characteristics of horizontal price-fixing (the classic antitrust violation) make it more subject to eventual exposure than the safety and environmental violations that now especially concern society. At bottom, a price-fixing conspiracy among competitors is a very unstable enterprise because it must extend beyond the individual firm. If one may generalize based on the detected price-fixing conspiracies of recent years, they tend to have involved dozens of corporate participants within an industry,¹⁶ and thus many employees are likely to know about the illegal activity, thereby multiplying the likelihood of exposure. More importantly, when a new competitor enters the affected market because of the excessively high prices, the existing conspiracy must either offer the entrant membership in the cartel, or engage in some form of strategic price-cutting to drive it out.¹⁷ Add to this picture, in industries that employ sealed competitive bidding, the tendency for price-fixing conspiracies to produce conspicuously parallel price movements and the odds of eventual exposure rise exponentially in comparison to an illegal activity wholly contained within a single firm. Admittedly, other forms of crime may produce lasting evidence as well; for example, an environmental violation may leave scars lasting for decades. But illegal toxic dumps and industrial rivers tell few tales by which to connect the evidence to a particular actor.

Beyond ease of concealment, legal and behavioral characteristics distinguish price-fixing from other corporate crimes: safety and environmental violations involve questions of judgment which the participants can rationalize without consciously (or at least explicitly)

16. Many recent price-fixing conspiracies have involved numerous participants. At least 36 forest products companies were alleged in 1978 to have fixed the price of corrugated containers over a period of years; similarly, 24 companies were allegedly involved in a price-fixing conspiracy in the folding cartons market. These cases have resulted in total settlements paid to date by the defendants of over \$500 million. See Rudnitsky & Blyskal, *Getting into those deep pockets*, FORBES, Aug. 4, 1980, at 59-62. Twenty-nine corporations and 45 individual defendants were indicted in the electrical equipment antitrust cases in 1961. See Geis, *The Heavy Electrical Equipment Cases of 1961*, in WHITE-COLLAR CRIME 119 (rev. ed. 1977).

17. Because of this problem some economists have long argued that cartels are inherently unstable. See Dewey, *The Economic Theory of Antitrust: Science or Religion?*, 50 VA. L. REV. 413, 428 (1964) (case studies of cartels have not found them to be "very powerful organizations"). See generally Dewey, *Mergers and Cartels: Some Reservations About Policy*, 73 AM. ECON. A. PAPERS & PROC. 255 (1960).

engaging in behavior they know to be illegal. In addition, many, if not most, forms of corporate crime require some element of intent (*i.e.*, “knowingly” or “willfully”) which can be exceedingly difficult to prove in the context of prosecuting a white-collar worker for a “regulatory” offense. Although intent is also a prerequisite for a criminal antitrust violation,¹⁸ a price-fixing conspiracy, if detected, speaks for itself.¹⁹ These legal and behavioral differences between antitrust and other violations may affect the expected punishment cost necessary to deter corporate crime. If the individual does not realize he is committing a crime, his perceived risk of apprehension will be very low. Similarly, if intent is difficult to prove in prosecutions for regulatory offenses, the risk of conviction — if not of apprehension — will be lower than in the price-fixing cases. Accordingly, the penalty necessary to deter such illegal activity would rise. Thus, the classic price-fixing conspiracy may not be a representative example of organizational crime.

The final element in the deterrence equation requires little emphasis: corporate misbehavior involves high stakes. A \$50,000 bribe may secure a \$50 million defense contract, a failure to report a safety or design defect in a product may avert a multi-million dollar recall, and the suppression of evidence showing a newly discovered adverse side effect of a popular drug may save its manufacturer an entire product market.²⁰ Thus, when all the elements of the equation are combined, it is not unrealistic to predict that cases will arise in which the expected gain may be \$10 million or higher, while the likelihood of apprehension is under 10%. If so, a mechanical application of the economist’s deterrence formula suggests that only penalties of \$100 million or above could raise the “expected punishment cost” to a level in excess of the expected gain. Few corporations, if any, could pay such a fine and any attempt to levy it in installments would require the court to charge very high interest in order to compensate

18. *United States v. United States Gypsum Co.*, 438 U.S. 422, 435 (1978).

19. For example, any evidence of inter-firm price discussions, or the revelation to competitors of intended future bids, will virtually establish a *prima facie* case for the government. The covert manner in which price-fixing conspiracies are typically hidden from senior corporate officials shows that the participants recognize their potential vulnerability if any disclosure occurs.

20. For the classic case of Richardson-Merrell’s suppression of adverse findings with respect to the drug MER/29, see C. STONE, *WHERE THE LAW ENDS* 54-56 (1975). Stone estimates that a mere two-year delay in the withdrawal of the drug grossed its manufacturer an additional \$7 million. *Id. Cf.* Armstrong, *Social Irresponsibility in Management*, 5 *J. BUS. RESEARCH* 185 (1977) (describing a role-playing experiment which indicates that managers tend to make socially irresponsible decisions in order to further shareholder interests).

for the time value of money (which implies that a deferred fine is a substantially reduced fine).

B. *The Behavioral Perspective*

An abstract quality surrounds the foregoing economic analysis. Lucid as its logic seems, it ignores the organizational dynamics within the firm and treats the corporation as a "black box" which responds in a wholly amoral fashion to any net difference between expected costs and benefits.²¹ Students of organizational decision-making have always rejected this "black box" model of the firm and have been quick to point out that a fundamental incongruence may exist between the aims of the manager and those of the firm.²² Indeed, this assertion is but a corollary of the famous Berle-Means thesis that control and ownership have been divorced in the modern public corporation.²³ Given this separation, it follows that the "real world" corporation manager may view corporate participation in criminal activities from the standpoint of how to maximize his own ends, rather than those of the firm.

Does the behavioral perspective indicate that corporate misbehavior may be easier to deter than the foregoing economic analysis suggests? Regrettably, the reverse may be the case: for several reasons, the behavioral perspective suggests that it may be extraordinarily difficult to prevent corporate misconduct by punishing only the firm. First, from such a perspective, it seems clear that the individual manager may perceive illegal conduct to be in his interest, even if the potential costs to which it exposes the firm far exceed the potential corporate benefits. For example, the executive vice president who is a candidate for promotion to president may be willing to run risks which are counterproductive to the firm as a whole because he is eager to make a record profit for his division or to hide a prior error of judgment. Correspondingly, the lower echelon executive with a lackluster record may deem it desirable to resort to illegal means to increase profits (or forestall losses) in order to prevent his dismissal or demotion.²⁴ Others in between these two extremes may

21. For a well-known critique of the neo-classical model's "black box" approach to corporate behavior, see C. STONE, *supra* note 20, at 35-37.

22. *Id.* at 46-50.

23. A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (rev. ed. 1967). For a much-praised reinterpretation of this thesis, see M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976).

24. For a series of recent examples, see Getschow, *Overdriven Executives: Some Middle Managers Cut Corners to Achieve High Corporate Goals*, *Wall St. J.*, Nov. 8, 1979, at 1, col. 6. Studying a series of cases in which middle-level managers sent falsified data to their corporate headquarters, Getschow finds a common pattern in which "an employee often confronts a

have an interest in incentive compensation or other personal objectives which cause their interests to deviate from those of their firm. Necessarily, the manager acts within a shorter time frame than the firm (if only because in the long run, the manager, unlike his firm, will be dead), and thus may focus more on short-run profit maximization.

Neo-classical economists have always objected to this argument. They have framed a theoretical rebuttal: if properly motivated, the corporation could implement controls adequate to detect and penalize such free-lance activity by its agents.²⁵ In theory, the firm has the power to reduce the incongruence between the aims of the manager and the firm by using internal sanctions to compel the manager to adopt the firm's ends as his own.²⁶ In practice, it is debatable whether such a system could be installed since some forms of misconduct may be easily concealed even from the firm. The deterrence trap discussed above also poses a barrier, since if the firm cannot be adequately penalized, it will not vigorously monitor its agents.

In light of this possible rejoinder, it is important to move from theoretical to empirical arguments. The theoreticians of deterrence tend to assume that the actor has perfect knowledge, or at least can calculate with reasonable accuracy the odds of apprehension. In reality, we lack even an approximate estimate of how much white-collar crime occurs or how often it results in conviction.²⁷ Because an accurate calculation of the cost/benefit calculus which the microeconomic approach utilizes is thus improbable, the critical variable becomes the actor's attitude toward risk. Is he a risk averter or a risk preferrer? Other things being equal, the risk-averse manager tends to be deterred by high penalties even when they are associated with low rates of apprehension, while a risk-preferring manager would look at the same combination of penalties and probabilities and not be deterred.²⁸ Knowing only that apprehension is a long-

hard choice — to risk being branded incompetent by telling superiors that they ask too much, or to begin taking unethical or illegal shortcuts." Other recent cases are mentioned in Editorial, *Why Managers Cheat*, Bus. Week, March 17, 1980, at 196 (discussing other recent cases). See note 37 *infra*.

25. See, e.g., R. POSNER, *supra* note 10, at 235-36; R. POSNER, *ANTITRUST LAW* 225-26 (1976).

26. I have surveyed the practical objections to this theoretical argument elsewhere. See Coffee, *supra* note 5, at 456-65.

27. This information is necessary to determine the risk of apprehension; yet, it seems unobtainable given both the likelihood that the victim will be unaware of his injury and the uncertain scope of the "white-collar crime." Cf. Coffee, *supra* note 5, at 442 (both definition and accurate census of white-collar crime impossible, though crucial to any economic analysis of the problem).

28. For a cogent exposition, see K. ELZINGA & W. BREIT, *THE ANTITRUST PENALTIES* 120-

shot, the risk preferrer will be likely to chance profitable illegal behavior, even though an apprehension would devastate his career.

Although some theorists have argued that the typical corporate manager is risk averse,²⁹ some empirical evidence points in the opposite direction. Repeated studies have detected a phenomenon known as the "risky shift": businessmen participating in role-playing experiments have shown a pronounced tendency to make "riskier" decisions when acting in a small group than when acting alone.³⁰ That is, the degree of risk they are willing to accept increases dramatically when the decision is reached collectively within a small group — exactly the context in which most business decisions are made. Other experiments have found such small groups of businessmen willing to ignore extremely strong evidence of social irresponsibility and legal obstacles when making business decisions involving the introduction of dangerous or unsafe products.³¹ These experiments can be read in several ways. They may indicate that businessmen are more risk-preferring (at least, collectively) than the average citizen, or they may imply that businessmen acting in small groups become more optimistic and reduce their estimates of the risks in a given situation from what they would perceive them to be individually.³² Either way, the result is the same: so long as the odds on apprehension are unknown, but probably low, many businessmen are likely to reach a subjective estimate of the legal risks in a given situation which leads them to accept these risks — even if the average citizen alone would not.

A related and reinforcing perspective on the psychology of the representative business manager is suggested by another central tenet of the organization theorist. While the economist assumes that firms uniformly seek to maximize profits, organization theorists, such

29 (1976). See also Breit & Elzinga, *Antitrust Penalties and Attitudes Toward Risk: An Economic Analysis*, 86 HARV. L. REV. 693, 704-06 (1973).

29. K. ELZINGA & W. BREIT, *supra* note 28, at 126-28.

30. Reed, *On the Dynamics of Group Decisionmaking in High Places*, DIRECTORS & BOARDS, Winter 1978, at 40-49; M. SHAW, GROUP DYNAMICS: THE PSYCHOLOGY OF SMALL GROUP BEHAVIOR (2d ed. 1976); Stoner, *Risky and Cautious Shifts in Group Decisions*, 4 J. EXPERIMENTAL SOC. PSYCH. 442 (1968). See also M. MACCOBY, THE GAMESMAN (1976). For a critical review of this literature, see Cartwright, *Determinance of Scientific Progress: The Case of Research on the Risky Shift*, 28 AM. PSYCH. 222, 225-29 (1973). See also note 32 *infra*.

31. Armstrong, *Social Irresponsibility in Management*, 5 J. BUS. RESEARCH 185, 194-210 (1977).

32. This interpretation has been suggested to me by Professor Richard Lempert of the University of Michigan Law School, and it seems to me the most plausible explanation for a frankly perplexing phenomenon. In short, what we may be witnessing is a shift not toward risk, but toward optimism because groups feel themselves more able to overcome difficulties than do individuals.

as Nobel laureate Herbert Simon, have found the typical manager more likely to engage in what they term "satisficing" behavior.³³ That is, instead of assembling all available information and choosing the best alternative, individuals tend to accept the first alternative presented to them that satisfies the minimum criteria. In short, individuals pursue not optimal solutions, but satisfactory ones; they seek not answers that maximize, but ones that suffice. From this perspective, which assumes that individuals act not on perfect knowledge but rather on random search strategies,³⁴ it is possible to see why the harried manager finds illegality attractive in many circumstances. Overworked, overloaded and faced with a maze of sometimes conflicting governmental regulations, the simplest solution which permits him to function is often that of falsification.

Finally, the behavioral perspective highlights one of the most basic causes of misbehavior within organizations: individuals frequently act out of loyalty to a small group within the firm with which they identify.³⁵ Thus, engineers working on the development of a particular project may develop an intense dedication to it which leads them to suppress negative safety findings.³⁶ Similarly, a plant manager may falsify environmental data out of a fear that the prohibitive costs of bringing the plant into compliance might result in its closing.³⁷ This pattern is consistent with a considerable body of so-

33. The classic works in this area are J. MARCH & H. SIMON, *ORGANIZATIONS* (1958), and R. CYERT & J. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* (1963). On "profit satisficing," see J. MARCH & H. SIMON, *supra*, at 8-10.

34. Herbert Simon has argued that the firm does not have perfect knowledge, but must search through various alternatives in sequential fashion. See R. CYERT & J. MARCH, *supra* note 33, at 10. This process is largely conditioned by the environment: that is, the most obvious or available alternatives will be considered first, and the search may be concluded when the first answer is obtained which provides a satisfactory strategy capable of meeting the basic criteria. See J. MARCH & H. SIMON, *supra* note 33, at 113-17, 138-42, 169-71. Since this sequential search model does not imply that further investment of time or effort will produce a superior result, the individual is likely to abandon his inquiry with the first "satisfactory" result. *Id.* at 140-41.

35. See C. ARGYRIS, *INTEGRATING THE INDIVIDUAL AND THE ORGANIZATION* (1964). See also R. LIKERT, *THE HUMAN ORGANIZATION* 49-51, 158-88 (1967). For a related exposition, see Likert, *A Motivational Approach to a Modified Theory of Organization and Management*, in *MODERN ORGANIZATION THEORY* 184 (M. Haire ed. 1959).

36. See Stone, *supra* note 20, at 43-44. See also Getschow, *supra* note 24.

37. Professor Leonard Orland of the University of Connecticut Law School recently served as a consultant to the Department of Justice in its prosecution of a large chemical corporation for dumping substantial quantities of highly toxic mercury into the Niagara River. He informs me that the immediate motivation for the violation appears to have been the plant manager's fear that compliance with governmental regulations would have encouraged the corporation to close down the already obsolete plant because the expense of new equipment could not be justified. A similar fear seems to have caused a lower-level official of Allied Chemical to falsify reports to the Army Corps of Engineers concerning the dumping of Kepone into Chesapeake Bay. See Zim, *Allied Chemical's \$20 Million Ordeal with Kepone*, *FORTUNE*, Sept. 11, 1978, at 82, 84. This also seems to fit the larger pattern described by Getschow, *supra* note 24.

cial science data which suggests that the individual's primary loyalty within any organization is to his immediate work group. Within this group, he will engage in candid disclosure and debate, but he will predictably edit and screen data before submitting them to superiors in order to cast his sub-unit in a favorable light.³⁸

From this perspective, the following generalization becomes understandable: the locus of corporate crime is predominantly at the lower to middle management level.³⁹ Although public interest groups are vocal in their denunciations of "crime in the suites," in truth the most shocking safety and environmental violations are almost exclusively the product of decisions at lower managerial levels. Senior executives may still bear some causal responsibility, but the chain of causation is remote, and their influence on decisions is only indirect.

To understand this assessment, the multi-divisional and often radically decentralized⁴⁰ structure of the modern public corporation must be examined. Increasingly, a central corporate headquarters monitors operationally autonomous divisions, but its review is focused on budgetary matters and strategic planning. Operational control typically remains in the division. Indeed, some economists have compared the central corporate office to a miniature capital market, since its primary function is to allocate funds to profitable divisions and to discipline those which fail to meet targeted profitability goals.⁴¹

The nature of this disciplinary monitoring by the central office is of particular relevance. Because it is at considerable organizational distance and its attention is focused on the income statement, the central office can avoid responsibility for operational decisions while at the same time holding the division responsible for a failure to

38. See Coffee, *Beyond the Shut-Eyed Sentry: Toward A Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1144 (1977); Likert, *supra* note 35, at 190-202.

39. The recent *Fortune* survey of criminal activity within major corporations reached a similar conclusion: "Except in cases hinging on illegal political contributions—once a way of life in many corporations and rarely investigated or prosecuted prior to Watergate—the chief executive is seldom personally implicated. Typically, even the executives running the guilty subsidiary or division disavow any knowledge of the wrongdoing below." Ross, *supra* note 3, at 64. See also Sonnenfeld & Lawrence, *Why Do Companies Succumb to Price-Fixing?*, HARV. BUS. REV., July-Aug. 1978, at 145 (stressing the tendency for collusive price-fixing to occur at lower echelons, despite top management efforts to prevent such practices).

40. See Coffee, *supra* note 38, at 1132-46. For the classic historical overview of the transition to the multi-divisional firm, see A. CHANDLER, *STRATEGY AND STRUCTURE* (1962).

41. See generally P. DRUCKER, *MANAGEMENT: TASKS, RESPONSIBILITIES, PRACTICES* 572-91 (1973); P. DRUCKER, *THE CONCEPT OF THE CORPORATION* (1946); O. WILLIAMSON, *MARKETS AND HIERARCHIES* 133-37 (1975); O. WILLIAMSON, *CORPORATE CONTROL AND BUSINESS BEHAVIOR* 116-19 (1970).

meet profit quotas assigned it. Through a variety of penalties and incentives — *i.e.*, salary and fringe benefits, increased or diminished staff and budget, and the threat of dismissal or demotion — the central office in the multi-divisional firm pressures the operating divisions to comply with its goals. Thus, the directive from the top of the organization is to increase profits by fifteen percent, but the means are left to the managerial discretion of the middle manager who is in operational control of the division.

Properly applied, such pressure establishes and enforces accountability without sacrificing the flexibility and adaptiveness that are the virtues of decentralization. However, this structure also permits the central headquarters to insulate itself from responsibility for operational decisions while simultaneously pressuring for quick solutions to often intractable problems.⁴² The middle manager is acutely aware that he can easily be replaced; he knows that if he cannot achieve a quick fix, another manager is waiting in the wings, eager to assume operational control over a division. The results of such a structure are predictable: when pressure is intensified, illegal or irresponsible means become attractive to a desperate middle manager who has no recourse against a stern but myopic notion of accountability that looks only to the bottom line of the income statement.

42. The intense pressure on middle management and the conflicting signals it receives from senior levels to obey or ignore legal commands has led one recent writer to view middle management as the new "oppressed class." See E. SHORRIS, *THE OPPRESSED MIDDLE: POLITICS OF MIDDLE MANAGEMENT* (1981). Similarly, in an editorial entitled "Why Managers Cheat," *Business Week* offered just such an explanation for illegal behavior within public corporations:

The behavior is rooted in the short-run focus on profits that has hypnotized so many corporate managements. This year's profits — and even more important, this quarter's — determine the management's actions. . . .

In the diversified corporation run by financial people who have no feel for the fiber and texture of a business, the bottom line is all that matters. They manage the bottom line to produce a desired number of dollars in profit, and then they order division executives to produce their share — or else. The door is opened for shenanigans that the top management doesn't expect and cannot curtail because it doesn't understand the business.

. . . . Middle management in a lot of companies is under excruciating pressure to meet profit goals that are too tough.

BUS. WEEK, March 17, 1980, at 196.

Business Week's observations are hardly novel. In the early 1960s, at the time of the electrical equipment price-fixing conspiracy, some newspapers traced the underlying cause of that episode to the "Cordiner Plan" (named after the then-president of General Electric) under which decision-making decentralized at the division level. As the *New York Times* saw it, "This [plan] gives managers of different branches complete authority to run independently of central headquarters. They are required to show a profit or be dismissed." N.Y. Times, Feb. 28, 1961, at 26, col. 1, *quoted in* Note, *supra* note 9, at 291 n.49. This variety of causal explanation, however, fails to note that virtually all multi-product large corporations are similarly decentralized because of the functional impossibility of having one senior management run frequently unrelated and disparate businesses. Thus, the search for a remedy must seek ways to reduce the level of pressure on middle managers while recognizing that decentralization is an inevitable pattern within large organizations.

Paul Lawrence, a professor of organizational behavior at the Harvard Business School, has summarized this dilemma:

A certain amount of tension is desirable. But at many companies the pressures to perform are so intense and the goals so unreasonable that some middle managers feel the only way out is to bend the rules, even if it means compromising personal ethics. . . . When a manager feels his job or division's survival is at stake, the corporation's standards of business conduct are apt to be sacrificed.⁴³

For the middle-level official the question is not whether the behavior is too risky to be in the interests of the corporation from a cost/benefit standpoint. Rather, it is: which risk is greater — the criminal conviction of the company or his own dismissal for failure to meet targets set by an unsympathetically demanding senior management. Because the conviction of the corporation falls only indirectly on the middle manager, it can seldom exceed the penalty that dismissal or demotion means to him. The middle manager thus faces a very different set of potential costs and benefits from the corporate entity. For example, a given crime may carry with it a forty percent risk of apprehension — presumably too high a level to be very attractive to the corporation. But if compliance with the legal standard subjects the middle manager to a fifty percent chance of dismissal for failure to meet a corporate profit quota, crime may well be attractive to him even if it is anathema to his corporate employer. Caught between Scylla and Charybdis, this middle-level manager will seek short-run survival through concealment, falsification and, when necessary, illegality.

To sum up, in the modern public corporation it is not only ownership and control that are divorced (as Berle and Means recognized long ago), but also strategic decision-making and operational control. In an era of finance capitalism, the manager responsible for operational and production decisions is increasingly separated by organization, language, goals, and experience from the financial manager who today plans and directs the corporation's future.⁴⁴ This

43. Getshow, *supra* note 24, at 1.

In a textbook illustration of this pattern, Ford Motor Company engineers falsified auto emissions data supplied to the Environmental Protection Agency by tinkering with the cars undergoing federal certification tests. *Id.* at 34. This test rigging was discovered and eventually resulted in Ford paying seven million dollars in civil and criminal penalties. It seems unrealistic to believe that senior Ford management would even tacitly have approved such actions, if only because such tests could not be rigged for long without detection. G.M. has had a similar experience with middle management misbehavior that resulted in substantial financial loss to the corporation. As a result of a covert assembly line "speed-up" in violation of its collective bargaining agreement, General Motors was forced to pay \$1 million in back-pay to affected workers and incurred lasting enmity with its labor force. *Id.*

44. *Cf.* Hayes & Abernathy, *Managing Our Way to Economic Decline*, HARV. BUS. REV., July-Aug. 1980, at 67 (criticizing new managerial philosophy of American business which

tends both to insulate the upper echelon executive (who may well desire that the sordid details of "meeting the competition" or "coping with the regulators" not filter up to his attention) and to intensify the pressures on those below by denying them any forum in which to explain the crises they face. This generalization helps to explain both the infrequency with which corporate misconduct can be traced to senior levels and the limited effort made to date within many firms to develop a system of legal auditing which approaches the sophistication of financial auditing.

This portrait is to a degree deliberately overdrawn. Some corporations have developed procedures by which middle managers participate in the shaping of long-term profit goals for their division, and relatively few corporations enforce the notion of accountability so rigidly as to permit no excuse for failure to meet a profit goal.⁴⁵ Consider it, then, a portrait of the pathological organization. But to the extent it even approximates the internal dynamics within some firms, such corporations are essentially undeterrable (at least in the short run) by penalties focused only on the firm. In the last analysis, whether we take the economic perspective or the behavioral one, we tend to reach this same conclusion.

C. *The Externality Problem*

The idea of externalities as applied to the actions of public bodies is probably best illustrated by the common practice of most highway departments in liberally dumping salt on frozen roads. This technique cures their problem of ice-coated roads at a relatively low cost, but it also imposes an "external cost" on landowners and drivers: plants die along the borders of such roadways, and cars rust and deteriorate more quickly because of the effect of the salt on their exteriors. This cost, however, is not borne by the highway department, and thus is externalized in the same sense that a manufacturer

gives excessive attention to short-term financial performance). *See also* Ingrassia, *Corporations: A Perilous Life at the Top*, Wall St. J., Feb. 5, 1981, at 18, col. 3 (quoting business historian Harold F. Williamson on the short-term focus of American management). *See also* note 42 *supra*.

45. The *Wall Street Journal* has reported that "some companies, stung by the consequences of middle managers' wrongdoing, now . . . are trying to make sure that in motivating people, they don't create an atmosphere conducive to unethical behavior." Getschow, *supra* note 24, at 34. One company cited was Mead Corporation, which was forced in 1976 to plead no contest to price-fixing charges. This shock apparently provoked reevaluation of its incentive system for motivating middle managers. *But see* E. SHORRIS, *supra* note 42, for the counter view that middle management is unavoidably exposed to intense pressure and ambiguous commands from senior levels. *See also* text at notes 193-94 *infra*.

traditionally never bore the cost of his pollution that fell on the adjoining landowners downwind.

In this same sense, punishment imposes both external and internal costs. For example, the direct public cost of imprisonment (*e.g.*, the cost of the prison system) is an internal cost which law enforcement authorities must recognize in jailing people. But the welfare cost of sustaining the jailed person's family is likely to be externalized, falling on other agencies and receiving less attention.

The problem of external costs is present in the case of corporate punishment, and comes into focus when we consider the incidence of financial penalties imposed on the corporation. As a moment's reflection reveals, the costs of deterrence tend to spill over onto parties who cannot be characterized as culpable. Axiomatically, corporations do not bear the ultimate cost of the fine; put simply, when the corporation catches a cold, someone else sneezes. This overspill of the penalty initially imposed on the corporation has at least four distinct levels, each progressively more serious. First, stockholders bear the penalty in the reduced value of their securities. Second, bondholders and other creditors suffer a diminution in the value of their securities which reflects the increased riskiness of the enterprise. These points have been made many times both in the *Model Penal Code*,⁴⁶ and in the writings of such respected scholars as Francis Allen,⁴⁷ Sanford Kadish⁴⁸ and Alan Dershowitz.⁴⁹ The analysis, however, needs to be carried several steps further: the third level of incidence of a severe financial penalty involves parties even less culpable than the stockholders. As a class, the stockholders can at least sometimes be said to have received unjust enrichment from the benefits of the crime; this arguably justifies their indirectly bearing a compensating fine. However, if the fine is severe enough to threaten the solvency of the corporation, the predictable response will be a cost-cutting campaign, involving reductions in the work force through layoffs of lower echelon employees who received no benefit from the earlier crime.⁵⁰ Severe financial penalties thus interfere

46. See MODEL PENAL CODE § 2.07, Comment (Tent. Draft No. 4, 1955).

47. See F. Allen, *Regulation by Indictment: The Criminal Law as an Instrument of Economic Control* 13 (Sept. 28, 1978) (McInally Memorial Lecture at the University of Michigan Graduate School of Business Administration).

48. See Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 433 (1963).

49. See Note, *supra* note 9 (student note by Dershowitz, then Editor-in-Chief, *Yale Law Journal*).

50. I anticipate that some will rebut that the fine is a "sunk cost" which should not enter into future firm decision-making, except insofar as it encourages avoidance of future costly legal violations. To be sure, the corporation will probably not cut back on profitable opera-

with public goals of full employment and minority recruitment by restricting corporate expansion. In a society willing to bail out a Chrysler to save the jobs of its workers, it would seem perversely inconsistent to punish a Ford for its Pinto by imposing financial sanctions that resulted in plant closings and layoffs. Finally, there is the fourth level of incidence of a financial penalty: it may be passed onto the consumer. If the corporation competes in a product market characterized by imperfect competition (a trait of most of the "real world"), then the fine may be recovered from consumers in the form of higher prices. If this happens, the "wicked" corporation not only goes unpunished, but the intended beneficiary of the criminal statute (*i.e.*, the consumer) winds up bearing its penalty.

This tendency for corporate penalties to fall most heavily on the least culpable is not the only externality which law enforcement officials must consider. Nearly as important is the impact of large fines on the innocent corporation. Put simply, the innocent corporation can be forced to settle.⁵¹ This phenomenon can be seen from both an economic and an empirical perspective. The cost/benefit approach of economists indicates that the rational choice for the innocent corporation charged with a violation depends very much on the possible sanction. For example, if a private antitrust plaintiff commences a treble damage action seeking \$30 million in damages and the defendant corporation accurately perceives the plaintiff's likelihood of success on the merits to be ten percent, the rational corpora-

tions, and it may borrow if necessary to continue such operations. But nevertheless, almost all corporations continue some marginal or even unprofitable operations for sustained periods. It has been observed that cost cutting campaigns occur most commonly when the corporation runs into a financial crisis, a finding that is inconsistent with the theoretical principle of wealth maximization under which a firm should cut redundant costs and operations at all times, not just when it incurs financial reversals. Even neo-classical economists have acknowledged the validity of this critique of the traditional profit-maximization assumption. See Alchian, *The Basis of Some Recent Advances in the Theory of Management of the Firm*, 14 J. INDUS. ECON. 30 (1965), reprinted in READINGS IN MICROECONOMICS 131 (2d ed., W. Breit & H. Hochman ed. 1971). In short, it appears that a financial crisis motivates the firm to reduce the degree of "organizational slack" it tolerates, and a large fine seems likely to do so also. Moreover, even in a highly profitable firm having no marginal or deficit operations, it is possible that the company may be forced to reduce staff because of a sudden diminution of working capital (caused by the fine) which it cannot recoup through borrowings. Financial institutions are likely to be more reluctant to lend to the convicted corporation after the fine and may be unwilling to increase outstanding lines of credit until convinced (possibly after a substantial interval) that the first conviction and fine will not be followed by others. Additionally, a corporation deprived of a significant portion of its capital may be unable to expand production and employment — a result which also should be counted as an externality caused by punishment.

51. See Note, *Contribution and Antitrust Policy*, 78 MICH. L. REV. 890, 906-07 (1980) ("A company faced with this massive liability may have little choice but to settle and to surrender its opportunity to go to trial on the merits of its case") (footnote omitted). See also Lempert, *Panic Aided Record Box Settlements*, Legal Times of Wash., May 7, 1979, at 1.

tion would still settle such a "frivolous" action at \$2.5 million (because the discounted value of plaintiff's action is in reality \$30 million multiplied by .10, or \$3 million). In short, high authorized penalties can produce extorted settlements. Although this danger is less pronounced where the action is brought by a public enforcer, the innocent corporation still may plead *nolo contendere* to avoid the collateral estoppel effect of a criminal conviction in subsequent civil litigation.

Empirical evidence brings another factor into the analysis: the accused corporation often cannot afford the time interval necessary to establish its innocence. Frequently, it has been reported that once an antitrust indictment is filed, the defendant corporation experiences difficulties in obtaining credit from its current lenders because of the enormous contingent liability overhanging its balance sheet.⁵² Left without sources of funds in a capital intensive industry the corporation may find it financially impossible not to plead *nolo contendere* or to settle the private suits that inevitably follow on the heels of such an indictment. For example, the major forest product companies were indicted in 1978 for allegedly fixing corrugated container prices over a period of years. Private civil suits were filed soon after the indictments, and the majority of the defendants settled, together paying an estimated \$310 million.⁵³ Yet, two of the largest defendants — The Continental Group and Mead Corporation — pleaded "not guilty" and were later acquitted.⁵⁴ Although an acquittal does not necessarily mean the defendant is factually innocent, the disquieting possibility here is that only the largest corporations possessed sufficient financial resources to fight over an extended period in the face of potentially bankrupting liabilities. If the reverberating impact of that \$310 million in settlements resulted in workers being laid off or in financial injury to the pension funds which typically hold the bonds of such corporations, then it is difficult to view such a settlement on untested (and apparently rebuttable) evidence as a victory for the public interest.

The point here is not simply that the concept of the private attorney general needs to be viewed with greater skepticism, but that remedies can sometimes be worse than the disease they were meant to

52. The founder of the Green Bay Packaging Company was recently quoted to the effect that his company settled antitrust charges because the existence of so large a contingent liability would otherwise have caused its lenders to cut off further borrowing. See Lewin, *Justices Take Key Trust Case*, Natl. L.J., June 30, 1980, at 18, col. 1.

53. Rudnitsky & Blyskal, *supra* note 16, at 59.

54. Lempert, *supra* note 51, at 1.

cure. Truism that this is, its significance in this context is profoundly heretical. To illustrate, let us begin with a hypothetical case and then turn to some actual ones. Suppose over the course of a number of years, the leading producers of potato chips engage in a price-fixing conspiracy that raises the price of a bag of chips by three cents. Given the volume of the market and the length of the conspiracy, damages are reliably placed at \$100 million, which when trebled results in a potential liability of \$300 million. Nearly all of the recovery would go to large corporations which operate grocery stores and to other institutional buyers (who, presumably, have passed the cost along to unidentifiable individual consumers). The impact of this penalty will devastate some of the conspirators, resulting in layoffs and plant closings, and will inhibit the ability of all conspirators to expand their work force. Creditors and suppliers of these corporate conspirators may also suffer.

Who benefits? No "true" victim is compensated, because the consumer receives nothing out of these settlements. Others may be deterred, but the low risk of apprehension may still make the crime attractive, particularly to middle and lower echelon corporate employees who see a cost/benefit trade-off different from that of their firm. Even if we could compensate the real victims, the additional three cents a bag paid by all consumers is a minor injury spread over an extended period which is dwarfed by the concentrated injury visited on those who bear the "overspill" of the penalties imposed on the corporate conspirators.

This example may seem atypical, and it is conceded that some corporate crimes — such as those that threaten lives — justify such draconian sanctions. But when we turn to actual cases, they seem to have much in common with the potato chip case.⁵⁵ In the corrugated containers case noted earlier, the settling defendants have agreed to pay \$310 million, but the estimated average award per member of the plaintiff class is only \$1,425.⁵⁶ In another recent class action antitrust suit against the leading manufacturers of folding cartons, the total settlement was \$218 million, and the average award per mem-

55. In a similar vein, economist Lester Thurow has analyzed the Federal Trade Commission's long prosecution of the major dry cereal producers. The FTC estimates that \$1.2 billion in extra charges resulted between 1958 and 1972 as a result of the oligopolistic structure of this market. But this works out, he finds, to .1¢ per breakfast — "hardly one of the nation's pressing problems," as he puts it. Thurow questions whether this justifies the substantial dislocation that an antitrust decree requiring divestiture might produce. See Thurow, *Let's Abolish the Antitrust Laws*, N.Y. Times, Oct. 19, 1980, § 3 at 2. Unlike Professor Thurow, my answer is not to repeal the antitrust laws, but to change the form of punishment we use to deter the corporation.

56. Rudnitsky & Blyskal, *supra* note 16, at 59.

ber of the class was \$6,790.⁵⁷ In these and other cases, the principle that money has a declining marginal utility means that the defendants absorb a jolting loss while the plaintiffs (who are largely corporations) receive an individual recovery which is of minimal significance to them.⁵⁸ Even if damages were not trebled, the problem would remain because a cash fine telescopes into a single year the far smaller gains received during the early years of an extended conspiracy.

D. *The Nullification Problem*

We have been examining two distinct negative consequences of severe corporate penalties: the "overspill problem" (penalties fall heavily on innocent or less-culpable parties) and the "extortion problem" (the innocent may settle in the face of unacceptable potential liabilities which cannot be quickly rebutted). The first of these problems helps to explain why sentencing courts have traditionally imposed only modest penalties on corporations. An ounce of history is here worth a pound of logic. At least until recently, the fines imposed for corporate offenders have been small and well below the authorized ceilings. In the great electrical equipment price-fixing conspiracy of the 1950s — the most famous and publicized price-fixing conspiracy in American history — the average fine each corporate offender paid was \$16,550.⁵⁹ General Electric paid the largest fine — \$437,500 — but it amounted to only 0.1% of its total profit.⁶⁰ Empirical studies show that the fines in the typical antitrust case seldom approach the authorized maximum.⁶¹ At present, the maximum authorized fine stands at \$1 million per count for corporate antitrust violations, and a pending Senate bill would codify the same

57. *Id.* at 60.

58. Because money has a declining marginal utility, the severity of a fine increases disproportionately as its monetary value is raised. See Coffee, *supra* note 5, at 430 & n.27. This is so because the higher the fine, the closer one is taken to his "bottom dollar"; each increment lost is more highly valued.

Although this argument is less compelling in the case of corporate offenders than individuals, there is still a "bunching effect" associated with most corporate penalties which increases their impact. Typically, the misconduct has continued over a sustained period, usually producing only modest annual revenues for the corporation. For example, Allied Chemical's profit from Kepone never exceeded \$600,000 per year. Zim, *supra* note 34, at 83. But when compensatory damages are levied in a single year, even the modest gains that accrued over the multi-year period are telescoped into a lump sum that may be enough to bankrupt the corporation. In addition, the gains from the crime may not be available to the corporation since they may have been paid out to present and former stockholders as dividends.

59. K. ELZINGA & W. BREIT, *supra* note 28, at 56.

60. *Id.* The fine was also less than 0.3% of its net profit for the year.

61. See Posner, *A Statistical Study of Antitrust Enforcement*, 13 J. L. & ECON. 365, 392 (1970) (average fine in antitrust cases between 1965 and 1969 was \$116,622).

ceiling for all corporate felonies.⁶² Yet between 1967 and 1970 when the maximum fine was a lowly \$50,000 per count, the Justice Department recommended the imposition of the maximum fine in less than a third of the cases where it obtained convictions.⁶³ If even the prosecutor will not recommend a penalty of \$50,000 per count, it is little wonder that the judges resist draconian sentences.

This pattern of nullification is by no means unique to the corporate context. Few phenomena are better established and more easily observed in the administration of the criminal law than the nullification of severe penalties.⁶⁴ Both judges and juries seem instinctively to resist the imposition of stern punishments. In the corporate context the defendant may not merit sympathy, but only the most obtuse judge can fail to understand that such penalties will ultimately fall on innocent parties. Indeed, even if an adamant judge decides to impose a severe penalty, the defendant corporation might still be able to dissuade him by hinting at the dire consequences and by orchestrating a predictable political reaction. The scenario is not difficult to imagine. Notified that the court intends to impose a \$25 million fine, the corporation informs politicians, union officials, and community leaders that it may be forced to close its plants in their communities. This shocking news galvanizes them into action, and a political coalition is forged to save the threatened jobs. In short order, the court is inundated with letters, phone calls from Congressmen, and newspaper editorials. This is exactly what has happened in the case of administrative enforcement action against some corporations.⁶⁵ Few courts would be wholly immune from the same pres-

62. 15 U.S.C. § 1 (1976). The penalties in the pending federal Criminal Code, S. 1722, are contained in § 2201(b), and in H.R. 6915, 96th Cong., 2d Sess., § 3502(2) (1980).

63. K. ELZINGA & W. BREIT, *supra* note 28, at 1.

64. The literature on nullification is lengthy. The seminal effort to link this phenomenon to a theory of punishment is Michael and Wechsler, *A Rationale of the Law of Homicide II*, 37 COLUM. L. REV. 1261, 1265 (1937). For a recent examination of this concept in the context of corporate crime, see Block & Sidak, *The Cost of Antitrust Deterrence: Why Not Hang a Price Fixer Now and Then?*, 68 GEO. L.J. 1131, 1134 n.20 (1980). In a succeeding section, this Article will argue that, to overcome this tendency toward nullification, the sentencing court must be shown a compensatory purpose for the punishment.

65. See Reich, *The Antitrust Industry*, 68 GEO. L.J. 1053, 1062-63 n.34 (1980) (describing several examples in which combined community, political and even editorial opposition forced the Federal Trade Commission to withdraw enforcement actions it had already commenced). In one 1979 case, a voluntary plant closing laying off 1500 workers was the decisive factor causing the F.T.C. to accept a result which it had secured a preliminary injunction to prevent. *Id.*

Defendant corporations can also raise other arguments against fines. A fascinating example is supplied by the Consumer Product Safety Commission's decision, *In re Bassett Furniture Industries, Inc.* See CPSC News Release, *CPSC, Bassett Furniture Reach Consent Agreement Over Crib Hazards*, Feb. 14, 1980. Here, over the strong dissent of two commissioners, a three-man majority of the Commission accepted a \$175,000 civil penalty against a crib manu-

tures if the threatened loss were great enough.⁶⁶

We face an apparent paradox: the low rates of apprehension and the potentially high rewards that characterize much of corporate criminal behavior make severe penalties necessary, but the overspill problem makes such penalties seemingly unfair, the deterrence trap makes their availability questionable, and the extortion problem makes their effect undesirable. This despairing description does not mean, however, that penalties cannot be designed which have less overspill and which reduce the judiciary's inclination to pull its punches. One conclusion seems inescapable: the cash fine system chiefly functions in the case of corporations as a kind of public morality tax, but not as a deterrent threat.⁶⁷ Alternative sanctions are desperately required.

II. THE INDIVIDUAL AS TARGET

At least two schools of thought exist as to whether penalties should be focused on the individual executive or on the corporation. The Chicago School favors punishing the corporation, and its reasoning is characteristically direct: if the penalties imposed on the firm are sufficient to deter it, then it will take internal corrective ac-

facturer whose unsafe product had resulted in several fatal infant strangulations. A \$1 million fine was authorized, but the majority approved a consent agreement imposing the lesser fine in return for the corporation's agreement to advertise the existence of the defect and to provide a free repair kit. The dissenters believed that the corporation (with annual sales of \$281 million) could afford both the fine and the cost of advertising, but the majority was apparently concerned that the two might be mutually exclusive and was unwilling to accept further delay in the commencement of the remedial program (which would be necessary if the Commission were forced to sue). *Id.* This summary is also based on an April 18, 1980, interview with Commissioner Sam Zagoria (a dissenter). The *Bassett* case suggests that corporations can effectively mitigate the authorized penalty structure through plea bargaining: here, the corporation is able to barter elimination of a threatened danger to consumers for a reduced sanction.

66. I recognize that rules of procedure and professional conduct restrict attempts to pressure or influence courts, in contrast to the manner in which administrative bodies may be permissibly lobbied. Nonetheless, the sentencing process has always stood as a partial exception to this pattern. Typically, when a "white collar" executive faces sentence, the court will receive an avalanche of mail from friends, ministers, and community leaders testifying to his service to the community and the hardship that a prison sentence would work on others. From this starting point, it is but a short step to letters, petitions, and editorials asking courts not to impose draconian penalties which will require the closing of a local plant. Indeed, union officials have here shown themselves to be the natural allies of corporate management by testifying against increases in the authorized penalties for price-fixing on the ground that such higher penalties would fall on workers. See *Hearings on Legislation To Strengthen Penalties Under the Antitrust Laws Before the Senate Comm. on the Judiciary*, 87th Cong., 1st Sess., pt. I, at 86, 91 (1962) (unions express concern over adverse implications for workers as a result of increased corporate penalties for antitrust offenses).

67. A counter-argument might still be made that, although such fines are inadequate to deter the corporation, they still can be passed on to the individual manager through derivative actions and lawsuits authorized by the proxy rules. At present, however, the obstacles to a successful action for damages under either the proxy rules or through a derivative suit appear to be overwhelming. See note 70 *infra*.

tion to prevent misconduct by its agents for which it is legally responsible.⁶⁸ One point can be made in favor of this argument: the firm is better positioned than the state to detect misconduct by its employees. It has an existing monitoring system already focused on them, and it need not conform its use of sanctions to due process standards. Indeed, if the penalties are severe enough, the corporation has both the incentive and, typically, the legal right to dismiss any employee it even suspects of illegal conduct.

A rebuttal of the Chicago view emerges from our earlier analysis: it is seldom clear that penalties can be made high enough to deter the corporation because of the "deterrence-trap" problem. If the risk of apprehension and conviction is low, or if potential offenders perceive it to be low, the corporation may see its convicted agent not as a reckless fiduciary, but as simply an unlucky casualty. If pressured the corporation may dismiss him, but as long as the expected gains from his actions exceed the expected punishment costs, it has little reason to tighten its monitoring system.

In addition to the deterrence-trap problem, the question of externalities must once again be considered. Even if a severe penalty imposed on the firm is adequate to trigger an internal disciplinary response, it will have adverse consequences as well: reduced corporate solvency, an increased risk of bankruptcy, possible layoffs and closings of marginal plants, and injury to stockholders and creditors. As suggested earlier, these consequences can sometimes be more harmful than the crime itself, particularly where they are borne by a narrow class and the injury caused by the crime is widely diffused. The Chicago School position may therefore show mercy to the corporate executive (who is saved from the possibility of incarceration by the recommendation of a corporate focus), but it imposes a harsh penalty on the less privileged classes (such as employees, consumers, and others dependent on the corporation) who bear the indirect burden of corporate penalties.

There are other reasons to question the adequacy of penalties focused exclusively on the firm: evidence of internal discipline within large corporations is conspicuously absent at senior corporate levels;⁶⁹ stockholders who wish the corporation to steer well clear of legal risks may be unable to control managers whose own self-inter-

68. See R. POSNER, *supra* note 10, at 236.

69. See Coffee, *supra* note 5, at 445, 458-59; Loving, *How Bob Rowen Served His Time*, FORTUNE, Aug. 27, 1979, at 44; Jensen, *Watergate Donors Still Riding High*, N.Y. Times, Aug. 24, 1975, at 1, col. 1; Nathan, *Coddled Criminals*, HARPER'S, Jan. 1980, at 30-33. These case studies suggest that the corporation becomes sufficiently embarrassed to fire the convicted senior executive only when he is imprisoned (and rarely even then).

est lies in such risk-taking;⁷⁰ and some managers may be extreme or even irrational "risk preferrers" who gain enjoyment from the gamble.⁷¹

All this suggests that penalties should be focused on the actual decision-maker rather than the corporation. Another important characteristic of corporate misconduct cuts in favor of such a policy prescription: the corporate manager rarely receives any direct pecuniary benefit or gain from his illegal actions on behalf of his corporation. In part, this is so because his conduct is almost always hidden from senior management. If the pecuniary gain to the corporation exceeds the gain to the manager, then the manager should be more easily deterred. In short, the deterrence trap is not a barrier in the case of the individual because (1) the expected gain is less, and so the expected punishment cost can exceed it, and (2) there is no wealth boundary on the maximum penalty since the executive, unlike the firm, can be imprisoned.

But the analysis cannot stop at this point. For in some circumstances, the executive may find that the expected punishment cost is exceeded by the cost of internal corporate sanctions which will befall him if he refuses to violate a legal norm. This internal sanction may consist of an outright penalty (demotion or dismissal) or a lost op-

70. In particular, under current law, shareholders may be precluded from holding management responsible for fines or other damages caused by illegal action through derivative suits. See, e.g., *Abbey v. Control Data Corp.*, 603 F.2d 724 (8th Cir. 1979), cert. denied 444 U.S. 1073 (1980); *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (1963); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U. L. REV. 96 (1980); Note, *Pleading and Proof of Damages in Shareholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 175 (1964).

Similar attempts under the proxy rules to hold corporate officials liable for illegal payments which they made, authorized or tolerated have generally run afoul of the "transaction causation" doctrine. Under this doctrine, unless the making of such a payment was directly or indirectly the subject of the solicitation, the misstatement in the proxy statement cannot be said to have legally "caused" the illicit action. See *Lewis v. Elam*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,013 (S.D.N.Y. 1977); *Levy v. Johnson*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,899 (S.D.N.Y. 1977); *Meer v. United Brands*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,648 (S.D.N.Y. 1976). As a result, neither the derivative suit nor the direct suit under the proxy rules is likely to be attractive to the contingent-fee motivated plaintiffs' attorney on whom the deterrent threat of these civil sanctions here depends.

71. The "Begelman affair" in Hollywood, in which a high corporate executive blatantly diverted funds from employees, suggests that such managers exist. See N.Y. Times, Oct. 4, 1977, at 53, col. 1. Similarly, the Equity Funding case in which corporate executives forged bogus insurance policies in order to report fictitious profits shows a reckless attitude toward legal risks which were almost certain to mature. See generally N.Y. Times, Mar. 19, 1975, at 75, col. 7. Indeed, there is the intriguing possibility that smaller firms within an industry may decide to compete against larger entrants by accepting a higher degree of legal risk. One study of the much-criticized Velsicol Corporation (which has repeatedly been involved in environmental and toxic law violations) reached the conclusion that Velsicol entered high-risk areas that its larger competitors tended to avoid. See Klein, *Under Attack: Small Chemical Firm Has Massive Problems With Toxic Products*, Wall St. J., Feb. 13, 1978, at 12, col. 3.

portunity (nonpromotion or denial of an anticipated fringe benefit). To be sure, these internal sanctions are far less severe than is a felony conviction (even without a prison term), but the probability of their application is much higher. Put more simply, the risk of punishment by the corporation may be much greater than the risk of punishment by the legal system. For example, assume that a hypothetical division manager knows that a particular foreign arms sale is important to his corporation, and that senior management expects him to consummate the deal. To assure the sale, he need only make an illegal payment to a foreign government official. In so doing, he runs the risk of a felony conviction, yet failure to make the payment may result in his replacement as the division manager. Although his corporate superiors will rarely instruct him explicitly to engage in an illegal act, they may nevertheless proclaim their insistence on "accountability" and "management by results." In all likelihood, our hypothetical division manager sees criminal conviction as a far more severe sanction than dismissal, but also as a far more remote risk. His dilemma may emerge more clearly if we quantify it: suppose the manager views conviction as three times as severe a penalty as dismissal, but there is no more than a 25% chance of conviction. Conversely, there may be a 75% likelihood that he will lose his position if the payment is not made and the contract is lost. Under these assumptions, the two expected punishment costs — one public and one private — come out exactly equal, and hence his behavior as a rational actor is indeterminate. Change the assumptions only slightly, and the private "expected punishment cost" exceeds the public one.

Internal corporate discipline may therefore counterbalance, or even overcome, more severe public sanctions because it has a higher probability of application. To some degree this problem is unavoidable, but it need not be aggravated. Focusing exclusively on the individual decision-maker would encourage exactly such disciplinary behavior within the corporation. Very large firms view middle-level managers as a fungible commodity that can be sacrificed as convenient scapegoats and easily replaced. Senior managers can piously express appropriate shock at their subordinates' actions while still demanding strict "accountability" on the part of such managers for short-term operating results.⁷²

Thus, a dual focus on the firm and the individual is necessary. Neither can be safely ignored. However, this unsurprising conclusion only takes us back to the deterrence trap and the externality

72. See BUSINESS WEEK, *supra* note 42, at 196; Getschow, *supra* note 43; Hayes & Abernathy, *supra* note 44.

problem. How can we adequately punish the firm so that an internal disciplinary response is triggered, without also producing prohibitively adverse social consequences? To this topic we now turn.

III. OPTIMIZING CORPORATE DETERRENCE: FROM DESCRIPTION TO PRESCRIPTION

The preceding sections have argued that both real and perceived externalities associated with corporate punishment have restrained courts and legislators in authorizing and imposing penalties on a corporation. This Section will argue that it is therefore desirable to find "socially cheaper" methods of punishing the corporation. This notion of social economy does not imply less severe penalties, but rather penalties which minimize both the real and the apparent overflow of the costs of deterrence onto the nonculpable. Concededly, any assertion that there can be "socially cheaper" penalties may seem unintelligible to the neo-classical economist. If one proceeds from the assumption that the "expected punishment cost" must exceed the expected gain before the firm will act to prevent criminal behavior by its agents,⁷³ then our quandary may be insoluble, at least for crimes having a low risk of apprehension. But from a behavioral perspective, which examines the internal dynamics within the firm, we can identify leverage points where a parsimonious use of penalties directed at the firm may still be effective.

An analogy may help clarify this difference in approach: both the neo-classical economist and the conventional liberal politician seem to have agreed that fines will not work unless they are severe. Under a regime of harsh penalties, the state simply bludgeons the corporation into compliance. Such a strategy reminds one of two giant sumo wrestlers circling each other before the charge: force meets force in a head-on conflict, and innocent parties may get trampled in the ensuing havoc. There is an alternative: to extend this analogy, the judo wrestler relies not on brute force, but rather turns his opponent's own strength against him. The violence is controlled; the innocent less subject to injury. Similarly, the behavioral perspective suggests opportunities for controlled uses of force which, like the judo expert, exploit the target's own internal forces and tensions.

George Orwell demonstrates in *1984* that every man has some subconscious fear which society can bring to bear against him. While Orwell's example terrifies us, it can also instruct us as to how society might harness the internal forces within the firm to enhance

73. See text at notes 10-11 *supra*.

the deterrent threat of the law. Specifically, to deter corporate crime more effectively, one might sensibly begin by exploring the principal fears and interests of the manager, and then match the consequences of a criminal conviction to them. Several possibilities suggest themselves: (1) much evidence suggests that corporate managers fear a hostile take-over of their firm, which would typically be accomplished through a tender offer;⁷⁴ (2) the manager's self-interest is very much identified with the value of the firm's stock, and stock options, phantom options, stock bonus plans, and other forms of incentive compensation cement such a linkage; (3) the competitive struggle for advancement and promotion within the firm implies that managers identified publicly as having been involved in corporate misconduct will be disadvantaged in their opportunities for advancement (both internally and externally with other firms);⁷⁵ (4) there is a general fear within most organizations of loss of autonomy; any intrusion into the sphere in which the manager sees himself as autonomous will be resented and resisted.⁷⁶ Penalties that play on these fears and interests may effectively increase deterrence. Finally, private litigation in the form of the derivative suit may evade nullification by transferring costs imposed upon the corporation to the responsible officials (who may view the penalty as substantial because it is a large percentage of their net worth). Thus, the possibilities for efficient integration of civil and criminal enforcement deserve particular attention. How these forces might be harnessed in the aftermath of a criminal conviction of a corporation will be the focus of this Section.

74. The following summary seems correct beyond question: "Managers gain psychological rewards from their positions of authority within the corporation. Leadership of a successful company brings a manager power and prestige; the possibility of losing these benefits is regarded by managers as a traumatic experience." Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1243 (1979). A hostile takeover frequently results in the replacement of senior management and is thus defended against with extraordinary zeal by the incumbent senior management. For such a case study, see Flaherty & Greene, *Oxy v. Mead: The Big One of 1978*, FORBES, Dec. 11, 1978, at 63. Because it increases the threat of a hostile takeover, the equity fine will provide senior management a considerable incentive to police middle-level management, where most crime within the corporation occurs. See note 39 *supra* and accompanying text.

75. Professor Posner has based his theory that enforcement should focus on the firm on the premise that employees fired for misconduct cannot find equivalent employment elsewhere. See R. POSNER, ANTI-TRUST LAW 226 (1976). SEC proxy rules also discourage the promotion of an executive with a criminal record to high office within a public corporation. See SEC v. Jos. Schlitz Brewing, 452 F. Supp. 824 (E.D. Wis. 1978); SEC v. Kalves, 425 F. Supp. 310 (S.D.N.Y. 1975); Cooke v. Teleprompter, 334 F. Supp. 467 (S.D.N.Y. 1971).

76. See A. DOWNS, INSIDE BUREAUCRACY (1966); M. MACCOBY, THE GAMESMAN *passim* (1976); V. THOMPSON, MODERN ORGANIZATION 24 (1961); O. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR 47-51 (1970).

A. *The Equity Fine: Toward a More Focused
"Capital Punishment"*

The time has come for a basic policy assertion: when very severe fines need to be imposed on the corporation, they should be imposed not in cash, but in the equity securities of the corporation.⁷⁷ The convicted corporation should be required to authorize and issue such number of shares to the state's crime victim compensation fund as would have an expected market value equal to the cash fine necessary to deter illegal activity.⁷⁸ The fund should then be able to liquidate the securities in whatever manner maximizes its return.⁷⁹

This strategy reduces the earlier encountered obstacles to adequate corporate deterrence: (1) the overspill of corporate penalties to workers and consumers is reduced, and the costs of deterrence are concentrated exclusively on the stockholder; (2) in turn, the nullification phenomenon may be reduced, since the latent threat to employees and the community dependent on the corporation that a cash fine carries is no longer present; (3) much higher penalties (in terms of total monetary value) can be imposed, because the market valuation of the typical corporation vastly exceeds the cash resources available to it (with which a cash fine might be paid); (4) the manager's self-

77. While I refer to the fine in general terms of equity securities of the corporation, the fine should be imposed in the form of common stock. In theory, the equity fine could be levied in a different form of equity security (e.g., preferred stock or warrants) or perhaps as a debenture. I see no need to discuss these variants in any detail, but their common deficiency is that senior equity holders have traditionally been exposed to oppression by a management which identifies with the interests of the common stockholder. See, e.g., *Barrett v. Denver Tramway Corp.*, 53 F. Supp. 198 (D. Del.), *aff'd.*, 146 F.2d 701 (3d Cir. 1944); *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (Del. 1940). The possibility of such essentially unreviewable mistreatment seems even greater when the senior class is created by judicial order so as to make the common shareholders resentful and unwilling to accept the senior's entitlement to priority.

In this Article, I will not discuss the accounting treatment which would be necessary to support imposition of a fine in the form of common stock in a state which requires shares to be issued for a par value. However, this problem seems easily surmountable because the issuance can be seen as cancelling an equivalent cash liability that the corporation owed to the state.

78. The court would determine the number of shares to be issued by first finding the optimal fine under the economic formula discussed at note 11 *supra*. Then the court would order the issuance of the number of shares having a pre-indictment value equal to the fine. See note 81 *infra* as to the use of pre-indictment values.

79. Crime victim compensation funds are now in operation in varying forms in several jurisdictions. The funds compensate victims of many types of crime; the fine paid by a defendant corporation would therefore not necessarily compensate the particular victims of its behavior. See J. HUDSON & P. GALAWAY, *RESTITUTION IN CRIMINAL JUSTICE* (1977). Such a fund is contemplated by the pending Federal Criminal Code, S. 1722, 96th Cong., 1st Sess. § 4111 (1979) ("Establishment of a Victim Compensation Fund"). Professor Roy Schotland has persuaded me that the fund should be administered by an independent trustee operating under the traditional principles of fiduciary administration applicable to pension plans and mutual funds, rather than by a civil service-type agency. A trustee should be obligated only to maximize the recovery to the beneficiaries of the fund and, absent additional factors, should owe no fiduciary duty directly to the corporation.

interest is better aligned with that of the corporation because the resulting per-share decline in the corporation's common stock following such a penalty will reduce the value of stock options and other incentive compensation available to him; (5) the manager will fear that the creation of a large marketable block of securities makes the corporation an inviting target for a takeover; and (6) the typical stockholder's apparent focus on short-term profit maximization will now have to take into account the risks of illegal behavior; accordingly, the stock value of legally "risky" companies will predictably decline, and stockholders will begin to demand increased internal controls within corporations to reduce such legal exposure. Each of these assertions is, of course, subject to qualifications, and each merits a brief analysis.

The most important of these advantages is also the most obvious: although common stock is virtually a cash equivalent, the burden of the equity fine falls very differently than that of cash fines. Little impact on employees, creditors or suppliers seems likely from the equity fine, since the capital of the corporation is not depleted.⁸⁰ Nor would an equity fine prevent corporate expansion or require layoffs of employees. Cash fines, in contrast, may conceivably produce more harm than the illegal conduct. For example, because concealment of toxic or environmental violations is relatively simple, the optimal fine might have to be very high (even though the demonstrated damage was low). In an extreme case, the optimal fine might equal ten percent of the aggregate market value of the corporation's common stock. Such a cash fine — if indeed the corporation could pay it — would probably inhibit corporate expansion, cause plant closings and layoffs, and reduce the value of the corporation's bonds and other debt securities (because of the increased "riskiness" of the now depleted corporation). An equivalent equity fine would require only that the company issue a quantity of shares having a pre-indictment value equal to the optimal cash fine (in this case, if nine million shares were outstanding, then one million additional shares would be issued).⁸¹

80. Employees do suffer some loss from the equity fine to the extent that they hold stock options or are the beneficiaries of Employee Stock Ownership Plans (ESOPs) or receive incentive compensation based on the market price of the security (*i.e.*, "phantom stock options"). This loss will be felt by middle and upper echelon officials, but will be less severe than the loss which a layoff represents to a worker and may be a means of realigning the officials' self-interest with that of the corporation.

81. I assume that the pre-indictment value should be used to avoid the double-counting effect which would result if the market discounted the impact of the equity fine before it was imposed by decreasing the value of the corporation's shares. The problem of finding a stable valuation date for shares is one with which corporate lawyers are amply experienced in other

In essence, the equity fine would have no more effect on the corporation's solvency than if an equivalent stock dividend were issued to its stockholders. To be sure, the dilutive effect of such an issuance will reduce the per-share value of the common stock, but an equivalent cash fine might have an even greater impact on the corporation's stock value since the risk that the enterprise will go bankrupt would substantially increase in the aftermath of a cash fine. For example, the consequence of an equity fine equal to 25% of the outstanding shares after the fine should be to reduce the value of each shareholder's investment in the corporation by 25%. A cash fine in a similar amount would very likely cause bankruptcy or, at the least, a considerably greater decline in the market value of the corporation's shares because of the corporation's reduced capital. In other words, because cash fines reduce the corporation's ability to weather future financial reversals and to undertake new opportunities, the risk of bankruptcy increases, its prospects for growth falter, and investors will discount its shares (to reflect the increased risk) to a degree that is greater than the proportionate dilution incident to the equity fine.

Not only are employees and creditors relatively unaffected by reallocation of equity ownership, but also the cost of the fine is less likely to be effectively passed on to the consumer in the form of higher prices. This is so for two reasons: first, there is no short-term financial crisis which might tempt corporate managers to experiment with higher prices, and second, even if the corporation possesses sufficient monopoly power to raise prices, at least the increased revenues will be shared with the former victims, who are now

contexts. It is usually solved by taking a thirty-day average of the closing market price prior to the announcement. Cf. Burns, *The Competitive Effect of Trust-Busting: A Portfolio Analysis*, 85 J. POL. ECON. 730-34 (1977) (filing of complaint by government has dramatic effect on stock prices).

Corporate lawyers are, of course, aware that the issuance of shares and their resale by an underwriter (a term which could include such a fund if it took "with a view to distribution") requires registration under the Securities Act of 1933, 15 U.S.C. §§ 77(a)-77(aa) (1976). This would entail considerable costs and delay. However, several exemptions from this registration requirement are available. First, the private placement exemption — § 4(2) — could be utilized for the issuance of the shares to the fund (because the fund would be a true institutional investor), and the resale of such shares could be made pursuant to rule 144 or a separate private placement. In addition, the exemption under § 3(b) of the Act for small issuances could also be utilized in many cases. Even if the compensation fund were not the recipient, the shares could be distributed to actual victims of the crime pursuant to exemption afforded by § 3(a)(10), which provides an exemption for judicially or administratively approved issuances which are in exchange (including partial exchange) for "outstanding . . . claims or property interests." The theory here would be that the victims of crimes have claims against the corporation and could exchange such claims in return for the shares. Resale ordinarily would be exempt under § 4(1). The SEC could also exempt most such issuances from the registration requirement by a rule adopted under section 3(b). Even if registration were required, the costs of this process could be borne by the defendant corporation.

shareholders, if indirectly, through the victim compensation fund. This result may not protect the consumer in the short run, but it does mean that the equity fine cannot be seen as a cost of doing business because it is substantially less recoupable than a cash fine.

The impact of the equity fine on every group having an interest in the corporation except stockholders is negligible, and even the impact on stockholders can be measured and limited. In contrast, a cash fine of similar magnitude has unforeseeable effects because it may set off a chain of falling dominoes. To sum up, the equity fine simply subdivides the corporate pie into more and smaller pieces, and then redistributes a limited number of the pieces to the broad class of crime victims.

This analysis leads to the second obvious question: would the equity fine's avoidance of the adverse side effects of corporate punishment produce less judicial and prosecutorial nullification? In short, would more severe penalties be imposed? To a substantial degree, the answer to this question depends on how sympathetically courts view the stockholder, on whom the equity fine imposes the cost of deterrence. Here, the logic of deterrence is cold and cruel: the more the stockholder's shares are subject to dilution through equity fines, the greater his interest in preventive and monitoring controls within the corporation. Nevertheless, courts frequently temper justice with sentiment, and the equity fine may be viewed by some courts as an unjust penalty which falls on "innocent" shareholders while cash fines fall on the "evil" corporation. Fallacious as such a distinction between the firm and its shareholders is, a sentencing court may unconsciously assume it, *unless* the equity fine can be presented as fair as well as efficient. Four arguments can be made, however, why equity fines are indeed fairer than cash penalties. First, the use of such a fine is less severe because it averts future corporate insolvency. Second, the proceeds of the equity fine will fund a general purpose victim compensation fund (thus permitting the court to view itself as engaging in humanitarian fundraising rather than as simply imposing a penalty). Third, the equity fine falls evenly across an entire class (*e.g.*, stockholders), while the burden of cash fines imposed on the corporation ultimately falls disproportionately on a few (*e.g.*, those laid off, the community surrounding a specific plant that is closed, etc.). The loss is more diffused in another sense as well: few stockholders hold only one security while most employees hold only one job. This last point — that equity fines produce "cost spreading" over a larger class —

utilizes a neutral fairness criterion,⁸² and thus we avoid the more controversial socioeconomic assertion that stockholders can afford the cost better than lower paid employees. Fourth and finally, stockholders have a potential means of redress: they can seek to pass on the penalty to responsible officials through derivative suits. Once equity fines become prevalent, it can also be argued that stockholders "assumed the risk" by investing in such a company.

All these justifications for imposing costs on shareholders seem superior to the traditional rationale, which is that since the shareholders received indirectly the benefit of the crime, they should also bear the burden of punishment to cancel out the "unjust enrichment."⁸³ Such a rationale is misleading because it hides both (1) the need to elevate the "expected punishment cost" to a level well in excess of the actual gain in order to compensate for the low risk of apprehension and (2) the possibility that the stockholders who benefited from the crime are not the same as those who now bear the cost of the penalty.⁸⁴

Finally, the equity fine reduces the incongruence between the interests of managers and shareholders. From the managers' perspective, two negative consequences flow from a substantial equity fine: first, by increasing the number of outstanding shares it reduces the per share value of the corporation's stock, and this in turn has devastating consequences for outstanding stock options held by management officials. In this light, the equity fine partially falls upon senior and middle management officials (whereas the cash fine may have an impact on lower level employees). Given the difficulty of identifying the truly blameworthy official in many instances of corporate misbehavior, this characteristic of the equity fine may be desirable. Given that the responsibility for a decision is often too diffused to isolate a single culprit with sufficient confidence to impose criminal sanctions, the equity fine responds to this problem by spreading a

82. For an argument that cost spreading reduces the perceived intensity of an injury and makes its imposition seem fairer, see G. CALABRESI, *THE COST OF ACCIDENTS* 40 (1970).

83. Cf. McAdams, *The Appropriate Sanctions for Corporate Criminal Liability: An Eclectic Alternative*, 46 U. CINN. L. REV. 989, 994-95 (1978) (shareholders derive the benefit from illegal activities).

84. Although a number of commentators have approved this "unjust enrichment" rationale, I think they are unconsciously motivated by a desire for retribution rather than for deterrence. Cancelling out the profit may achieve retribution, but it will not deter unless the risk of apprehension is equal to 100% (in which case an insanity defense should be permitted). A retributive rationale for corporate punishment also becomes suspect when one realizes that the stockholder-beneficiaries of corporate misbehavior may well have (and, to some extent, certainly have) sold their shares in the secondary market prior to the crime's discovery.

modest penalty among the relatively narrow class which may have shared responsibility for the decision.

A second consequence of an equity fine is to place a large marketable bloc of the corporation's securities in the hands of the trustee who manages the victim compensation fund. This in turn raises a possibility that the convicted corporation will become the target of a hostile takeover. To the aggressive corporate suitor, such a bloc supplies the necessary toehold acquisition from which to launch a tender offer or other campaign for control.⁸⁵ Empirically, it is evident that incumbent managers fear takeovers and take elaborate precautions against them. Thus, to the extent that the equity fine raises the probability of a takeover, we create a sanction — which is virtually costless to society — by which to dissuade corporate managers from criminal behavior. Predictably, where senior management sees its own position in office threatened by the criminal behavior of subordinate middle management officials, it will install greater internal controls than when the only consequence is a modest cash fine to the organization and possibly the criminal prosecution of the subordinate. In this sense, the equity fine structures a limited degree of vicarious responsibility into the criminal justice system: senior officials are not held criminally liable for the acts of their subordinates, but their positions are indirectly placed in jeopardy. Thus, to return to the earlier analogy of the sumo wrestler and the judo expert, society here uses a force internal to the firm — fear of a potential takeover — to increase deterrence without creating externalities.

The effect of the equity fine on the stockholder may be even more desirable. In a well-known essay, Professor Walter Werner has argued that the conduct of top managers is substantially influenced by the stockholders' desire for short-term capital appreciation.⁸⁶ From this perspective, the corporate manager who makes illegal payments or evades environmental regulations has not breached the stockholders' trust, but instead is faithfully pursuing their desires. The market in effect demands misconduct, and the manager responds to that de-

85. See A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* 1 (1978) ("large blocks of stock in institutional hands" makes a corporation a target for tender offer). The victim compensation fund here contemplated seems as much an "institutional investor" as are pension plans.

In addition, it is commonly observed that the typical target of the hostile tender offer is the cash-rich corporation whose liquid assets could fuel further expansion by the raider. Here, the contrast between the cash fine and the equity fine is even more marked: the former depletes cash reserves and makes the defendant to this degree a less inviting target, while the latter leaves a cash-rich corporation an equally inviting, but even more vulnerable, target.

86. See Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977). See also note 44 *supra*.

mand out of a fear that otherwise the marketplace will discount the value of his firm's shares. Others have also recently theorized that investors in the contemporary stock market have a short-run focus, and place little emphasis on the long-run adverse consequences.⁸⁷

If the premise that stock market pressures induce at least some forms of corporate misconduct is correct, the equity fine is a punishment which truly fits the crime, for its primary effect is to dampen stock market pressure for the aggressive pursuit of illicit short-term gain. In turn, if top managers do respond to stock market influences (as Professor Werner suggests), an investing public more sensitive to corporate crime may produce a more cautious top management that would install greater internal auditing controls to restrain lower echelon managers. In the end, even if the lower-tier manager is oblivious to the stock market, his behavior can be influenced through the positive and negative incentives manipulated by senior management, incentives which today pressure for short-term earnings growth.

Not only does the equity fine focus the penalty on the stockholder, but it also permits the imposition of a more severe fine. A basic principle of microeconomics — that the value of the firm as a going concern is the discounted present value of its expected future earnings — will explain this point.⁸⁸ This “going concern value” of the firm typically exceeds its “book” and “liquidating” values. As a result, a cash fine faces a lower maximum boundary because it cannot be paid out of expected earnings (which may never be earned). Even the established corporation would have trouble borrowing from lenders at a level in excess of its book value based only on the shaky security of anticipated earnings. Yet it is precisely this source of value — the expected earnings — which the equity fine can tap, because stock prices are a function of expected earnings.

Moreover, in those cases where the profits of an illegal activity will continue into the future, the equity fine also automatically adjusts the penalty upward to reduce unjust enrichment. No matter how great such profits are, they must flow to new stockholders in the proportion that the equity fine bears to the total number of shares.

The utility of an equity fine comes into clearer focus when we consider the not uncommon case of a young company with high-growth prospects, low book value, limited cash resources, and little

87. See BUSINESS WEEK, *supra* note 42; Hayes & Abernathy, *supra* note 44; Lorne, Book Review, 77 MICH. L. REV. 543, 547 (1979).

88. Cf. V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 1-78 (2d ed. 1979); Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293 (1975) (value of firm discounted present worth of future net cash flow).

borrowing capacity. Because of its expected earnings growth, the stock of such a company may trade at a high price-earnings multiple. It is essentially immune from high cash fines because it has only modest liquid assets, and in part for this reason it may be tempted to risk illegal activities.⁸⁹ An equity fine permits society to reach the company's future earnings today by seizing a share of the firm's equity (which is, of course, equal in value to the market's perception of the discounted present value of those earnings).

In short, the equity fine permits the imposition of much more severe penalties than are possible under a cash fine system. Not only are we able to outflank the "deterrence trap" by this means, but we can also do so without producing the externalities which can make the punishment more harmful than the crime. The immediate relevance of this point is, however, that its significance would not be lost on the stock market. Because the equity fine can vastly exceed the cash fine, the stock market will begin to discount the securities of those companies perceived to be vulnerable to future criminal prosecutions. This leads in turn to a unique result: punishment will, to a degree, precede the crime as companies perceived to be run in a manner that encourages illegal behavior will see their stock values decline. As noted earlier, corporate managers will have an incentive to institute preventive monitoring controls to forestall this decline — just as today they have an apparently more than adequate incentive to maximize short-term profits. Managers who fail to convince the stock market that their companies are reasonably protected against such legal risks will see their company's stock value decline — thereby inviting a take-over by other firms which think they can do a superior job. Thus, we have come full circle to the idea that the law can use competition among firms and within firms to enhance the deterrent threat of the law.

The equity fine opens still other opportunities for creative legal engineering. For example, the amount of the equity fine could be graduated, increasing substantially with each succeeding criminal conviction within a defined time period: *e.g.*, a fine of shares equal to one percent of the outstanding stock with the first conviction, five percent with the second, and twenty percent with the third.⁹⁰ This

89. In addition, there is the possibility that smaller firms may be more willing to accept risk as a means of competition with larger, more established entrants in a market. See note 71 *supra*.

90. Of course, a cash fine could also be increased with subsequent convictions, at least in theory. However, because of the problems of nullification and overspill discussed earlier, it is less likely that a court would to the same extent increase cash fines for habitual corporate offenders.

enhanced penalty for the recidivist corporation would serve to direct the stock market's disapproval to those companies which, by repeated delinquencies, have subjected themselves to potentially draconian equity fines.⁹¹ Under such a system of fines, it seems doubtful that management could survive in office despite a series of corporate criminal convictions; others with greater credibility in the view of the market, who could therefore restore the discounted loss in market values, would replace the old managers. Additionally, the issuance of such a large bloc of new securities could serve as a vehicle for the temporary appointment of special "public interest" directors (as some reformers have urged).⁹² This is possible because the victim compensation fund may receive a bloc sufficiently large to empower it to select at least a minority of the board members. Admittedly, the impact of special constituency directors can be viewed with some skepticism,⁹³ but the important point is that the equity fine provides a virtually automatic means for replacement of the directors and management of habitual corporate offenders.

All this leads to an ironic result: for years, the field of securities law has seen a debate over how expansively its critical concept of materiality should be defined. On the one hand, "liberal" proponents of a doctrine called "ethical materiality" have argued that the corporation's disclosure should encompass all matters bearing on the integrity and social performance of the corporation and its officers.⁹⁴ Conversely, those of a more "tough-minded" persuasion have replied that shareholders in fact pay little heed to such data, and are interested only in information which affects expected earnings per share.⁹⁵ Empirically, the case for the latter school is strong. The

91. Recidivist sentencing statutes are in force in most jurisdictions for individual offenders. See 3 AMERICAN BAR ASSOCIATION STANDARDS FOR CRIMINAL JUSTICE ch. 18-4.4 at 278-90 (2d ed. 1980) [hereinafter cited as ABA STANDARDS]. See also MODEL PENAL CODE, § 7.03, comment 2 (Tent. Draft No. 4, 1955). But in the case of organizational offenders, the only parallel is the "RICO" ("Racketeer Influenced and Corrupt Organizations") statute which is triggered by a "pattern of racketeering activity," a term the statute defines to mean two alleged offenses within a ten-year period that need not have resulted in prior convictions. See 18 U.S.C. §§ 1961-1968 (1976). Regrettably, however, the RICO statute is a nightmare of overbroad draftsmanship. It hardly meets the need for a recidivist penalty structure for organizations.

92. See C. STONE, *supra* note 20, at 152-84. The SEC has also repeatedly obtained outside directors as a condition for settling its enforcement cases. See note 176 *infra*.

93. See Solomon, *Restructuring the Corporate Board of Directors: Fond Hope — Faint Promise*, 76 MICH. L. REV. 581 (1978).

94. See Stevenson, *The SEC and the New Disclosure*, 62 CORNELL L. REV. 50 (1976); Sonde & Pitt, *Utilizing the Federal Securities Laws to "Clear the Air! Clean the Sky! Wash the Wind!"*, 16 HOW. L.J. 831 (1971).

95. See Mann, *Watergate to Bananagate: What Lies Beyond?*, 31 BUS. LAW. 1663 (1976); Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 185-86 (1979).

available data seem to show that publicity about a corporation's illegal activities does not cause the price of its stock to decline,⁹⁶ thus suggesting that the opponents of "ethical materiality" were right. But as penalties are made more severe, the gap between the ethical investor as a normative concept and the economic investor as an empirical reality begins to close. As penalties increase, the hard-boiled investor becomes interested in the corporation's posture vis-à-vis such topics as the environment, design safety, and discrimination — because he cannot afford not to be concerned.

Having now presented the case for the equity fine, what objections to it seem likely? Three stand out: (1) it will deny capital to certain unavoidably risk-prone industries (such as those producing toxic wastes) and thus interfere with the process of "re-industrialization;" (2) it is unconstitutional; and (3) even if constitutional, it is such an abhorrent form of "creeping nationalization" that no legislature would ever authorize it. Each objection needs only a brief response.

First, the equity fine interferes less with the process of capital formation than does the cash fine, because only the latter actually depletes capital. Although such an equity sanction may make it difficult for some companies to market offerings of their equity securities, the simple fact is that for the past decade few corporations have used common stock issuances as a means of raising capital.⁹⁷ The most popular and heavily predominating purpose of equity issuances has been to serve as the currency for merger and acquisitions and to provide incentive compensation for managers. To the extent the sanction restricts these goals of the firm, one might argue that this is less a liability than a serendipitous benefit of the approach.

A related argument is that the equity fine will taint certain disfavored industries because the investor will be unable to distinguish the varying criminal liabilities of high risk and low risk companies in the same industry. Admittedly, the individual investor cannot undertake such an exhaustive analysis, but he need not. The professional security analyst has demonstrated the ability to evaluate complex technologies, to distinguish qualitative differences in managements, and to appraise other forms of internal control systems.⁹⁸

96. See Note, *Disclosure of Payments to Foreign Government Officials Under the Securities Acts*, 89 HARV. L. REV. 1848, 1855 n.45 (1976); Hetherington, *supra* note 95, at 186 (noting that in proxy votes, shareholders have always rejected attempts to forbid such payments by management).

97. For a summary of recent statistics, see *Is Desperation the Mother of Invention?*, FORBES, May 12, 1980, at 52.

98. Those who accept the "efficient market" theory that stock market prices reflect the

There is little reason to doubt that, if the stakes are high enough, the analyst can turn his attention to the question of legal risk as well. Moreover, management has every incentive to demonstrate its efforts to him. Finally, here as elsewhere, a company's track record will be predictive of the future: companies with a record of prior convictions pose higher risks than those that have never been convicted. This is particularly the case under an equity fine system that substantially increases the amount of the penalty for recidivist corporations.

Is the equity fine unconstitutional? This Article will not develop the full range of fanciful arguments that might be presented.⁹⁹ But a simple rebuttal begins from the principle that the greater subsumes the lesser. A common provision in many statutes authorizes the forfeiture of the corporate charter under certain general conditions — conditions that a felony conviction probably satisfies.¹⁰⁰ If states can revoke the charter, the equity fine is but a piecemeal substitute that is far more modest and humane in its scope and effect. In addition, the “reserved power” clause in most state corporation statutes permits the state to impose additional conditions retroactively on the grant of a corporation charter.¹⁰¹ The equity fine would be a reasonable exercise of this power.¹⁰²

Finally, is an equity fine unprecedented and unthinkable? In a narrow sense, it lacks clear precedent, but civil litigation against cash

intrinsic values of the corporations so traded tend to rely on competition among such analysts as the means by which efficiency is obtained. Compare Murphy, *Efficient Markets, Index Funds, Illusion and Reality*, J. PORTFOLIO MANAGEMENT, Fall 1977, at 5 (securities analyst can outperform even efficient market), with Note, *The Efficient Capital Markets Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). Cf. J. LORIE & M. HAMILTON, THE STOCK MARKET 70-110 (1973) (discussing role of securities analyst in an efficient market).

99. Undoubtedly, some will argue that such a sanction violates the principle enunciated in *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819), that a private corporation charter is protected against subsequent adverse legislative amendment by the constitutional prohibition against impairment of contractual obligation. Such arguments, of course, overlook Justice Story's concurring opinion in this case in which he suggested that the impairment clause would pose no obstacle if the state reserved a power authorizing such retroactive amendments at the time it granted the charter. States have uniformly followed Justice Story's suggestion, and a reserved power is now a ubiquitous feature of state corporation codes. See note 101 *infra*.

100. See, e.g., MODEL PENAL CODE § 6.04 (Tent. Draft 1962); CAL. CORP. CODE § 1801 (Deering 1977); DEL. CODE ANN. tit. 8 § 283; N.Y. BUS. CORP. LAW §§ 1101-1103, 1111(6) (McKinney 1963). These statutes codify the ancient writ of quo warranto. See generally Note, *Corporations: Quo Warranto: Forfeiture of Franchise on Account of Crime*, 13 CORNELL L.Q. 92 (1927).

101. See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 142 (1953).

102. In reality, the equity fine is likely to be a less draconian penalty than the remedy of divestiture now available with respect to antitrust offenses. This divestiture sanction not infrequently falls on innocent shareholders. See Adams, *Trustbusting and the 'Innocent' Shareholder: 'Compensation' If Stock Prices Fall?*, 10 ANTITRUST L. & ECON. REV. 51 (1978).

starved defendant corporations is often settled in return for the issuance of shares. In the case of the corporation, there is little reason to distinguish the civil and criminal suits, since there is no real difference in the sanctions they can trigger. Moreover, other sanctions recently imposed on corporations have many of the same characteristics as the equity fine (except that they are inferior substitutes). In a much publicized case, the Federal Communications Commission ruled this year that because General Tire and Rubber Company had engaged in various forms of misconduct, including illegal political payments, its subsidiary was unfit to hold three profitable television franchises it had long operated in New York, Boston, and Los Angeles.¹⁰³ In response, the subsidiary has attempted to spin off its remaining radio and television properties.¹⁰⁴ One could question the logic of the FCC's decision, but, stripped of its rhetoric, General Tire has been sanctioned by the loss of valuable properties. Such a compelled spin-off might eventually leave shareholders holding substantially equivalent, though subdivided, investments, but the result seems far less direct, more overbroad, and clearly more likely to create externalities than the equity fine. Other examples of novel corporate penalties that courts have recently imposed could also be cited: disqualifications from government contracts, loss of subsidies, denial of licenses, etc.¹⁰⁵ The trend is visible. But the time has come to urge that the law adopt a rational strategy in lieu of the unplanned, semi-conscious evolution that is now taking place.

B. *The Hester Prynne Sanction: Using Adverse Publicity to Trigger Internal Reform*

As Hester Prynne knew, public stigmatization can be a powerful sanction. Although we cannot hang a scarlet letter on the corporation, the criminal process has a unique theatricality which can con-

103. See *RKO's Unfolding Spinoff Efforts*, N.Y. Times, Sept. 15, 1980, § 4, at 1, col. 3.

104. *Id.* To date, the Commission has rejected this spin-off proposal.

105. In theory, these penalties are being imposed by government agencies to sanction corporations for violations of that agency's regulations. Thus, in the RKO case the license forfeiture was justified by the FCC on the ground that the parent corporation had misrepresented material facts to the agency about the operation of its subsidiary. While the sanction may have been adequate in size to deter, however, there is little certainty as to when it will be invoked, and, if invoked, whether it will be sustained by the courts. In addition, there is a possibility that an externality may be visited upon the public (for example, if the RKO license were transferred to an inferior broadcaster). For recent examples of this eclectic trend, see *Federal Contracts Denied Firestone Over Bias Dispute*, Wash. Post, July 16, 1980, at D7, col. 5; *Caesars Drops Top Executives and Gets Jersey License*, N.Y. Times, Oct. 26, 1980, § 1, at 45, col. 1; *Head of Firm Quits After Charge*, Wash. Post, July 9, 1980, at E7, col. 2 (reporting resignation of chief executive incident to settlement of SEC civil complaint).

vey public censure far more effectively than the civil-law process.¹⁰⁶ Recent research also suggests that the threat of stigmatization may be the primary deterrent in the case of middle-class defendants.¹⁰⁷ But can we focus adverse publicity with similar efficacy when it is the corporation that is convicted? If we can, adverse publicity might seem an optimal penalty for corporate misbehavior, because it seems to minimize the externalities associated with other forms of corporate punishment.

Little doubt exists that corporations dislike adverse publicity and that unfavorable publicity emanating from an administrative or judicial source has considerable credibility. From this starting point, commentators have suggested a variety of formal publicity sanctions; for example, Professor Brent Fisse has recommended that the government publish a "corporation journal" which would detail the offenses of convicted organizations.¹⁰⁸ There is a danger, however, that in practice such well-meaning reforms would become so bureaucratized and pedestrian as to have only a negligible impact. A cool-headed appraisal of the limits on adverse publicity as an effective legal sanction for organizations seems necessary. Such an appraisal will serve as a prelude for this Article's suggestion that the focus of adverse publicity as an organizational penalty should be shifted from the corporate entity to the individuals within the firm. Such an approach again harnesses internal forces within the firm so as to reduce the incongruence between the interests of managers and their firm.

A strategy that seeks to deter corporations through adverse publicity aimed at the firm may fail because of the following problems:

First, the government is a relatively poor propagandist. It has trouble being persuasive; rarely is it pithy; never can it speak in the catchy slogans with which Madison Avenue mesmerizes us. At its best, the government sounds like the back pages of the *New York Times* ("good, gray and dull"); at its worst, its idea of communica-

106. It should not be forgotten that only criminal cases carry captions such as "United States of America v. . . ." or *People of the State of New York v. . . .* There is what might be termed a "Greek Chorus" effect to the jury's finding in a criminal case.

107. Nagin & Blumstein, *supra* note 12. Although this study focused on draft evaders, its authors expressed a view that their findings might apply to middle-class offenders generally. *Id.* at 269-70. Indeed, the business executive as criminal may have much in common with the draft evader because both tend to see themselves as the innocent victims of government harassment.

108. Fisse, *The Use of Publicity as a Criminal Sanction Against Business Corporations*, 8 MELB. U. L. REV. 107 (1971). See also M. CLINARD, P. YEAGER, J. BRISSETTE, D. PETRASHEK & E. HARRIES, *ILLEGAL CORPORATE BEHAVIOR* 222-24 (1979); Gellhorn, *Adverse Publicity By Administrative Agencies*, 86 HARV. L. REV. 1380 (1973).

tion is exemplified by the *Federal Register*. This soporific quality of governmental prose matters little when it is addressed (as it usually is) to lobbyists, bureaucrats and lawyers. But to be effective, a publicity sanction must make the public pay attention. Those who have had success in reaching the public — *e.g.*, the television networks and the advertising agencies — recognize H.L. Mencken's maxim as an iron law: No one ever lost money underestimating the intelligence of the American public. Such insight may have made Freddie Silverman famous, but in this context it raises an ethical dilemma: publicity requires over-simplification. The message must be simple and catchy — even if a price must be paid in terms of its accuracy. But this price is troubling; it seems indecent for the government to engage directly in so dubious an endeavor as attempting to persuade in the manner of Madison Avenue advertising agencies.

Second, government publicity may be drowned out because the communication channels of our society are already inundated with criticism of corporations. In the language of the communications theorist, there is too much noise in the channels for any message to be heard with clarity. Unkind words about corporations come from a multitude of sources today: Naderites, editorialists, television commentators, politicians facing election campaigns, etc. The result is that the currency is being devalued. Weak criticism tends to rob accurate censure of its expressive force. The criminal conviction of the corporation should be a unique event, but it loses its special force when the public constantly receives an implicit message that all corporations are corrupt or amoral.

Third, corporations can dilute this sanction through counter-publicity. As recent Mobil Oil advertisements about the energy crisis should remind us, the corporation can fight back — and effectively. In addition, recent Supreme Court decisions upholding the corporation's first amendment right to comment on public issues cloud the constitutional status of any attempt to restrict such corporate rebuttals.¹⁰⁹ In sum, these first three factors require us at least to be tentative in any judgment about the effectiveness of governmental publicity.

Fourth, the efficacy of publicity in cases involving consumer fraud or jeopardy to the public safety does not imply that publicity will be equally effective in dealing with "regulatory" crimes. The public responds with outrage when it learns it has been sold an unsafe prod-

109. *See, e.g.*, *Central Hudson Gas & Elec. Corp. v. Public Serv. Commn.*, 100 S. Ct. 2343 (1980).

uct, administered a dangerous drug, or exposed to a carcinogenic environmental hazard, but its reaction may be far less intense when the crime threatens no obvious injury. The muckrakers learned this lesson to their dismay at the start of this century. While an Upton Sinclair or an Ida Tarbell could arouse the public's indignation over the contents of sausage, they were less successful at crystallizing public concern over institutional corruption. Aiming at America's brain, they hit only its belly. To be sure, the recent history of the Watergate scandals and particularly of the illegal corporate payments scandals may lead us to temper this conclusion. The public did show considerable interest in the details of the Lockheed, Gulf Oil and United Brands scandals. But novelty wears off, and companies which subsequently disclosed illegal payments at least as extensive received far less public attention.¹¹⁰ In any event, there is little evidence that either the public or investors changed their behavior because of these disclosures in any way which prejudiced these corporations. Consumers did not shun Gulf gasoline or United Brands bananas as a result of illegal payments publicity. Those who did suffer were largely producers of capital equipment — such as Lockheed and Northrup — who lost prospective sales to foreign governmental purchasers. Only in these cases did publicity not directly aimed at the quality of the defendant's product produce financial injury to the corporation.¹¹¹ But this observation leads to still another, more general problem with publicity as a sanction:

Fifth, if publicity directed against the corporation is effective, it will produce the same externalities as cash fines. Adverse publicity is something of a loose cannon; its exact impact cannot be reliably estimated nor is it controllable so that only the guilty are affected. Here, the recent Ford Pinto case supplies a paradigm: although acquitted, Ford's ability to market the Pinto has obviously been impaired. The impact of reduced sales or the termination of a product line once

110. Exxon received far less attention, for example, than Lockheed, yet its acknowledged political payments reached "nearly \$60 million." See generally *Political Slush Fund Hid Other Spending, Cost Exxon Millions*, Wall St. J., Nov. 14, 1975, at 1, col. 6.

111. Both federal prosecutors and defense counsel have indicated to me that there is one important exception to this generalization: a conviction under the "RICO" statute, 18 U.S.C. §§ 1961-1968 (1976), would represent a "public relations disaster" for a public corporation because stockholders would not understand that no connection with organized crime was necessary in order for the corporation to have engaged in a "pattern of racketeering activity." As a result, the prosecutor today gains substantial plea bargaining leverage by indicting a corporation on a "RICO" charge since he can drop this stigmatizing charge in return for a plea of guilty to an equally broad but less sensational offense such as mail fraud. The leverage that the "RICO" charge gives may, however, be short-lived: if too often used by the prosecutor, the public would come to understand the overbroad nature of the statute, and hence its potential public relations impact would be lost.

again falls disproportionately on workers at the bottom of the hierarchy. If we are willing to bear these costs (as sometimes we must), it seems easier to rely on even cash fines in preference to the wholly unpredictable impact of a legal stigma. By no means is this argument a rejection of governmentally mandated publicity as a means of correcting false advertising or of alerting the consumer to potential dangers. But the civil law can also achieve these goals and with less effort and greater precision. Through product recalls, civil orders requiring corrective advertising, and even notices from the producer asking customers to desist from further use of the product, administrative agencies can and have used publicity to protect the consumer.¹¹² Here the end result is achieved without the extraneous emotion and complexity that follows from attempting to use publicity itself as a form of punishment.

*Finally, civil liberties issues surround the use of publicity as a sanction.*¹¹³ The criminal process inherently involves adverse publicity, and, to this extent, some element of the punishment precedes the conviction. Publicity begins with the indictment, and an acquittal does not fully undo the damage. In contrast, the quieter, less public character of civil-law adjudication allows us to withhold the impact of adverse publicity until there has been a finding.

Although a corporate defendant may be required to give notice of its conviction to victims, more serious problems emerge when the government itself seeks to broadcast the significance of the conviction outside the courtroom. In the frequent case where the defendant plea bargains and the government in return drops some of the charges in the indictment, it would seem improper for the government to discuss unproved and unadmitted allegations in its publicity efforts.¹¹⁴ Such an attempt would implicitly violate the plea bargain and would involve the government in possibly unconstitutional

112. The FTC's order requiring corrective advertising by Listerine is, of course, the most celebrated example of such a power being put to sensible use. *See* Warner-Lambert Co., 86 FTC 1398 (1975), *affd. sub. nom.* Warner-Lambert Co. v. FTC, 562 F.2d 749 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 950 (1978). More recent examples would include the corrective advertising required of Proctor and Gamble, the manufacturer of a brand of tampons responsible for toxic shock syndrome.

113. Former SEC Commissioner Roberta Karmel has criticized the SEC's use of public reports under Section 21(a) of the Securities Exchange Act of 1934 on this ground, arguing that such reports involve unreviewable stigmatization. However, the criminal process seems a safer context for the use of such a power since a finding of guilt beyond a reasonable doubt will precede any such report.

114. Due process of law requires that the government honor its plea agreements. *See, e.g.,* Santobello v. New York, 404 U.S. 257 (1971). It would seem to infringe on the government's promise if the prosecutor were to continue to assert publicly the defendant's guilt on charges the prosecutor agreed to drop.

forms of stigmatization. Similar problems arise where officially prepared publicity describing the corporation's conduct alleges misbehavior by unindicted corporate officials. Restraint seems necessary in these circumstances, but it is likely to give a fragmentary, disjointed character to governmental efforts at publicity.

These considerations might lead one to reject the use of publicity as a formal criminal penalty for organizations. But this would be an overreaction. Most of the foregoing problems arise from the attempt to direct publicity against the corporation as an entity. Stigmatizing a legal fiction is both difficult (because the consumer cares about the product, not the producer) and dangerous (because of the overspill problem and the uncontrollable character of the penalty). However, there remains the possibility that the focal point of adverse publicity can be shifted from the entity to the individual officer. Of course, this automatically occurs when we prosecute the individual, but it seldom happens when the prosecutor takes the easier course and pursues the corporation.¹¹⁵

What then can the court sensitive to civil liberties do at sentencing to refocus public censure from the firm to the responsible individuals? Two possibilities exist under conventional sentencing law. First, the court typically receives a presentence report from the probation office before imposing sentence.¹¹⁶ Typically, a probation officer interviews the offender and examines the prosecutor's files. In the corporate context this appears an exercise without a purpose, since the normal probation officer is ill-equipped to study the corporation. But, the court might appoint and compensate a special probation officer¹¹⁷ — a distinguished local lawyer, a business school professor or an experienced corporate director — who could study the corporate offender on a necessarily enlarged scale. He would interview corporate officers and, perhaps, the corporation's attorneys, in order to determine more fully the context and causes of the crime. Because the corporation is not itself entitled to claim the fifth amendment privilege against self-incrimination,¹¹⁸ corporate officials could refuse to answer a probation officer's questions only if

115. See generally *Developments in the Law — Corporate Crime*, 92 HARV. L. REV. 1227, 1243-45 (1979) [hereinafter cited as *Developments in the Law*].

116. 3 ABA STANDARDS, *supra* note 91, at Ch. 18-5.1 (2d ed. 1980) (setting forth expected contents of such a report) (the author of this Article served as reporter for chapter 18 of these standards).

117. The Federal Criminal Code expressly grants this authority. See S. 1722, 96th Cong., 1st Sess. § 3802 (1979).

118. See *Bellis v. United States*, 417 U.S. 85 (1974); *United States v. White*, 322 U.S. 694 (1944); *Wilson v. United States*, 221 U.S. 361 (1911); *Hale v. Henkel*, 201 U.S. 43 (1906).

they themselves claimed the privilege in their own right. Not only would this be difficult for most executives to do, but, under existing law, they would still have no right to refuse to provide corporate books and records in response to a subpoena, even if such corporate records incriminate them. Under Supreme Court decisions, the corporation's property right to the records has decisive significance.¹¹⁹ In addition, it has traditionally been a sentencing factor to consider whether the defendant "cooperated" with the authorities. This principle has been recently reaffirmed by the Supreme Court.¹²⁰ As a result, the offender corporation which resists a presentence inquiry might subject itself to enhanced penalties.

Thus, a financially sophisticated probation officer armed with a subpoena power can probably obtain access to virtually all corporate information and records bearing on the crime, with only the attorney's work product standing as a probable exception. What should such an officer attempt to achieve? An appropriate model might be the careful study prepared for Gulf Oil by John J. McCloy, its special counsel, which detailed in specific and unemotional terms the extent of the internal falsification and deliberate deception of the Gulf board by senior Gulf management. That deception fostered Gulf's extensive program of domestic and foreign political payments.¹²¹ The impact of the McCloy Report on the Gulf board was immediate and substantial; it triggered internal reforms within Gulf and hastened the resignation of some apparently culpable senior officials.¹²²

Equally important, the McCloy study, although written in dry and hyper-precise tones, was picked up by the media. It was republished by the popular press, and it became a paperback bestseller.¹²³

119. See *Fisher v. United States*, 425 U.S. 391 (1976); *Couch v. United States*, 409 U.S. 322 (1973); *Dreier v. United States*, 221 U.S. 394 (1911); *Wilson v. United States*, 221 U.S. 361, 381 (1911).

120. *Roberts v. United States*, 445 U.S. 552 (1980) (sentencing court may properly consider as a factor in deciding to impose consecutive sentences that defendant refused to cooperate with government officials investigating a related criminal conspiracy). Although *Roberts* recognized that a fear of *physical* reprisal or the assertion of the fifth amendment privilege could justify noncooperation and prevent its use as a sentencing factor, the corporation lacks the privilege against self-incrimination (see note 118 *supra*) and cannot be physically retaliated against; thus, the use of noncooperation as an adverse sentencing factor seems much less troublesome in its case. For a fuller discussion of *Roberts*, see Coffee, "Twisting Slowly In the Wind:" A Search for Constitutional Limits on Coercion of the Criminal Defendant, 1980 SUP. CT. REV. _____ (forthcoming).

121. See Board of Directors of Gulf Oil Corp., Report of the Special Review Committee of the Board of Directors of Gulf Oil Corporation (1975).

122. See Robertson, *The Directors Woke Up Too Late at Gulf*, FORTUNE, June 1976, at 121.

123. J. MCCLOY, THE GREAT OIL SPILL (1976) (paperback edition of Gulf Oil Report).

Undoubtedly, it also supplied the raw material for other more journalistic treatments of the same topic. Clearly, this theme of intrigue among senior corporate management has a certain fascination for a substantial public audience. To be sure, this audience will still buy gasoline from Gulf, but economic injury to Gulf is neither necessary nor desirable once the censure is shifted onto the individual.

The suggestion, then, is that the presentence report on corporate offenders be prepared in considerable factual depth in the expectation that such studies will either find an audience in their own right or, more typically, provide the source material for investigative journalism. This approach permits the government both to avoid the ethical dilemma of itself being a publicist, and to rely on the more effective public communication skills of the professional journalist. In a sense, this approach integrates public and private enforcement.

The proposal faces a serious barrier, however, in the traditional (but not uniform) rule that the presentence report is a confidential document not available for public inspection.¹²⁴ Overbroad as the notion of corporate privacy is in this context, techniques for evading this obstacle seem obvious: for example, the SEC might routinely request that such presentence reports be prepared on all publicly held corporate offenders. SEC files will then eventually become available for public inspection under the Freedom of Information Act.¹²⁵ The SEC could also require disclosure of substantially equivalent data in the corporation's next proxy statement.¹²⁶

A second approach would outflank all problems of confidentiality. The same report could be prepared not as part of a presentence investigation but as a mandated study imposed as a condition of pro-

124. See 3 ABA STANDARDS, *supra* note 91, at Standard 18-5.3 (2d ed. 1980) ("The presentence report should not be a public record"). As explained therein, however, the presentence report is today a public record in some jurisdictions, including California and Virginia.

125. The SEC's procedures regarding disclosure of confidential information under the Freedom of Information Act have been revised in the wake of *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979). See Securities Act Release No. 6172 (Dec. 28, 1979), 45 Fed. Reg. 62421 (Jan. 8, 1980) (to be codified in 17 C.F.R. § 200.83). Cf. Pitt, *Procedures to Limit Third-Party Disclosure*, Natl. L.J., Jan. 22, 1979, at 25, col. 1 (explaining steps an attorney can take to limit SEC disclosure of information about client). Nonetheless, although the "reverse FOIA" lawsuit has been successful in preventing agency disclosure of trade secrets under the Freedom of Information Act (5 U.S.C. § 552 (1976 Supp. I & Supp. III 1979)), the concept of "trade secret" should not be stretched so far as to cover a study by a probation officer of illegal behavior. Such information is neither of a proprietary character nor is it "secret," since the agency receives the information from an outside source, rather than from the corporation.

126. See cases cited at note 75 *supra* (requiring disclosure in proxy statement of management improprieties).

bation.¹²⁷ Such a condition of probation seems reasonably related to the goal of crime prevention and thus could be sustained.¹²⁸ Several problems now seem simplified: (1) because the counsel preparing the report is at least in theory the corporation's own counsel (that is, the report will be prepared by special counsel chosen by the corporation but with the court's approval), the attorney-client privilege question is reduced in significance; (2) the conditions of probation could reasonably require dissemination of the report to stockholders (and hence, as a practical matter, to the world generally); and (3) the corporation's response to the report could be legitimately considered by the court in determining how long to continue the period of probation.¹²⁹ In effect, this last factor creates an incentive for internal reforms and discipline of culpable officials.

By either route — probation condition or presentence report — the sentencing court should draw upon the recent SEC experience with illegal payments cases. In response to the SEC's Voluntary Disclosure Program (which promised preferred treatment for those corporations which voluntarily reported their questionable payments), hundreds of public corporations conducted elaborate investigations, and the corporate self-scrutiny report developed both as a distinctive genre and as a field of legal practice.¹³⁰ One critical generalization stands out from this experience: the adequacy, and indeed integrity, of the self-study report depends above all on the independence of the special counsel conducting it. Dispassionate observers have noticed a major difference between studies conducted by the corporation's own counsel and those undertaken by an independent special counsel (selected in some instances with judicial or agency participation).¹³¹ An investigation by the corporation's own counsel is likely

127. For a discussion of judicial authority to sentence a corporation to probation, see Note, *supra* note 8, and notes 169-73 *infra* and accompanying text.

128. For a discussion of the "reasonableness" requirement, see 3 ABA STANDARDS, *supra* note 91, at Standard 18-2.3(e) (2d ed. 1980); MODEL PENAL CODE, § 301.2(1)(1) (Proposed Official Draft, 1962); see also Note, *Judicial Review of Probation Conditions*, 67 COLUM. L. REV. 181 (1967).

129. This same position is taken by the pending Senate bill to recodify the Federal Criminal Code, S. 1722, 96th Cong., 1st Sess. (1979), with respect to fines imposed on organizations. Section 2202(a)(4) requires the court, in determining the size of the fine, to consider in the case of organizations "any measure taken by the organization to discipline its employees or agents responsible for the offense or to insure against a recurrence of such an offense." The Committee Report to the companion House Bill (H.R. 6915, H.R. REP. NO. 96-1396, 96th Cong., 2d Sess. 467 (1980)), takes a similar position. See note 161 *infra*. The court might also consider these same factors in determining how long to continue the period of probation.

130. For overviews, see Coffee, *supra* note 38, at 1115-27; Herlihy & Levin, *Corporate Crisis: The Overseas Payment Problem*, 8 LAW & POL. INTL. BUS. 547 (1976).

131. See Demott, *Reweaving the Corporate Veil: Management Structure and the Control of Corporate Information*, 41 LAW & CONTEMP. PROB. 189, 215-17 (Summer 1977).

to be far less probing.

This adverse publicity proposal has two essential premises, one procedural and one substantive. The procedural premise is a conservative one: what the government cannot do well itself, it should leave to the marketplace and private enterprise. Because it is neither likely nor desirable that a government would be a successful propagandist, government should attempt instead to encourage private initiatives. Mandated self-study reports would provide just such encouragement.

But what does adverse publicity accomplish where the corporation is not financially injured by the disclosures? Here we come to the substantive premise: publicity as a sanction can serve to reduce the incongruence between the interests of the manager and the firm, and it can do so in an extremely cost-effective manner. In general, it is difficult to identify culpable individuals with sufficient assurance to convict them (particularly in the face of judicial and jury empathy for middle-class defendants). Thus, a publicity sanction which identifies the responsible individuals after the corporate entity is convicted may in many instances be the only available way to censure the culpable manager. This publicity imposes costs on the culpable manager on three distinct levels: first, the manager suffers a loss of public- and self-respect, which some research suggests is the most potent deterrent for the middle-class potential offender. Second, adverse publicity substantially reduces the official's chances for promotion within the firm. Competition for advancement is keen within almost all firms, and competitors of the culpable official can be relied upon to use adverse publicity about their rival to their own advantage. SEC proxy disclosure requirements may pose a further barrier to such an official's advancement. Finally, disclosure of the identity of the culpable official also invites a derivative suit by which any costs visited on the firm can be shifted (at least in part) to the individual. Here again, private enforcement is desirably integrated with public enforcement through the linking mechanism of disclosure.

A final virtue of this approach should also be recognized. Because courts and legislatures find vicarious criminal liability ethically troubling, the negligent official faces little threat that he will be the target of a criminal prosecution, even where his actions or inactions are a proximate cause of the corporation's offense. Similarly, the supervising official who "looks the other way" and tolerates misconduct by his subordinates is likely to be immune from the civil law's reach. Both, however, are within the reach of a publicity sanction. The mandated corporate self-study can focus both on active miscon-

duct and on the passive negligence of senior officials. The empirical evidence suggests that even an entrenched senior executive becomes vulnerable to ouster once there has been sufficient adverse publicity about him that his continued presence embarrasses the firm.¹³² Once a serious internal corporate investigation is begun, few, if any, corporate officials are immune.

Earlier it was suggested that corporate pressure on the middle manager may make the remote risk of criminal prosecution seem less serious to him than the "clear and present" danger of dismissal if he fails to achieve targeted goals. However, publicity may create a countervailing force: the knowledge that a corporate conviction would lead to a judicially mandated, independently conducted internal audit — which would assess the performance of upper-echelon supervisors in addition to those directly involved in the crime — might do much to overcome the sometimes extreme pressure under which middle managers today function.

C. *Integrating Public and Private Enforcement: A Reexamination of the Private Attorney General*

Nullification of criminal penalties may be a fact of life which, like death and taxes, simply must be accepted. Whether this phenomenon is premised on a fear of the adverse social consequences from penalties imposed on the corporation, or whether courts are simply unwilling to impose high penalties which do not compensate the victims of the offense, nullification is an obstacle to adequate deterrence which intelligent policy planning must find a way to circumvent. But one exception to this problem clearly exists: while courts are reluctant to impose high penalties to punish or deter, they toler-

132. The chief executive officers of Gulf and Lockheed were forced to resign in the wake of illegal payments disclosures, and the chief executive officer of Northrop was required to relinquish one of his executive positions. See generally Robertson, *supra* note 122; see also *Clearing Payoff Storm, Northrop Chief Keeps Firm Hand on Controls*, Wall St. J., Dec. 15, 1976, at 1, col. 6; Barmash, *Heads Rolling in the Board Room*, N.Y. Times, Oct. 17, 1976, § 3, at 1, col. 3. Nevertheless, some high executive officers of several corporations have recently been retained in office notwithstanding a felony conviction. See Nathan, *Coddled Criminals*, HARPER'S, Jan. 1980, at 30; *Watergate Donors Still Riding High*, N.Y. Times, Aug. 24, 1975, § 3, at 1, col. 1; Loving, *How Bob Rowen Served His Time*, FORTUNE, Aug. 27, 1979, at 42, 44. In still other cases, the SEC has apparently required the resignation of a chief executive officer as a condition of a civil settlement. See *Company, CEO Charged With Self-Dealing, Consent to Governance Reforms, Injunction*, SEC. REG. & L. REP., BNA, July 16, 1980, at A-7 (chief executive officer agrees to resign and to "not become an officer or director of a public company without approval of the court"). Thus, although the evidence is mixed, instances are clear in which the disclosure has triggered either internal reforms or SEC imposed disqualification. The critical variable may be how embarrassed the corporation becomes at the retention of culpable officer, and this variable can be influenced by the mandated self-study here recommended.

ate enormous damages awards to compensate victims.¹³³ For example, in the famous electrical equipment conspiracy of the 1950s, the largest single fine (levied on General Electric) was \$437,500, but approximately \$600 million was paid by the defendants to settle private litigation.¹³⁴ Comparable, but lower amounts have been paid already in more recent and still unresolved price fixing cases.¹³⁵

At the risk then of seeming to rediscover the wheel, it is best to start our appraisal of private enforcement by noting that it offers two distinct advantages: (1) private enforcers are able to raise the total penalties exacted from the corporation to a level well in excess of those which either the criminal law or public enforcement generally can levy, and (2) by acting as "private attorneys general," civil plaintiffs multiply society's enforcement resources and thereby increase the probability of detection. This latter theme has been much emphasized, and the private antitrust plaintiff's ability to discover conspiracies and violations which have escaped the attention of public enforcers is frequently glorified as the great virtue of private enforcement. But here, a heretical observation is unavoidable: recent experience confirms the first assertion that private enforcement raises the penalty for illegal activity, but it provides very little evidence to corroborate the second proposition. Indeed, in the antitrust context, the current pattern is almost the reverse of the theory: the private plaintiff is typically a "free rider" who files his civil action in the wake of an indictment brought by the Antitrust Division.¹³⁶ It is not uncommon today for the private enforcer to attend the criminal trial and to take copious notes so that evidence uncovered by the government will yield a treble damage recovery for him. In effect, the private

133. My premise is that to induce courts to impose sanctions that truly deter, the penalty must also serve to compensate victims. This argument has recently been made by an experienced antitrust attorney. See Dorman, *The Case for Compensation: Why Compensatory Components are Required for Efficient Antitrust Enforcement*, 68 GEO. L.J. 1113, 1117-18 (1980) ("Without the promise of compensation, there is little likelihood that a system of antitrust law enforcement will efficiently deter violations"). Alternatively, civil actions may produce very high settlements because defendants are risk-averse and agree to high settlements to avoid even greater exposure at trial. This hypothesis is also consistent with empirical data since most private antitrust actions end in settlement. However, either hypothesis produces the same policy prescription: it is private enforcement operating in the wake of public enforcement that truly levies the sanction.

134. See K. ELZINGA & W. BREIT, *supra* note 28, at 56-57 (as to fine paid by General Electric); Wheeler, *Antitrust Treble-Damage Actions: Do They Work?*, 61 CALIF. L. REV. 1319, 1336 n.78 (1973).

135. See Rudnitsky & Blyskal, *supra* note 16; see also text at notes 56-57 *supra*.

136. See Reich, *The Antitrust Industry*, 68 GEO. L.J. 1053, 1065 (1980) ("Plaintiffs' counsel can increase their revenues . . . by depending upon the government to undertake 'test runs' of liability in advance"). For examples of private plaintiffs following in the wake of a government investigation, see Rudnitsky & Blyskal, *supra* note 16, at 59, 62.

enforcer reaps the benefit of the enforcement efforts by public enforcers. In such cases, the actual litigation undertaken by the private enforcers is chiefly internecine: they skirmish among themselves over such procedural issues as the appointment of lead counsel, the size of the settlement, and the allocation of attorney's fees. Nor is this pattern unique to antitrust cases. In the securities law field, it has been observed that few cases of insider trading have been detected by private plaintiffs; rather, once again, the private plaintiff rides the coattails of the SEC's enforcement staff.¹³⁷

Of course, this pattern is logical and predictable. Other things being equal, rational plaintiffs' attorneys will naturally pursue those cases where they can earn the highest recovery with the lowest investment of time and money. Since they receive the same benefit regardless of whether they or the government detects the violation, they will elect not to pursue their own cases independently when they can ride cheaply on the government's coattails. The aggregate result is a misallocation of resources since private enforcers, rather than increase enforcement, simply battle over the carcass of the defendant which the government has gratuitously bestowed on them.

At first glance, the solution to this problem seems obvious: create an incentive for the private enforcer to pursue his own cases by denying him a treble damage recovery where his action is filed in the wake of the government's investigation.¹³⁸ Such a proposal sensibly encourages the private enforcer to concentrate on detecting violations not known to the government. But it has a basic drawback in terms of the first proposition advanced in this section: it reduces the capacity of private enforcement to elevate the penalty to a level above that possible through the criminal law, and thus to offset (partially at least) the low risk of apprehension for many organizational crimes. In short, if the virtue of private enforcement was its ability

137. In a study of insider trading cases, Professor Dooley found that "virtually all private enforcement efforts were based upon proceedings brought by the Commission." Hetherington, *supra* note 95, at 228. Dooley found only five cases which have been initiated by private parties without prior SEC action. *Id.* at 228 n.142.

138. Professor Kenneth Dam proposes that a public agency's commencement of an action should cut off all private actions that are subsequently filed. See Dam, *Class Actions: Efficiency, Compensation, Deterrence and Conflict of Interest*, 4 J. LEGAL STUD. 47, 68 (1975). In effect, this prescription compels private enforcers to seek out new actions rather than ride the government's coattails. However, this sacrifices the goal of victim compensation unless the government is able to obtain restitution in its action. Also, from the perspective of this Article, it may fail to generate adequate deterrence since the government's action may result in an inadequate fine. Dam seems to recognize this point when he concedes that it is the treble damage action "which is the principal deterrent to antitrust violations." *Id.* at 116. In principle, an adequately punitive fine might replace the treble damage action, but this has not occurred in practice, and some commentators have argued that courts will not punish adequately unless they are pursuing a compensatory objective. See Dorman, *supra* note 133, at 1117-18.

to exact higher penalties, we would sacrifice that virtue by awarding compensatory damages rather than treble damages in private suits preceded by a government investigation.

Thus, a solution is necessary which both gives the private enforcer an incentive to discover undetected crimes and encourages the court to award multiple damages. Once the problem is so defined, various answers are undoubtedly possible. One solution in private antitrust cases might be to preserve treble damages, but, when the government's action preceded the private suit, to require that only one third of the damages go to the private plaintiff (*i.e.*, the compensatory portion) and the remaining two thirds go to a state-run crime victim compensation fund. This diversion of the recovery would still leave the sentencing judge with a sense that he is compensating "worthy" victims, rather than simply imposing punitive fines, but it would also encourage the private plaintiff to pursue his own cases to secure a higher recovery. An alternative route to this same end would be to legislate restrictions on the portion of the recovery that could be paid over to the attorney. Such legislation might sensibly place a much lower ceiling on the maximum allowable attorney's fee (including both those fees paid by the client out of the recovery and those separately awarded by the court) in free-rider cases.

Before accepting the private multiple damages remedy as the best means of outflanking the nullification problem, a serious policy appraisal must consider more than simply the need to encourage private litigants to pursue "new" cases rather than ride free on the government's case. In particular, the following questions stand out: (1) Is the class action an equally good substitute for a treble damages remedy since it also gives the plaintiff's attorney an adequate incentive to invest time and money on a risky proposition?; (2) Is the danger of extortionate settlements and fabricated injuries so heightened when we authorize the litigant to recover not only his own injuries, but a multiple thereof, that deterrence comes at too high a price?; and (3) If the typical loss caused by a generic type of crime exceeds the expected gain, does this imbalance weaken the case for a multiple damages formula since compensatory damages offer adequate deterrence? These questions require qualified answers.

First, although the class action may sometimes offer an acceptable alternative to the multiple damages action, often it will be an inadequate one. Simply put, there may be too many issues which are not common to all the members of the class for the class action device to be effective. For example, in a Ford Pinto-type case, if the victims of all Pinto explosions were to pursue Ford in a civil class

action, they might be able to obtain a decision that the design of the Pinto gas tank was defective. But, there would remain a number of issues which would necessarily be unique to each crash: proximate cause, contributory negligence in the care and operation of the vehicle, damages, etc. As a result, the plaintiff's attorney would still face a series of discrete individual litigations. Thus, the incentive provided by the class action form may not in all situations be an adequate substitute for the multiple damages formula.

An important generalization underlies this observation: in any legal dispute, the plaintiff needs to prove a certain number of distinct issues before he may recover. In a tort case, these typically include: (1) the existence of a legal duty owed to him, (2) negligent behavior by the defendant, (3) proximate causation, and (4) damages. The higher the percentage of these predicate elements which can be proved in a class action, the greater is the deterrent threat that civil litigation poses to the defendant. In those cases where a high percentage may be so proved, the availability of the class action is probably a more important deterrent than the existence of a treble damages recovery. But, both antitrust law and securities law are relatively unique in this regard because the critical issues can be established in the class action. The same is also true in mass disaster cases (*e.g.*, airplane crashes or possibly a nuclear accident). However, it is clearly not as true in a Pinto-type case. Therefore, the argument for legislating a multiple damages formula as a partial substitute for the class action is strongest in these latter contexts.

The second question posed above was whether the pursuit of adequate deterrence through private enforcement comes at too high a price. It may, because reliance on private enforcement may require us to abandon the advantages of prosecutorial discretion. Economists in particular have emphasized this theme, claiming that a "misinformation effect" results when a private party is offered a substantial reward for establishing that a violation of law has occurred.¹³⁹ Put simply, the private plaintiff as bounty hunter may misrepresent that a violation has occurred in order to claim the reward. Unlike the public enforcer, who has an interest in a rational body of law, the private enforcer cares only for victory. To rephrase Holmes, big bounties make bad law. This may be so both because plaintiffs will seek to extend and distort the law and because courts will predictably react by pulling back and partially nullifying such

139. See K. ELZINGA & W. BREIT, *supra* note 28, at 90-95, 113-15, 152-53 (recommending that optimal sanction is a fine without compensation to victims). But see Dorman, *supra* note 133, at 1117-18 (doubting that courts would impose such fines unless compensation results).

statutes. This danger is obviously greatest when the law's command is vague or when the offense is subject to fabrication by the purported victim. Rightly or wrongly, the Supreme Court appears to have become convinced that private enforcement of the federal securities laws poses exactly this danger of "vexatious litigation" brought chiefly to extort a settlement from a defendant who cannot afford the risk of an adverse determination.¹⁴⁰

How should we respond to this problem without sacrificing the private attorney general concept? We should start by distinguishing those statutes whose uncertain perimeters make prosecutorial discretion essential from those that involve behavior patterns which are less subject to fabrication. For example, a huge gulf here separates a securities violation and a horizontal price-fixing conspiracy: the operative trigger for liability under the securities laws is the term "materiality" which necessarily has fuzzy edges; in contrast, the typical fact pattern in a private horizontal price-fixing suit is a concrete activity — rigged bids or other unusual behavior — whose occurrence the plaintiff cannot fabricate nearly as easily as he can claim deception because of the omission of some allegedly material fact. Similarly, toxic and environmental violations seem immune from this danger, and may be sufficiently difficult to detect as to justify such an incentive for private enforcement efforts.

Conversely, where the "misinformation effect" is perceived to be a danger or where overenforcement otherwise seems possible, private plaintiffs should still be given a treble damage private cause of action, but it should be preconditioned on either a prior criminal conviction or a successful civil prosecution by a public enforcer for the same wrongdoing. Alternatively, a "probable cause" determination could be made by a public enforcer as a necessary prelude. Absent such a conviction, determination, or probable cause finding, the private plaintiff might still have a cause of action, but only for compensatory damages. In effect, the private plaintiff would "piggy-back" on the public agency, which would exercise discretion in determining the cases to be prosecuted. This integration of public and private enforcement both preserves prosecutorial discretion and uses private enforcement as a means of securing adequate deterrence. A statute which partially implements these principles is Section 909.4 of the Iowa Corrections Code, which gives "any person

140. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975) ("There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general"); see generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

who has suffered loss" a treble damage action against a "corporation, partnership or other association" convicted of a felony or aggravated misdemeanor.¹⁴¹ Although Iowa justifies this provision on the ground that organizations cannot be incarcerated, its real effect is to couple private enforcement as a caboose to the engine of public enforcement. Its deficiency, however, is that the treble damage formula focuses the private enforcer's energies on defendants who have already been apprehended, and thus removes the incentive to pursue the cases which public enforcement failed to detect. Conceivably, such a policy could be justified if one believed the danger of the "misinformation effect" were equally pervasive across the board. But this seems overbroad. Thus, the optimal statutory structure should authorize a treble damages penalty in private suits following government prosecution, but also supplement it with three other provisions:

(1) In private cases filed after an indictment, two thirds of the punitive damages should go to some public fund rather than to the private enforcer or, alternatively, the plaintiff's attorney's legal fees should be restricted. The intent here is that the ceiling on the attorney's recovery be substantially below that obtainable in cases brought prior to the commencement of the criminal action

(2) Private treble damage actions which precede a conviction should also be authorized for those generic types of violations that do not seem vulnerable to dissimulation by plaintiffs. Private attorneys recovery should not be limited here in order that there is a relatively greater incentive to pursue these "new" cases.

(3) Treble damage formulae are unnecessary where the damages caused by the crime vastly exceed the likely corporate gain from the crime, *unless* such damages could not be obtained through a class action and are too modest on an individual plaintiff basis to justify litigation.

No statutory structure can incorporate all these principles in ideal form, but as guidelines for the redesign of legislative codes, these principles outline a compromise under which deterrence can be increased without also enhancing the risk of "misinformation" or sacrificing prosecutorial discretion.

D. *Corporate Plea Bargaining*

An unnoticed advantage follows from the form of the Iowa stat-

141. IOWA CODE ANN. § 909.4 (West 1979). ("Treble damage liability for corporations, partnerships and associations").

ute that authorizes a private treble damages action following a corporate conviction: it makes possible a new form of plea bargaining that could have special utility in this context of corporate crime and could reduce the overspill of corporate penalties even if we continue to rely on cash fines. Essentially, such a statute gives enormous significance to the plea of *nolo contendere* and its collateral estoppel effects.¹⁴² To understand when such a plea should be accepted requires that we restate some policy assumptions.

For deterrence to work, the threat must be credible, but the sanctions need not be invariably imposed. The threat of a private damages penalty is credible because the corporate defendant knows full well that private plaintiffs will pursue their own self-interest if it is easy for them to do so. But given the existence of a credible deterrent, the windfall treble damages recovery, it does not follow automatically that the private plaintiff should be entitled to a windfall, if instead the public enforcer can bargain the treble recovery away for his own legitimate ends. Assuming that the consequences of the court's acceptance of a plea of *nolo contendere* is to deny collateral estoppel effect to the conviction, the public enforcer has the ability to short-circuit private enforcement if the defendant will plead guilty and otherwise cooperate with the prosecution. Many may shrink from this suggestion because of the repugnant results plea-bargaining has tended to produce in the context of individual defendants. Yet, it would be another example of a sentimental anthropomorphism infecting our policy toward corporate behavior if we were to reject plea-bargaining with organizational defendants on such grounds.

The nolo plea has today fallen into disfavor — and understandably so. Rule 11(b) of the Federal Rules of Criminal Procedure now requires the court to hear the views of the prosecutor before accepting a nolo plea,¹⁴³ and the Department of Justice's formal policy today is to resist such a plea, absent special approval from senior officials of the department.¹⁴⁴ Although the federal courts tend still to ignore this position in antitrust cases, nolo pleas are infrequently

142. See generally Hayden, *The Plea of Nolo Contendere*, 25 MD. L. REV. 227 (1965); A. VESTAL, RES JUDICATA/PRECLUSION at V-386-88 (1969).

143. FED. R. CRIM. P. 11(b).

144. UNITED STATES DEPARTMENT OF JUSTICE, PRINCIPLES OF FEDERAL PROSECUTION (1980) reprinted in 27 CRIM. L. REP. (BNA) 3277, 3286 (1980). ("Federal prosecutors should henceforth oppose the acceptance of a nolo plea, unless the responsible Assistant Attorney General concludes that the circumstances are so unusual that acceptance of the plea would be in the public interest").

accepted in other cases.¹⁴⁵ Yet when the government prosecutes a corporate defendant, plea bargaining over a nolo plea may make sense, since corporate prosecutions are costly to the state and there is little need for incapacitation.

In short, the nolo plea should be the subject of bargaining between the prosecutor and counsel for the corporate defendant. What might the prosecutor sensibly bargain for? Prime candidates would include the following: (1) restitution to injured victims (in effect, the injured party would receive compensation through the criminal process, but not treble damages); (2) preventive auditing and monitoring controls (which could be imposed as a condition of probation); (3) resolution of pending civil litigation (thus reducing judicial delay and unburdening the courts); and (4) a suspended fine (which might be used to backstop the conditions of probation).

In this light, the private enforcer becomes a bludgeon with which the prosecutor can threaten the defendant. To be sure, the acceptance of the nolo plea would not prevent subsequent private litigation, but it could change the odds by denying any collateral estoppel effect to the criminal conviction. This integration of private and public enforcement would require statutory clarification of the collateral estoppel effect of a criminal conviction. The need for clarification of the collateral estoppel effect may seem surprising since it is the conventional wisdom among lawyers that a criminal conviction does indeed have the collateral effect of conclusively establishing the facts alleged in all counts in the indictment which resulted in conviction. Curiously, however, this is not the law in most states. As Professor Vestal has demonstrated, a third party plaintiff is today clearly entitled to use the criminal conviction in only a minority of jurisdictions in order to deny the defendant the opportunity to relitigate civilly the issues on which he was criminally convicted.¹⁴⁶ Tradi-

145. For an example of a case where a nolo plea was accepted, see, e.g., *Patterson v. Stovall*, 528 F.2d 108 (7th Cir. 1976) (companion civil case to criminal case in which federal prosecutor approved plea of *nolo contendere* in return for restitution by defendant to civil plaintiffs). I have been informed also by a defense counsel that in the criminal prosecution of Schlitz Brewing Company for illegal payments, a nolo plea was accepted because a plea of guilty might have required the automatic forfeiture of various liquor licenses.

146. See A. VESTAL, *supra* note 142, at ch. 12. Professor Vestal found only a few decisions permitting a third party to claim that the defendant was collaterally estopped by the conviction: *Palma v. Powers*, 395 F. Supp. 924 (N.D. Ill. 1969); *Newman v. Larson*, 225 Cal. App. 2d 22, 36 Cal. Rptr. 883 (1964); *Teitelbaum Furs v. Dominion Ins. Co.*, 58 Cal. 2d 601, 375 P.2d 439, 25 Cal. Rptr. 559 (1962); *Pennsylvania Turnpike Commn. v. United States Fidelity & Guar.*, 412 Pa. 222, 194 A.2d 423 (1965). Although he found that the number of these cases had increased in a more recent examination, difficult problems remain, particularly where the victim wishes to sue in a jurisdiction different from that of the criminal conviction. See Vestal, *Issue Preclusion and Criminal Prosecutions*, 65 IOWA L. REV. 281, 321-37 (1980).

tionally, the doctrine of mutuality barred offensive use of the criminal conviction to estop the defendant: either both parties were bound or neither was bound, and clearly the civil plaintiff could not be estopped by the defendant's acquittal in the criminal case (where the plaintiff was not a party and where a higher standard of proof applied).¹⁴⁷ But the *Restatement (Second) of Judgments* has abandoned this doctrine,¹⁴⁸ and the Supreme Court laid it to final rest in *Parklane Hosiery Co. v. Shore*.¹⁴⁹ In the wake of *Parklane*, which permitted a civil plaintiff to make offensive use of a prior civil judgment obtained by a government agency, there is little reason to deny the same collateral effect to a prior criminal conviction. Statutory reform is, however, important because of one aspect of *Parklane*: the decision substitutes in place of the old mutuality doctrine the requirement that the defendant have a sufficient incentive to litigate "fully and vigorously" in the first action.¹⁵⁰ The Supreme Court recognized that this incentive may not exist where the defendant faced only nominal damages in the first action. This test calls into question the present sufficiency of the incentive to defend in criminal cases where the authorized fine is low (in particular, it makes it very questionable whether a collateral estoppel effect could be given to a misdemeanor conviction).

A statutory answer is desirable because the problem is circular. If the collateral estoppel effect of a felony conviction were established by statute, the defendant would have notice of the possible loss and would thereby be given, in *Parklane*'s terms, "every incentive to litigate . . . fully and vigorously."¹⁵¹ Once the criminal conviction is given such an effect, the absence of collateral estoppel

147. For a full discussion of the mutuality doctrine and the injustices it could cause, see *Blonder-Tongue Laboratories, Inc. v. University of Ill. Foundation*, 402 U.S. 313, 322-27 (1971). See also Semmel, *Collateral Estoppel, Mutuality and Joinder of Parties*, 68 COLUM. L. REV. 1457 (1968). In addition, the unfortunately narrow rule has evolved in some jurisdictions that a criminal conviction will collaterally estop the defendant in subsequent civil litigation only where such litigation concerns an attempt by the defendant to retain or enjoy the proceeds of the illegal conduct. See generally 46 AM. JUR. 2D JUDGMENTS § 618 (1969 & Supp. 1979). But see note 149 *infra*.

148. RESTATEMENT (SECOND) OF JUDGMENTS § 88 (Tent. Draft No. 2, 1975) (giving broad discretion to court to determine whether "offensive" issue preclusion should result). The *Restatement of Judgments* does not, however, address the effect of a criminal conviction.

149. 439 U.S. 322 (1979). While *Parklane* gave collateral effect to a prior civil proceeding (rather than a criminal conviction), several decisions have now approved issue preclusion because of a prior criminal conviction. See *Wolfson v. Baker*, 623 F.2d 1074 (5th Cir. 1980); *United States v. Frank*, 494 F.2d 145, 160 (2d Cir.), cert. denied, 419 U.S. 828 (1974); *Cardillo v. Zyla*, 486 F.2d 473 (1st Cir. 1973).

150. On the theme of "incentive to litigate," see also A. VESTAL, *supra* note 142, at V-350-51.

151. 439 U.S. at 332.

following a nolo plea makes plea bargaining attractive. Interestingly, another simplification becomes possible: the same court could probably hear both the criminal case and the subsequent civil cases. Such consolidation might arguably be unfair if the law forbids the offensive use of collateral estoppel, but less so if the law favors it. In short, existing practices under the *Multi-District Litigation Manual* could be carried one step further: both civil and criminal cases could be consolidated before the same judge, and the criminal case tried first.¹⁵²

To sum up, such a structure simplifies the prosecutor's task. He would have a powerful new weapon that could be used to speed restitution to victims. It also would involve less drastic penalties than would often be imposed if the prosecutor and the defendant were forced to fight an "all or nothing" battle for the benefit of the civil plaintiffs waiting in the wings. To be sure, the power thereby given to the prosecutor is potentially frightening, but some evidence exists that equally frightening powers now reside in the less accountable hands of the plaintiffs' attorney.

E. *Corporate Criminal Responsibility: A Pragmatic Reassessment*

Few criminal law issues have evoked as divided a response from Western legal systems as the issue of whether the corporation should be held criminally responsible. Civil law countries have rejected the idea of corporate criminal responsibility on the ground that the corporation lacks the requisite *mens rea* to commit a crime.¹⁵³ In contrast, the federal rule within the United States has been that of *respondeat superior*: crimes committed by an agent, within the scope of his authority, in order to benefit the corporation create criminal liability for the corporation.¹⁵⁴ The *Model Penal Code* takes still a

152. To be sure, such a scheme arguably retains an element of unfairness since the criminal court judge may be predisposed to grant offensive collateral effect to the conviction in the subsequent civil action, even though *Parklane* assumes this decision will be a discretionary one. However, there is little difference between empowering the same judge to hear all civil actions growing out of the same transaction as the criminal conviction and authorizing him, as a matter of sentencing discretion, to impose a sentence requiring restitution. Undoubtedly, such a sentence, if authorized by statute, would be constitutional. Yet the determination of the restitution award would have far less procedural formality than would the civil trial with respect to damages following the discretionary application of collateral estoppel. Hence, given that there are two routes to the same end, it seems short-sighted to object to the potential for unfairness in the more deliberate and procedurally guarded of the two.

153. See Mueller, *Mens Rea and the Corporation*, 19 U. PITT. L. REV. 21 (1957) (surveying law of France, Germany, Japan, The Philippines, Yugoslavia, and Czechoslovakia, and finding little precedent for corporate criminal liability outside of Anglo-American law).

154. See *Developments in the Law — Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, *supra* note 115, at 1247-51. See also *New York Cent. & H.R.R.R. v. United States*, 212 U.S. 481 (1909).

different and more complex approach: depending on the type of statute involved, the corporation is either (1) strictly liable, (2) liable only if it was negligent in the supervision of its employees, or (3) liable only if a "high managerial official" was involved.¹⁵⁵ Canadian courts appear to have reached a similar result as a matter of judicial construction.¹⁵⁶ Commentators have suggested further alternatives. The editors of the *Harvard Law Review* have recently criticized the *Model Penal Code*, claiming that its approach encourages evasion and makes ignorance bliss since in many cases the corporation has a valid defense if its senior officials were unaware of the conduct.¹⁵⁷ To replace the Code's formula, they suggest still another variant: the corporation should be presumptively liable in all cases for the acts of its employees at any level, unless it can establish the affirmative defense of due diligence.¹⁵⁸ They agree with the drafters of the *Model Penal Code* that such a defense provides a desirable incentive for the corporation to monitor its agents more closely.

Although there is merit in the Harvard proposal, its line of reasoning is not pursued far enough. If we grant that the purpose of the affirmative due diligence defense is simply to encourage closer monitoring and that it is not based on any notion of fairness or retributive justice, then there is a simpler means to this same end which does not increase the prosecutor's burden in securing a conviction. Put simply, due diligence should be not an affirmative defense, but rather a sentencing consideration. The legislature might indicate either through sentencing guidelines or express legislative standards that the penalty should be reduced where the corporate defendant can

155. MODEL PENAL CODE § 2.07 (1962). For an analysis, see *Developments in the Law*, *supra* note 115, at 1251-53.

156. See *Regina v. City of Sault Ste. Marie*, 85 D.L.R. 3d 161 (1978). *Regina* recognized a "half-way house" between *mens rea* and absolute (or "strict") liability. The case held that the defendant may seek to escape liability by establishing a defense that reasonable precautions had been taken.

157. *Developments in the Law*, *supra* note 115, at 1253-57. Under Model Penal Code Section 2.07(1)(c), the prosecutor must prove that either a "high managerial agent" or the board of directors performed, authorized, or recklessly tolerated the offense. This doubles the prosecutor's burden because in addition to proving that the crime occurred, the prosecutor must also impute intent to high managerial levels within the corporation; this in turn may create an incentive for high officials to insulate themselves from such information.

158. *Developments in the Law*, *supra* note 115, at 1257-58. In part, the Harvard rationale rests on the premise that criminal sanctions should only be applied where there is the requisite moral blameworthiness. But in the case of the organizational offender, the conviction is not itself the sanction; not until a penalty is applied does the organization typically experience a sanction. Thus, the due diligence defense can be delayed to the sentencing stage in the case of organizations without offending the civil libertarian precept that criminal sanctions should only be used to punish behavior involving moral culpability.

demonstrate at sentencing that it has taken measures reasonable under the circumstances to supervise and discipline employees.

What difference does it make whether the due diligence issue is heard at trial or at sentencing? At first glance, it might appear that the financial incentive to the corporation is the same either way. But this overlooks both the full significance of a criminal conviction and the wider angle of vision that the sentencing stage gives the court. First, delaying the due diligence issue to sentencing permits a conviction which can have collateral estoppel effect in civil litigation brought by victims injured by the crime. In this light, public enforcement establishes the central issues on which private litigants can piggyback.¹⁵⁹ Thus, the downgrading of the due diligence issues from an affirmative defense to a sentencing consideration serves the interests of both general deterrence and victim compensation.

Second, although at trial the fact finder can consider only whether the defendant was adequately diligent in monitoring employees at the time of the alleged criminal behavior,¹⁶⁰ a much wider range of information becomes relevant at sentencing. At sentencing, the court can inquire into developments since the time of the crime and even since the time of the trial: Have new measures been taken to prevent repetition? Have responsible or negligent employees been disciplined or fired? Such a wider angle of vision creates a stronger incentive for the corporation to reform itself. Indeed, by using some well-established circumlocutions, the court could indicate steps it wishes to see taken, and suggest that it would reduce the financial penalties initially imposed if such measures were taken. Interestingly, S. 1722, the current Senate bill to recodify the Federal Criminal Code, mandates exactly this focus on internal corrective measures and intra-corporate discipline as sentencing considerations.¹⁶¹

159. One advantage of such an integration is that the criminal process tends to reach a litigated determination much more quickly than the civil process, thus ensuring speedier recoveries for victims and fairer negotiations (since the defendant may not as easily exploit its ability to delay civil litigation when the criminal issues have already been determined adversely to it in an action brought by a public enforcer). In addition, public agencies appear willing to attempt to prove more novel, higher risk theories than private plaintiff's attorneys will attempt, given that the latter are motivated primarily by the expectation of contingent fees. See Reich, *supra* note 136, at 1065.

160. Negligent behavior occurring subsequent to the time of the criminal incident would generally be excluded from evidence as irrelevant and more prejudicial to the defendant than probative. But exactly this information should be considered at sentencing, because we are interested in the need at sentencing for deterrence.

161. S. 1722, 96th Cong., 1st Sess. at § 2201(a)(4) (instructing court in imposing fine against a corporation or other organization to consider "any measure taken by the organization to discipline its employees or agents responsible for the offense or to insure against a recurrence of such an offense"). This position is also approved in the Committee Report to the

These considerations also provide a partial answer to a more basic question: Why should we use the criminal law against the corporation when a system of civil penalties would encounter fewer constitutional obstacles? This question has particular merit in light of the Supreme Court's decision last term in *United States v. Ward*,¹⁶² upholding the constitutionality of a civil penalty which almost exactly paralleled a long-established criminal statute. *Ward* opens up a broad horizon of civil-law penalties which could be more simply enforced than penal statutes requiring a criminal trial. The classic reason offered for using the criminal law when financially equivalent civil remedies are available has been that the criminal law uniquely can focus public censure upon the guilty defendant.¹⁶³ This stigmatization argument clearly has some merit, but it does not stand alone. Two other pragmatic arguments for applying the criminal law — one procedural and one institutional — deserve consideration: first, because criminal cases are typically concluded in a much shorter time span than civil cases, the criminal law potentially can serve as an engine by which to expedite restitution to victims. This could occur either by authorizing the sentencing court to impose restitution as a sentence or by clarifying the collateral estoppel impact of a criminal conviction. Either way, the relative celerity with which criminal cases are resolved would benefit the victim, who otherwise might be forced by economic exigencies to make a hasty settlement when he cannot afford to wait out the civil docket's interminable delays.¹⁶⁴

Second, useful as a civil penalties system might be, particularly as a means for transferring the bulk of petty regulatory offenses now in most penal codes to an administrative forum, public enforcers cannot be transferred from a criminal to a civil context as easily as statutes. A great infrastructure of criminal law enforcers exists today in state and federal offices across the country. In sheer magnitude, the number of criminal prosecutors probably dwarfs the number of attorneys available to administrative agencies to enforce civil-law penalties. They cannot be transferred because, even apart from the

companion House Bill, H.R. 6915. See H.R. REP. NO. 96-1396, 96th Cong., 2d Sess. 467 (1980).

162. 100 S. Ct. 2636 (1980).

163. Compare Note, *supra* note 9, at 287 n.35 with Kramer, *Criminal Prosecutions for Violations of the Sherman Act: In Search of a Policy*, 48 GEO. L.J. 530, 531-35 (1960); cf. E. SUTHERLAND, *WHITE COLLAR CRIME* 43 (1949) (discussing the policy of removing the stigma of crime from penalties for antitrust violations).

164. This theme is discussed at greater length in the commentary to 3 ABA STANDARDS, *supra* note 91, at 18-2.8, 170-73.

usual arguments about institutional rivalry and bureaucratic turf-guarding, their core mission is the enforcement of the criminal law against individuals. As a result, by abandoning the notion of corporate criminal responsibility, we risk underutilizing this decentralized infrastructure of public enforcers. Moreover, there are important economies of scale and tactical advantages in prosecuting the corporation and its officers in a single criminal suit.¹⁶⁵

These arguments are, of course, of a political, pragmatic and institutional nature. But no apology need be made for such a focus. The study of corporate criminal responsibility too long has been led astray by commentators seeking to fashion retributive justifications and anthropomorphic analogies. Such an approach not only compounds the legal fiction of corporate personality with the legal fiction of corporate mens rea, but worse yet, it blinds us to the real issue of how to make deterrence work when the offender is an organization.

IV. BEYOND DETERRENCE: THE IMPLEMENTATION OF PREVENTIVE RESTRAINTS

Deterrence is an indirect organizational strategy: we raise the costs of an activity in anticipation that the organization will restrain its agents. Frequently, the civil law has relied on a more direct strategy, the injunction, which can be framed to require, rather than simply encourage, internal reform.¹⁶⁶ Only recently have criminal-law scholars begun seriously to consider that the criminal law could also intervene directly by interjecting the court or its agents into the corporation's decision-making processes in an attempt to remedy dysfunctions that seem causally related to the criminal behavior.¹⁶⁷ The most promising vehicle for such an attempt is the sentence of probation.¹⁶⁸ Traditionally, probation was seen as an elective disposition

165. See note 6 *supra*. Experienced defense counsel have informed me that the phrase "Westinghouse settlement" has today become a term of art to refer to a plea bargain under which the corporation pleads guilty, but charges are dropped against all individual defendants. Such a settlement may be a symbolic and hollow victory for the government — unless restitution is thereby secured or the interests of victims and society otherwise advanced through probation conditions or deterrent fines. But the tactical advantages that such a joint prosecution gives the government seem clear indeed.

166. For an interesting speculative discussion of the reach of such a remedy, see Note, *Judicial Intervention and Organization Theory: Changing Bureaucratic Behavior and Policy*, 89 YALE L.J. 513 (1980).

167. Among the articles that have considered this question are Fisse, *Responsibility, Prevention, and Corporate Crime*, 5 NEW ZEALAND U. L. REV. 250 (1973); Note, *supra* note 8; Note *supra* note 9.

168. For the federal probation statute, see 18 U.S.C. § 3651 (1976). For a general discussion of the principles applicable to probation conditions, see 3 ABA STANDARDS, *supra* note 91, at 18-2.3.

which the offender had to request or at least accept.¹⁶⁹ Thus, because the corporation would typically prefer to pay the fine as a cost of doing business rather than change the way it actually did business, it might often refuse such a disposition. More recently, however, probation has come to be seen as a disposition which, being as much in society's interest as the offender's, is neither elective nor a temporary holding category, but rather a sentence in its own right.¹⁷⁰ Concomitant with this transition, both the current Senate and House bills to recodify the Federal Criminal Code authorize a probationary disposition for convicted organizations,¹⁷¹ and the Second Edition of the *American Bar Association's Minimum Standards for Criminal Justice* has endorsed the use of such a sentence in some circumstances.¹⁷² A few cases have also accepted the idea of corporate probation under existing law.¹⁷³

The theory of corporate probation is, however, easier to state than its implementation is to outline. Assuming that the interests of individual managers are incongruent with those of the firm, that excessive pressures for immediate results are sometimes placed on middle level managers, and that financial penalties directed at the firm may not change the cost/benefit calculus of the individual within the firm, what can a sentencing court do about all this? Dissolution and similar remedies are too extreme to be taken seriously, and seem pa-

169. For a discussion of probation as applied to corporations, see *United States v. Atlantic Richfield Co.*, 465 F.2d 58 (7th Cir. 1972). Some decisions have held that the defendant may refuse probation. See *In re Osslo*, 51 Cal. 2d 371, 377, 334 P.2d 1, 5 (1958). The majority of decisions, however, have rejected this view and seen it as the court's choice, not the defendant's, as to the form of sentence. See *Cooper v. United States*, 91 F.2d 195, 199 (5th Cir. 1937) (Federal Probation Act "vests a discretion in the Court, not a choice in the convict"). This makes obvious sense in the case of the individual (where the state must house and feed the offender and thus has its own interests in avoiding the unnecessary use of incarceration), but it is equally sound in the case of the corporation where a fine may be inherently inadequate for the reasons discussed in Section I of this Article.

170. See MODEL SENTENCING AND CORRECTIONS ACT, § 3-301 (sentence of "community supervision" authorized in lieu of probation); 3 ABA STANDARDS, *supra* note 91, at ch. 18-2.3.

171. See S. 1722, *supra* note 62, at § 2001(c); H.R. 6915, *supra* note 62, at §§ 3301-3305. While the Senate bill expressly refers to probation as a disposition for organizations, the House bill prefers the term "conditional discharge." The House Committee Report, however, plainly indicates that there is no difference in intent. See H.R. REP. NO. 96-1396, 96th Cong., 2d Sess. 467 (1980).

172. See 3 ABA STANDARDS, *supra* note 91, at ch. 18-2.8 (limiting its recommendation to circumstances where the corporation has been repetitively delinquent or there exists a "clear and present danger" to the public health or safety). The author served as Reporter for this chapter of the ABA standards.

173. See *United States v. Atlantic Richfield Co.*, 465 F.2d 58 (7th Cir. 1972); *Apex Oil v. United States*, 530 F.2d 1291 (8th Cir.), *cert. denied*, 429 U.S. 827 (1976); *United States v. Nu-Triumph, Inc.*, 500 F.2d 594 (9th Cir. 1974); *United States v. J.C. Ehrlich, Co.*, 372 F. Supp. 768 (D. Md. 1974); *Borough of Roselle v. Santone Constr. Co.*, 119 N.J. Super. 315, 291 A.2d 385 (1972).

tently absurd once we realize that most corporations sooner or later will be convicted of a nontrivial crime.¹⁷⁴ Thus, the idea of a narrower, more surgical intervention in corporate decision-making sounds attractive in the abstract, but it remains a vacuous concept unless it can be fleshed out with specific examples.

Accordingly, the remainder of this Article will consider practical approaches to imposing sensible probation conditions on a convicted corporation. To be sure, other practical problems also surround the concept of corporate probation: How is it to be enforced? How long should it last? How is it to be integrated with other penalties, particularly with statutory ceilings on financial penalties? Important as these questions are, corporate probation will not grow out of its current infancy until courts see tangible benefits to be gained from such a disposition. The following examples are not intended to suggest that preventive restraints are normally desirable or appropriate, but only to illustrate the kinds of intervention that are possible.

A. *Dangers to Life, Health or Safety*

The American Bar Association has recognized that a probation-like disposition may be appropriate where there exists a "clear and present danger" to the public health or safety.¹⁷⁵ Such cases are increasingly likely to appear before sentencing courts as legal regulation of toxic and environmental hazards, drug safety, and product design comes to rely more extensively on the threat of criminal penalties. It is in this context that the concept of corporate probation will have to cut its eye teeth. But what should be done? The SEC has already pioneered. In its consent orders, the Commission has required companies to design and implement new auditing and monitoring controls.¹⁷⁶ Although most of these orders were negotiated in illegal payments cases, some have required similar measures in the environmental field, and one such settlement — that with Al-

174. Cf. M. CLINARD, P. YEAGER, J. BRISSETTE, D. PETRASHEK & E. HARRIES, *supra* note 108, at 214 (concluding that two thirds of large corporations violated the law). Although this study has been sharply attacked on a number of grounds, see Orland, *supra* note 3, at 506-09, even its critics would concede that corporate criminality is a pervasive phenomenon. See Orland, *supra*, at 510. The more realistic estimate reached by the *Fortune* editors that eleven percent of the public corporations have been involved in a significant criminal activity within the past decade hardly permits one to discount corporate criminality as an isolated phenomenon (particularly when the *Fortune* study counts only those charges that result in a plea or an adjudication). See Ross, *supra* note 3.

175. See note 172 *supra*.

176. For an overview of the scope of SEC consent orders, see Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Mathews, *Recent Trends in SEC Requested Ancillary Relief in SEC Level Injunction Actions*, 31 BUS. LAW. 1323 (1976).

lied Chemical — supplies a paradigm for what corporate probation could seek to accomplish.¹⁷⁷ Following Allied Chemical's disastrous dumping of Kepone, a highly toxic chemical, into Chesapeake Bay, the company entered into a loosely worded consent order with the SEC requiring it to undertake an "independent investigation of material environmental risk areas" and to take "appropriate action" based on what it discovered.¹⁷⁸ Based largely on findings of the investigation, Allied established a Toxic Risk Assessment Committee composed of scientists, doctors, and lawyers, to review all internal corporate information on the toxic hazards to consumers and employees from the company's activities. The committee has direct access to senior management and also reports significant findings to the Environmental Protection Agency. The EPA has hailed the system as an industry model.¹⁷⁹ More important than the specific steps taken by Allied is the process by which they were designed.¹⁸⁰ A prominent management consulting firm was hired to redesign internal communications systems within the firm. It found that the corporation's executives "could assess the safety standards of fewer than 20 percent of the company's activities."¹⁸¹ To shore up what all concerned recognized to be a "gaping hole in management reporting systems,"¹⁸² internal corporate communications were redesigned to centralize the flow of such information through a new senior executive position.

Transposed to the sentencing context, this same inquiry and redesign process could be measurably improved. For unlike the negotiation of a consent order, where the rights of the parties are uncertain and the agency frequently is forced to accept compromises because of weaknesses in its case, the court's authority would be clear. The court could itself appoint a management-consulting firm or a team of business school academics to determine if inadequate internal reporting or information flow contributed to the crime. Presented with a plan for improved internal reporting, the court might require the creation of a senior executive position to monitor

177. For background on the *Allied* case, see Coffee, *supra* note 38, at 1271-72.

178. SEC v. Allied Chem. Corp., No. 77-0373 at 2 (D.D.C., filed March 4, 1977).

179. Hayes, *Complying With E.P.A. Rules*, N.Y. Times, Jan. 16, 1980, § IV, at 1, col. 3.

180. In overview, three elements seem important here: (1) an independent critique, (2) a redesign of corporate internal reporting and the creation of an executive position sufficiently senior to be able to respond effectively to such information, and (3) the creation of a permanent evaluative body with adequate technical skills (which in the ideal case might be staffed by outside professionals).

181. Hayes, *supra* note 179, at 4, col 1. The study was conducted by Arthur D. Little, Inc.

182. *Id.*

environmental, toxic or other health and safety hazards. Similarly, a body analogous to Allied's Toxic Risk Assessment Committee could be established to evaluate risks. In contrast to the Allied committee, its members could include independent professionals having no other relationship with the corporation. The company's obligations to report to relevant regulatory agencies could also be tightened, and these agencies could be invited to comment on the proposed probation conditions.

Obviously, such a probationary disposition interferes with the managerial autonomy of the delinquent corporation. Predictably, corporations will resist the legislative authorization of such a sanction. This suggests, however, that there are deterrent as well as preventive benefits to be gained from such a plan. Ultimately, the relatively modest loss of managerial autonomy involved in such a temporary period of probation might prove as effective a deterrent as the financial penalties today imposed on corporations.

B. *The "Wraparound Sentence"*

The skeptic's obvious reply to the suggestion that the sentencing process should emulate the successes of the SEC consent decrees is that such emulation is unnecessarily duplicative. Why, if such sanctions work, should they not be left to regulatory agencies rather than incorporated into the criminal law? This is a sensible question which merits a tripartite reply: first, the jurisdiction of most regulatory agencies is hardly co-extensive with the full range of possible corporate criminal misbehavior. Even the SEC's elastic concept of "materiality" can be stretched only so far, and not every crime is necessarily material to investors even if it is seriously injurious to some segment of the public.¹⁸³ Second, agencies can be lobbied, and their willingness to pursue corporate misbehavior waxes and wanes both with the tide of political changes and with internal agency priorities that may require reallocations of manpower.¹⁸⁴ These changes are inevitable and are not here lamented; but as a result, the criminal justice system cannot rely on other agencies to accomplish its principal goal of crime prevention. Third, the primary enforce-

183. See Coffee, *supra* note 38, at 1258-62 (discussing possible theories of materiality). Currently, SEC regulations only require the disclosure of "material" pending legal proceedings in which the registrant is a party or its property the subject. See SEC Regulation S-K, 17 C.F.R. § 229.20, Item 5 (1980). Instruction 5 to this Item then defines certain environmental litigation as *per se* material, but otherwise legal proceedings generally appear to be considered material only if they involve a claim for damages which exceeds defined percentages of the current assets of the registrant.

184. See note 65 *supra*.

ment device of the SEC, the consent order, has a basic limitation: in practice, it seldom leads to any significant sanction if it is violated.¹⁸⁵ Typically, the SEC does no more than obtain another consent order or injunction; it rarely seeks a contempt penalty. Another problem with the SEC consent orders is that they frequently consist of vague language which parties can legitimately read differently.¹⁸⁶ This occurs in large part because the orders are negotiated as a form of plea bargaining, and concessions are offered by the public enforcer in the form of deliberate ambiguity.

Like the consent decree, corporate probation has its own limitations. For example, there is no natural probation officer to monitor compliance with the conditions of probations, particularly if such monitoring requires some technical expertise.¹⁸⁷ But a sentence of

185. The typical SEC consent order enjoins future violations of the securities laws and may impose additional ancillary relief. See note 176 *supra*. This injunction (typically called a "Go-and-sin-no-more" order) can, of course, lead to criminal contempt penalties if any of its terms are violated. In principle, it is not even necessary to show that an individual knew that his acts would violate the injunction. All that need be shown is that the acts were consciously and deliberately performed and did violate the injunction. Once enjoined, the burden is on the individual to be certain that he complies. See *United States v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967). Nonetheless, as a matter of enforcement policy, the SEC rarely attempts to obtain contempt penalties. Instead, the agency typically obtains another (and probably tighter) consent order when it feels the first has been violated. This practice may in part reflect the difficulty of proving that the conduct in question was in fact a violation of either the securities laws or the terms of the frequently vaguely worded consent order. For a discussion of other problems with civil injunctions, see Hazen, *Administrative Enforcement: An Evaluation of the Securities and Exchange Commission's Use of Injunctions and Other Enforcement Methods*, 31 HASTINGS L.J. 427 (1979); Mathews, *The SEC and Civil Injunctions: It's Time to Give the Commission An Administrative Cease and Desist Remedy*, 6 SEC. REG. L.J. 345 (1979).

One other major limitation on the civil injunction which the "wraparound sentence" may also outflank should be noted: equitable relief is traditionally not permitted to impose penalties. Without statutory revision, it seems clear that the SEC cannot explicitly seek a civil injunction which imposes sanctions on a deterrence-based rationale. See Farrand, *supra* note 176, at 1808. Of course, other rationales may (and do) permit the SEC to obtain relief which is in fact punitive, but, even with respect to these alternative theories, there are continuing doubts as to whether civil injunctions may pursue even the purely compensatory objective of seeking restitution for nonparty investors. *Id.* at 1800-05. I do not mean to criticize the Commission's persistent attempts to secure compensation, but to suggest the desirability of corporate probation as a means of securing those forms of relief and restitution which are beyond the grasp of the SEC. In addition, to the extent that remedial sanctions (such as disqualification from office) are found to be punitive and therefore beyond the SEC's reach in a litigated civil proceeding, they may be fully appropriate as probation conditions. Cf. *Hoffa v. Saxbe*, 378 F. Supp. 1221 (D.D.C. 1974) (upholding disqualification from office as condition of presidential commutation of sentence).

186. Consider again the *Allied Chemical* consent decree discussed in the text at note 178 *supra*. It required only that the corporation investigate environmental risks and take "appropriate" action. It is difficult to envision a court finding that such a vague requirement had been violated where the corporation made even the slightest effort to comply.

187. Discussions with officials of the Criminal Division of the Department of Justice lead me to believe that corporate probation will not be much utilized as a sanction, or at least will not become the vehicle for organizational remedies, until federal prosecutors are able to transfer to others the burden of monitoring compliance. This is in no respect intended as a criticism

probation does have built-in sanctions: a substantial fine can be suspended so as to hang over the corporation like the Sword of Damocles.¹⁸⁸ If probation is revoked for proved noncompliance with a condition of probation, then all or part of the suspended fine can be levied. Moreover, although due process requires a hearing before probation can be revoked,¹⁸⁹ there is no need to initiate a new prosecution or civil proceeding as there would be when contempt penalties are relied upon to enforce a consent order.

In short, the consent order and the sentence to probation have reciprocal strengths and weaknesses: the former is not easily enforced, the latter lacks an available monitoring body. But, by combining the two, each can remedy the problem of the other. The court could sentence the corporation to probation, and the administrative agency could monitor compliance with the terms. The court could also suspend a punitive fine (either in cash or an "equity fine") for the period of probation to ensure compliance. How would such a structure work? In many instances (such as the *Allied Chemical* case discussed earlier), the same criminal behavior, once discovered, will result in both a consent order (or an injunction in a litigated case) and a criminal conviction. In these instances, the sentencing court should "wrap" its sentence around the consent decree by making compliance with the consent decree a condition of probation. In effect, this tactic of incorporation by reference permits the agency to prove a violation of the consent order in a less formal manner than a civil contempt trial and to obtain a severe penalty as a result. Of course, such incorporation should be selective, not automatic, and not all terms of the consent order need be picked up. In those cases where there is no consent order, the court could still consult with appropriate regulatory agencies to act as an *amicus curiae* in fashioning and monitoring probation conditions. For example, in an environmental case, the EPA could suggest reporting requirements in

of federal prosecutors, but is simply a judgment which reflects the heavy caseload pressures they bear. Typically, the prosecutor defines his job as that of securing conviction. While he may be willing to plea bargain over the issue of remedies, he is neither well positioned nor adequately equipped to supervise compliance. In contrast, the SEC, which administers a continuous disclosure system for public corporations and has on-going contact with them, is better positioned to monitor corporate compliance.

188. *See* *United States v. J.C. Ehrlich Co.*, 372 F. Supp. 768 (D. Md. 1974). Alternatively, the court can suspend both the imposition and execution of the sentence until probation is violated. This is preferable since once a fine which is less than the statutory maximum is imposed, and its execution is suspended, a higher fine may not be constitutionally imposed on revocation. *See* *United States v. Best*, 571 F.2d 484, 486 (9th Cir. 1978); *United States v. Bynoe*, 562 F.2d 126, 128-29 (1st Cir. 1977) (double jeopardy violated by enhancing penalty after its imposition).

189. *Gagnon v. Scarpelli*, 411 U.S. 778 (1973).

addition to those imposed by law for a convicted corporation, and observance of those requirements could be clearly defined as a condition of probation.

C. *Activating Internal Discipline*

The foregoing approaches focus on the firm rather than the individual. To reach the responsible manager, society must either prosecute him or motivate the firm to use its own disciplinary resources (*e.g.*, dismissal, demotion, loss of fringe benefits, etc.). The premise of sanctions aimed at the firm is simply that, if we punish the firm heavily enough, it will restrain its employees or agents. But, the danger in this logic is that only low-level scapegoats may be disciplined by the firm, since passively responsible senior officials may be able to disguise their own involvement. The logic of deterrence may produce a highly biased form of internal discipline which never penetrates to upper levels.

How can internal discipline be improved? Again, the best answer seems to lie in the use of an internal investigation by a respected, disinterested counsel whose selection is approved by the court. As a condition of probation, the court could order such a study and require it to identify those whose negligence or indifference made possible the illegal conduct of the active participants. The real impact of such a report lies in its public submission to shareholders. Empirical evidence suggests that corporations can be embarrassed.¹⁹⁰ For example, if a report concludes that an official was seriously negligent in failing to act on information that a corporate product was hazardous, and the corporation sustained high financial penalties as a result, it becomes difficult for the corporation to fail to take action in response. More importantly, the court can encourage a disciplinary response by explicitly taking into account the extent of internal disciplinary measures in setting the fine or determining the length of probation.¹⁹¹ In a sense, the court by these measures is coercing the corporation to discipline its agents. Unsettling as that may sound, it is no different in principle from judicially approved practices that courts have long employed to coerce individual defendants into cooperating with the prosecutor.¹⁹²

190. See D. VOGEL, *LOBBYING THE CORPORATION* (1978) (containing case histories of instances where corporations have responded to citizen or consumer pressure). See also *Talking It Over: More Concerns Willing to Enter Negotiations on Holder Resolutions*, Wall St. J., Mar. 23, 1977, at 1, col. 6.

191. See note 161 *supra*.

192. See note 120 *supra*.

This strategy uniquely permits us to reach the negligent official whom the prosecutor rarely indicts and the jury only reluctantly convicts. Moreover, it makes possible the use of less severe sanctions than conviction or dismissal. Here as elsewhere, the possibility of lesser penalties reduces the likelihood of nullification.

D. *Realigning the Manager's Interests*

Finally, a court might use probation conditions to realign the manager's interests. The idea that the manager's interests are not necessarily aligned with those of the firm has run through this Article, and is indeed a familiar theme in the literature on corporate governance. But is this incongruence inevitable? The possibility of a judicially initiated realignment of the manager's self-interest is worthy of consideration. First, a practical illustration is again supplied by the Allied Chemical case: in the aftermath of its Kepone debacle, Allied revised its compensation system so that approximately one third of a plant manager's pay would be based on safety performance.¹⁹³ Allied then experienced a dramatic seventy-five percent decline in its plant injury record between 1975 and 1979.¹⁹⁴

What Allied has done voluntarily a court might also mandate. Admittedly, it would be difficult to monitor whether the incorporation of safety and similar criteria into the compensation structure was real or only cosmetic. Nevertheless, there are alternative paths to the same end which can be better monitored. For example, a court could prohibit fringe benefits and limit salary raises to some national or industry average rate of increase until prescribed safety, environmental or similar nonprofit maximizing targets are achieved.¹⁹⁵ Such a restriction need not be applied to the corporation as a whole, but could be limited to the division, plant, or headquarters unit involved in the criminal behavior. Clearly, some employees would evade this restriction through transfers to other firms or relocations within the same corporation, but others would

193. See Hayes, *supra* note 179, at 4, col. 1.

194. *Id.*

195. Harvard Business School Professor Joseph Bower gives an interesting example of how the incongruence between the corporation's aims and those of its managers must be resolved before corporate behavior will change desirably. Suppose, he writes, a corporation at its highest levels does indeed give priority to clean air as a corporate goal. Nonetheless, he concludes plant managers will not pursue that goal unless they are forgiven its impact on their plant's profitability. See Bower, *On the Amoral Organization*, in *THE CORPORATE SOCIETY* 178, 197 (R. Marris ed. 1974). Corporate probation could seek to reduce this incongruence through positive and negative incentives: required stock bonuses for those managers who do achieve reductions in their toxic emissions, or penalties in the form of limits on fringe benefits until such goals are achieved.

not. Those left behind would have a strong incentive to meet the defined targets — even if their corporation preferred to give only *pro forma* lip service to these same goals.

Attempts to tinker with the incentive structure within the firm are admittedly dangerous, for they interfere in unpredictable ways with the dictates of efficiency. Yet at the same time, such a preventive restraint shifts our focus from the firm or the individual to the subunit within the firm. Frequently, this is the true locus of misbehavior. Considerations such as group loyalty and special subunit goals not infrequently lead a cohesive working group to persist in behavior that is adverse to the overall interest of the firm. Decisions within the subgroup are often so collective in nature that a single responsible decision-maker equitably cannot be isolated for punishment.

If the working group is often the critical and indivisible unit which shapes behavior within the organization,¹⁹⁶ then an optimal system of sanctions must seek to diffuse its penalties over that subunit. Restrictions on stock options, fringe benefits and executive “perks” might achieve their goal in the case of senior management, but probably less so in the case of plant managers and other subordinate officials who less frequently qualify for such benefits. However, even in their case the inevitably intrusive impact of outside monitoring, particularly when coupled with rigorous reporting requirements, may provide sufficient deterrence. The purpose of these restraints is not to punish, but to realign the interests of the subunit on the theory that punishment imposed on the corporation may not produce effects that are felt at their level. Additionally, such a strategy plays off the key factor of group solidarity since an individual who would otherwise be willing to take the risk of illegal action may refrain if he thereby jeopardizes his fellow members of the subgroup.

Obviously, restrictions of the sort last discussed are likely to be much more bitterly resisted by the business community than probation conditions which simply require closer monitoring of health and environmental hazards. But ultimately, society must turn to other strategies if traditional approaches fail, and the corporate probation provides a vehicle for such an attempt.

CONCLUSION: TOWARD PUNISHMENT THAT FITS THE CORPORATION

One last question should be addressed: Do all the reforms dis-

196. See notes 35-40 *supra* and accompanying text.

cussed in this Article necessarily require legislative action? Or can they be at least partially implemented by the judiciary alone? Perhaps surprisingly, courts may be able to achieve them in substantial measure without legislative action. A publicity sanction could, for example, be implemented by placing the corporation on probation. The *nolo contendere* plea is already a discretionary decision given to the court.¹⁹⁷ Although the equity fine is not within the inherent power of the court, there is no necessary obstacle to the court accepting such a fine when offered by the defendant *as the alternative to a higher cash fine*. This scenario is more realistic than it at first sounds. Frequently a single criminal transaction will either violate multiple criminal statutes or be divisible into numerous counts of the same offense. As a result, a cumulative fine can be levied equal to the maximum fine per count times the number of counts resulting in conviction. Under the pending Senate bill to recodify the Federal Criminal Code, the maximum fine would be \$1 million per count.¹⁹⁸ Thus, very high fines are possible, particularly in environmental cases where the illegal activity often takes place many times over an extended period.¹⁹⁹ As a result, it ironically may be a defendant and not a prosecutor who is the first to ask a sentencing court to consider the possibility of an equity fine. But clearly, the court could prepare the way for such a request by tentatively imposing a high cash fine and then suggesting to defense counsel that it consider developing an alternative formula that would offer equivalent deterrence.²⁰⁰

197. FED. R. CRIM. P. 11(b). *But see* note 144 *supra*.

198. S. 1722, *supra* note 62, at § 2201(b)(2) (\$1,000,000 maximum for all felonies and for those misdemeanors resulting in loss of human life). *See also* H.R. 6915, *supra* note 62, at § 3502.

199. Allied Chemical has, for example, already paid out over \$15 million as a result of its conviction for the dumping of Kepone into the James River. *See Hayes, supra* note 179, at 1, col. 3.

200. On several recent occasions, sentencing courts have induced (or accepted) charitable contributions by convicted corporations as an alternative to a severe cash fine. For example, Allied Chemical was first fined \$13.2 million by Federal District Judge Robert Merhige for its Kepone dumping violations, but then was permitted to reduce the fine in a corresponding amount when Allied Chemical established a foundation (the Virginia Environmental Endowment) and contributed \$8 million to it. The judge's motivation appears in part to have been a desire to keep the funds in Virginia (again, an example of courts resisting high penalties unless they seek some compensating benefit flowing from them other than simply increased deterrence). *See Zim, Allied Chemical's \$20 Million Ordeal with Kepone*, FORTUNE, Sept. 11, 1978, at 82, 89. Allied's motivation is clearer since, while fines are not deductible for tax purposes, charitable contributions (and public relations expenses) are. Thus, it has been estimated that Allied Chemical received a \$4 million tax break through this alternative. *See Stone, A Slap on the Wrist for the Kepone Mob*, 22 BUS. & SOC. REV. 4 (1977).

A similar procedure was employed by federal district Judge Zampano in sentencing Olin Corporation for illegal arms sales to Southern Rhodesia. After the court first ordered a charitable contribution and then rescinded this order on the ground that community restitution was an unauthorized disposition, Olin made a "voluntary" \$510,000 charitable contribution which

Corporate probation is an area where courts undoubtedly should proceed cautiously, and this Article has intended more to scout the perimeters of that remedy than to recommend it as a mandatory sentence. But in an economy characterized by imperfect competition, organizational slack, and innumerable obstacles that interfere with the expected impact of penalties for corporate misbehavior, direct judicial intervention in certain areas of the firm's decision-making processes will at times be necessary. It is a curious paradox that the civil law is better equipped at present than the criminal law to authorize these interventions. Corporate probation could fill this gap and, at last, offer a punishment that fits the corporation.

The strategies outlined in this Article — the equity fine, adverse publicity, integration of civil and criminal remedies, plea bargaining for restitution, and corporate probation — have a common denominator: like the judo wrestler they use existing forces within the legal environment and the corporation's social system to increase corporate deterrence with a minimum of socially counter-productive results. Unless we follow such a course, the Lord Chancellor's frustrated observation that the corporation has neither a soul to damn nor body to kick may remain an epitaph for society's attempts to control organizational misbehavior.

was announced at its sentencing. *Judge in Arms Case Orders Olin To Pay \$510,000 in Charity*, N.Y. Times, Mar. 31, 1978, § D (Business), at 1, col. 1. I am also indebted to Professors Leonard Orland and Brent Fisse for a full description of the *Olin* case.

The court's ability to order a charitable contribution or "community restitution" is doubtful and in any event is beyond the scope of this Article. *Cf.* *United States v. Clovis Retail Liquor Dealers Trade Assn.*, 540 F.2d 1389 (10th Cir. 1976) (probation conditioned upon payment of "community restitution" held improper, because the recipient charity or persons which it helps were not aggrieved in that amount "by the offense for which conviction was had"). But what is here relevant is both the apparent willingness of defendants to suggest less costly alternatives to the cash fine and the interest of courts in finding ways to use the fine to benefit the community in which the offense occurred. Given these mutual interests, the court might similarly induce an offer of an equity fine from the defendant as an alternative to a higher cash fine. Procedurally, the court could first impose the higher cash fine and then reduce it upon a motion by the defendant under Rule 35 of the Federal Rules of Criminal Procedure accompanied by an offer to make a donation of equity securities to the state crime victim compensation fund. Under the pending legislation to recodify the Federal Criminal Code, all criminal fines paid to United States courts will be deposited in a Victim Compensation Fund. *See* S. 1722, § 4111. In addition, under § 4111(d), this fund would be authorized to receive "all contributions to such fund from public or private sources." Hence, although the court might not compel such an equity fine, it could encourage its donation and then offset it against the criminal cash fine it might otherwise have imposed. Even if such a contribution is not tax deductible as a charitable contribution or as a public relations expense, the court could give a greater than 100% offset against the fine in order to "encourage" such a donation.