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Recognizing the "Bad Barrel" in Public Business Firms: Social and Organizational Factors in Misconduct by Senior Decision-Makers

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INTRODUCTION

This Article examines an important and current issue with respect to the law of large public firms: the law's failure to recognize the importance of group and organizational factors in senior-level misconduct within the firm. These firms are complex organizations, which are composed of subsidiaries, divisions, and subdivisions in the organizational hierarchy.[1] The subdivisions are, in turn, made up of groups and teams of individuals who work within them. Under U.S. business practice, individuals are responsible for decisions at every level of the business and, as is characteristic of U.S. public companies, a chief executive officer (CEO), who is also usually the chair of the board of directors, sits at the apex of a typical firm's

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1. For the classic account of the structure of large, multi-dimensional business firms, see ALFRED D. CHANDLER, JR. WITH TAKASHI HIKINO, SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM 31-34 (1990).

hierarchy.[2] Yet, at the highest level of the public firm, a group of individuals, the board of directors or similar governing body, is ultimately responsible for supervising the firm and is encouraged—and indeed mandated—to make collective, major decisions with respect to specific strategic issues and to ensure that an adequate supervisory system for the firm is in place.[3] Although it is recognized that the CEO, not the board, establishes the strategy for and directs the operation of the firm, which the board is asked to approve, he or she does not do this alone, but with a team of senior executives, who are themselves assisted by subordinate executives.[4] Moreover, directors and executives make their decisions or perform their actions using existing practices and perspectives—in short, an organizational culture—that have been developed over time in the firm.[5] In sum, groups and organizations matter for the conduct of senior decision-makers in the legal and business reality of the large public corporations.

When, however, a serious scandal arises from misconduct by these directors and senior executives, the law downplays or even ignores the group and organizational factors in the misconduct. The legal analysis of the problem generally focuses on the individual(s) concerned, whether directors or executives, and regulators or the courts then punish him or her (or them). Any group in which the targeted individual worked is recognized by the law only as a collection of *other* individuals who, as such, may also have participated in the misconduct and violated their legal duties, and are thus deserving of censure. The law does punish an organization in some cases. Under the agency and tort law doctrine of respondeat superior, a business organization may be liable for the misconduct of its agent acting in the scope of employment or for the benefit of the organization.[6] This doctrine is also used to make a business organization criminally liable if

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2. *See* SPENCER STUART, BOARD INDEX 17 (2007) (noting that sixty-five percent of S&P 500 companies had a combined Chair/CEO in 2007).

3. *See* MODEL BUS. CORP. ACT § 8.01(b), at 8-3 (2008).

4. For a review of the organizational literature on management teams, see JEFFREY PFEFFER, NEW DIRECTIONS FOR ORGANIZATION THEORY 89-93 (1997).

5. *Id.* at 121.

6. *See* RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006).

one of its agents commits a crime within the firm.[7] The well-known case of Arthur Andersen is an example of organizational criminal liability.[8]

The emphasis upon individual liability and punishment, with little consideration for group and organizational factors, has several results. The targeted individual director or officer may be found civilly liable, and may even be criminally prosecuted and convicted. However, he or she is also being punished for any group or organizational contribution to the problem, unless the law punishes the group or organization—which rarely occurs. This outcome is inequitable, for an individual should not be punished for a group or organizational failing. It also raises a practical issue: if group or organizational influences on individual misconduct are significant, leaving them unaddressed may lead to more misconduct by those within a business firm, and even by business firms in general. By contrast, group or organizational liability raises its own equitable and practical problems. For example, to make a group or organization liable may mean that its members with little or no involvement in the misconduct are swept within the liability or punishment, which is not only inequitable but also has its own adverse practical consequences (e.g., individuals feel that the law is irrational). These concerns also surfaced in the Arthur Andersen prosecution, where it was generally perceived that many innocent employees suffered when the firm failed as a result of its criminal conviction.[9]

It is important to be clear here. There is no question that misconduct by a senior decision-maker has much to do with the personal failings of that individual. Generally, the individual director or executive who commits misconduct may exhibit a flawed moral development by pursuing his or her own self-interest in violation of ethical, social, and legal

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7. *See infra* note 149.

8. Actually, this accounting firm was criminally prosecuted for obstruction of justice because of its employees' destruction of documents relating to its participation in Enron's fraud. Its conviction, however, was overturned by the U.S. Supreme Court. *See* Arthur Andersen LLP v. United States, 544 U.S. 696 (2005); *see also infra* note 152.

9. *See, e.g.*, Assaf Hamdani & Alon Klement, Deterrence and the Corporate Death Penalty 2 (Dec. 16, 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1024698.

norms. Yet, groups and organizations can facilitate or exacerbate this misconduct, for example, by encouraging an individual to pursue his or her own self-interest and to ignore other norms. Indeed, as will be discussed further below, business and even law schools have undermined the moral development of executives because they have based their training on an impoverished model of a human being, the calculating self-interested individual, and this model has encouraged executives to act in ways compatible with it. Groups and organizations can equally act as a check on individuals who might be prone to misconduct by preventing persons from joining the organization in the first place, by resisting their pursuit of self-interest through promoting other norms and models of conduct, and by punishing misconduct. Groups and organizations are thus critical because they can either promote and magnify the misconduct, or prevent it or reduce its effects.

The purpose of this Article is to explore and support the contention that laws dealing with business associations do not adequately address the group and organizational role in the misconduct by senior decision-makers in public firms, to discuss the reasons for this failing, and to propose reforms to the current state of affairs. In order to undertake the above exploration, this Article provides background on group and organizational causes of or factors in misconduct by senior decision-makers in business firms and on the relationship of these causes to individual elements. The background is based upon the academic disciplines that have explored these issues and questions, chiefly social psychology and organizational studies.[10] Since the literature here is voluminous, the review of the literature is conducted only to present scholarly evidence on how groups

10. *See infra* Part I.

and organizations contribute to certain kinds of misconduct occurring at the upper level of business organizations.[11]

Moreover, because the laws affecting these decision-makers are numerous and ever-growing, the examination of them is quite focused. Corporate law is reviewed because it establishes the decision-making structure of the firm and the duties of directors and executives, and it is the foundation upon which all other relevant laws build.[12] Federal securities laws must be considered because they are also important in the governance of public companies, and because their violation is the basis for the significant punishment of senior decision-makers through enforcement actions of the Securities and Exchange Commission (SEC) and federal prosecutors.[13] Finally, and significantly, this Article reviews federal criminal prosecution of senior decision-makers, as well as the business firm itself, for securities law violations. As will be discussed further below, the focus here is not so much on the substance of the federal securities laws, which allow the SEC and federal prosecutors to pursue pretty much whomever they wish to target.[14] It is the manner in which they pursue and prosecute individuals and organizations that has most starkly raised the issue of individual vs. group/organizational liability.[15]

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11. I have used this literature in other work. *See, e.g.*, James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435, 460-72 (2004). I am not alone in these efforts. *See, e.g.*, Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629 (1997); Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition:* Corporate Irresponsibility *and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002). For papers from a symposium with this focus, see *Corporate Misbehavior by Elite Decision-Makers Symposium: Perspectives from Law and Social Psychology*, 70 BROOK. L. REV. 1165 (2005).

12. *See infra* Part II.A.

13. *See infra* Part II.B-C.

14. To take only one example, Sarbanes-Oxley added new crimes that sometimes overlapped with existing ones. *See, e.g.*, 18 U.S.C. § 1348 (Supp. V 2005) (new crime of securities fraud); 18 U.S.C. § 1349 (Supp. V 2005) (new crime of attempt and conspiracy to commit securities fraud). On the symbolic importance of adding new crimes that essentially duplicate existing ones, see William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 533-39 (2001) (contending that prosecutors favor new laws that increase their discretionary powers with respect to indictment).

15. *See infra* Part II.C.2.

Since the law does not take adequate account of group and organizational causes of misconduct, this Article makes proposals on how to address these failings. The main point of the proposals is that the law needs to balance its current focus on punishing the individual director or executive engaged in misconduct with reform of the organization where the misconduct occurred. Currently, organizational reform occurs during enforcement actions against, or the prosecution of, the organization for the actions of its agents. But the reform is usually superficial, for the main goal of the SEC and federal prosecutors is to obtain the organization's help in identifying and punishing the individuals directly involved in the misconduct. Seriously addressing the group and organizational factors that contributed to particular misconduct would require a substantive reform that is based upon organizational and social psychological research. Although there are limits to what government enforcement authorities can do, their current emphasis on individual prosecution is sending the wrong message: that misconduct is primarily an individual issue and, therefore, the group and organization have little responsibility for contributing to it. This Article's proposals suggest how lawmakers could take the organization and group seriously and thus envision true organizational reform.

This Article is organized as follows. Part I first reviews representative social psychological and organizational literature to set forth an understanding of its basic teachings about group and organizational factors in and causes of misconduct by senior decision-makers of public firms. It then draws four lessons from the review. First, social psychology and organizational studies suggest that a group's mindset and an organization's culture can significantly contribute to misconduct by an organization member. Second, the literature emphasizes the significance of the leader in perpetuating and shaping a group's mindset and an organization's culture and thus in checking or promoting misconduct. Third, how the group or organization functions—in particular, whether dissent is permitted—clearly affects whether it checks or amplifies misconduct by its members. Fourth and finally, the group and organization must be based upon social, ethical, and legal foundations and cannot be sustainable if built only or primarily upon the self-interest of its individual members.

Part II conducts a targeted review of several legal areas in order to see how well they take into account the group or organizational causes of or factors in senior-level misconduct identified above. As noted above, it considers corporate law and the enforcement of the federal securities laws by the SEC and federal prosecutors. The analysis of civil and criminal enforcement of the federal securities laws particularly focuses on organizational liability, in conjunction or in contrast with individual liability, for holding a public firm liable for the acts of its directors, officers, and employees squarely raises the issue of group and organizational causes to their misconduct. This review of relevant laws and of their enforcement and prosecution reveals that, by and large, group and organizational causes or factors are given little attention in corporate law jurisprudence and by the SEC and federal prosecutors in securities law enforcement. In organizational parlance, the legal emphasis is on "bad apples" rather than "bad barrels."

Part III of this Article argues that the current state of affairs in corporate and securities law should be reformed to reflect the group and organizational causes of and factors in senior decision-maker misconduct. The basic argument is that, unless the law recognizes these causes and factors, organizational reform will be superficial and will not address the culture and practices that contributed to the misconduct, which will likely resurface in the organization. Part III thus considers the possibilities of reform within the legal areas already examined and the impediments to it, particularly the obstacle of the self-interest ideology. Part III further argues that organizational civil and criminal liability must be maintained because it is societal acknowledgement that social and organizational factors contribute to misconduct and because it is one of the few tools that allow society, through prosecutors and regulators, to address group malfunctioning and pathological organizational culture. The contention is that the current policy of preferring deferred or non prosecution agreements to organizational prosecution and conviction should be continued, but that federal prosecutors should work together with the SEC in designing these agreements to focus more on organizational reform and should enlist social psychologists and organizational theorists in the effort.

I. REPRESENTATIVE SOCIAL PSYCHOLOGICAL AND ORGANIZATIONAL LITERATURE

Certainly, one part of a law review article cannot survey the entire relevant literature of social psychology and organizational studies on group or organizational causes of misconduct among senior decision-makers in publicly traded companies. A comprehensive survey, however, is not the goal here. Rather, it is to provide enough discussion of the literature and research in social psychology and organizational studies to convince the reader, or to confirm what the reader already suspects, that, when misconduct occurs in this setting, there have usually been group or organizational causes to it or group or organizational factors that magnify it and fail to check it. This Part also highlights several causes and factors that the literature considers significant.

The following discussion adopts a framework provided by several organizational theorists. They have made the common sense observation that there are multiple causes of most misconduct in business organizations.[16] There are certainly individual-level causes, such as a person's having a predisposition to misconduct.[17] This focus is primarily the domain of psychology, among other fields.[18] Since, as will be seen below, the law sees individuals as the primary cause of misconduct, there is no reason to dwell upon individual-level causes, except insofar as they interact with group or

16. *See* Blake E. Ashforth et al., *Re-Viewing Organizational Corruption*, 33 ACAD. MGMT. REV. 670, 671-72 (2008) (pointing out the need for a more systematic approach to organizational corruption, which would consider interacting factors from different levels in the organization).

17. *See* PFEFFER, *supra* note 4, at 41 (discussing predispositions and observing that the perspective on predispositions will have important policy implications).

18. *See, e.g.*, YOAV VARDI & ELY WEITZ, MISBEHAVIOR IN ORGANIZATIONS: THEORY, RESEARCH, AND MANAGEMENT 126-39 (2004) (discussing the general, empirical exploration into the cognitive and emotional determinants of organizational misbehavior (OMB), where there is an attempt to find empirical evidence for individual-level elements—intentions, attitudes, affect, emotions—in it).

organizational factors.[19] Rather, the focus is on the other factors identified by social psychologists and organizational theorists: group and organizational causes. The former is generally the domain of social psychology and, thus, the discussion below of groups is based upon that literature. The review of organizational causes naturally uses organizational studies literature, although, since this discipline is itself somewhat eclectic and borrows from other disciplines, including social psychology,[20] the review of this literature is not neatly separated from the social psychological discussion. A final Subpart takes stock of insights from the review, as a springboard for the analysis of the law's failings.

A. *Groups in Social Psychology*

1. *Some Social Psychological Basics.* Social psychological literature points out the obvious fact that, as human beings, we are social beings and actually need to form groups in most contexts of our daily lives.[21] According to one social psychological theory—social identity theory—groups help give their members a place in society, a social role, and value, which the social side of our nature demands.[22] Under this theory, a person needs a social identity or identities for self-esteem, and groups provide that identification.[23] This naturally requires that a person embraces, and is embraced by, a given group. A group also provides its members with a "mindset" and patterns of conduct—including with respect to other groups—which are necessary in a world characterized by uncertainty, diverse

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19. There is a rich literature on individual-level biases and cognitive errors that can lead to poor individual decision-making, but this is not the focus of this Article, although it has been the focus of other articles I have written. *See, e.g.*, James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1341-47 (2001).

20. *See* PFEFFER, *supra* note 4, at 16-17 (discussing methodological diversity in organizational studies).

21. *See* ROGER BROWN, SOCIAL PSYCHOLOGY 551 (2d ed. 1986).

22. *See* Michael A. Hogg, *A Social Identity Theory of Leadership*, 5 PERSONALITY & SOC. PSYCHOL. REV. 184, 186-87 (2001).

23. *Id.*

groups, and social relationships.[24] The group mindset is created through the contributions of past and present group members. While in a group, an individual is not the person he or she was before (or is in other groups), because his or her self-conception, viewpoints, and conduct are based upon and formed by a conceptual model that he or she learns from the group.[25] Of course, an individual must be socialized into the group and must learn its patterns of thinking and conduct. This happens from his or her interactions with group members.

Under social identity theory, a group leader has a special importance in the group.[26] The leader occupies this role because he or she appears to be closest to the group's "ideal." Given this special status, the leader can move the group to adopt new perspectives and patterns of conduct, but within limits: a good leader anticipates where the group is ready to go. Because other group members think and decide on the basis of their self-identification with the group and their desire to situate themselves favorably within the group, they generally wish to be well regarded by and close to the leader.[27] Moreover, a leader helps maintain and establish group dynamics that allow his or her group to function properly in all kinds of ways, such as dealing with changes in the group's environment and ensuring that the group fits into larger society.

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24. *See* Michael A. Hogg & Barbara-A. Mullin, *Joining Groups to Reduce Uncertainty: Subjective Uncertainty Reduction and Group Identification*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION 249, 250-55 (Dominic Abrams & Michael A. Hogg eds., 1999).

25. This is referred to in the literature as "depersonalization" of the individual as he or she becomes a group member. *See id.* at 254; *see also* Dominic Abrams, *Social Identity, Social Cognition, and the Self: The Flexibility and Stability of Self-Categorization*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION, *supra* note 24, at 197; Deborah J. Terry et al., *Group Membership, Social Identity, and Attitudes*, *in* SOCIAL IDENTITY AND SOCIAL COGNITION, *supra* note 24, at 280, 284.

26. *See* S. ALEXANDER HASLAM, PSYCHOLOGY IN ORGANIZATIONS: THE SOCIAL IDENTITY APPROACH 40-59 (2d ed. 2004).

27. This latter process is called "social comparison" in the literature. *See* HASLAM, *supra* note 26, at 283; James H. Davis, *Some Compelling Intuitions About Group Consensus Decisions, Theoretical and Empirical Research, and Interpersonal Aggregation Phenomena: Selected Examples, 1950-1990*, 52 ORG. BEHAV. & HUM. DECISION PROCESSES 3, 12-13 (1992).

2. *Misconduct in Social Psychological Terms.* What, then, from the above suggests how a group can be a cause of or factor in misconduct by senior decision-makers? An obvious answer is that the group may become corrupt because its leader is corrupt. A corrupt Chairman/CEO or another senior executive may lead the board or a group of executives into misconduct, or into an acquiescence of misconduct.[28] Here, the group simply amplifies the misconduct that the leader initiates.[29] For example, the leader adopts a perspective that slightly twists an acceptable business goal (e.g., it is important to meet earnings expectations at all costs in order to satisfy shareholders) and directs unethical or illegal ways of achieving them.[30] This perspective becomes that of the group through the social identity process. As will be discussed below, the law generally adopts this answer, seeing group corruption as due to the failings of an individual.

Group members are socialized into misconduct and the perspective that justifies it. According to another social psychological theory—social processing theory—individuals look for signs of what are acceptable attitudes and conduct in groups.[31] Misconduct by co-members, and particularly by a leader, signals that it is allowed, and even the norm, in an

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28. *See generally* John M. Darley, *How Organizations Socialize Individuals into Evildoing*, *in* CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 13 (David M. Messick & Ann E. Tenbrunsel eds., 1996).

29. *See* VARDI & WEITZ, *supra* note 18, at 81-82.

30. A good example is the scandal about stock option backdating. The "acceptable" perspective might be: The company needs to attract new employees, and to keep existing high performers, at all costs so as to maintain its industry position. An executive then gives the order to backdate an option grant to a new employee or an existing one so that an employee receives a guaranteed bonus upon the receipt of options (i.e., they are immediately "in the money"). The action is justified as in keeping with the perspective, and it is further supported because it is an industry practice. But, it produces misleading financial statements because the company fails to recognize on them a compensation expense (i.e., the "in the money" amount for the recipient of the option). For a general discussion of backdating, see SUNIL PANIKKATH, NERA ECONOMIC CONSULTING, OPTIONS BACKDATING: A PRIMER (Oct. 5, 2006), http://www.nera.com/image/PUB_Backdating_Part_1_Primer_SEC1381_final.pdf.

31. *See* Merideth Ferguson, From Bad to Worse: A Social Contagion Model of Organizational Misbehavior *6 (July 13, 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=915945.

enterprise. If, moreover, individuals in a group engage in misconduct, it is more likely that new members of the organization will do the same—or quickly depart—and a spiral of misconduct occurs.[32] Furthermore, social cohesion, a group attribute that is measured by the frequency of interactions among members, amplifies a group's misconduct.[33] The above suggests that, however the misconduct is instigated, whether through a current or past leader or another group member, it takes on a life of its own through the group, which magnifies it.

The origins of misconduct among senior executives are often more complicated than a leader's predisposition to it. Individuals with similar predispositions and values are drawn together into groups in business organizations in the first place, even if their values ultimately prove harmful to the organization and to larger society.[34] This has been shown to be the case in business organizations at lower levels than the executive level, and there is some evidence for it in the corporate scandals at the senior level as well. Indeed, the world views of many senior business decision-makers are similar.[35] It is well established by business school academics that business schools, the preparers of executives and financial professionals, have for years espoused a toxic view of human beings as being mainly self-interested profit maximizers.[36] Executives have been taught to base their thinking and conduct upon this model, which relegates other standards or models to a secondary position in their business activities. When individuals formed in this way come together, they may engage in schemes of mutual self-enrichment, even if their actions ultimately destroy

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32. *See id.* at *11.

33. *See id.* at *14.

34. *See* VARDI & WEITZ, *supra* note 18, at 41.

35. *Cf.* Philip E. Tetlock, *Cognitive Biases and Organizational Correctives: Do Both Disease and Cure Depend on the Politics of the Beholder?*, 45 ADMIN. SCI. Q. 293, 320-24 (2000).

36. The seminal article from this perspective is Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGMT. LEARNING & EDUC. 75, 76-77 (2005). *See also* Dennis A. Gioia, *Business Education's Role in the Crisis of Corporate Confidence*, 16 ACAD. MGMT. EXECUTIVE 142, 143 (2002) (explaining that ethical training has been marginalized in business schools, which has coincided with the increasing dominance of economics in these institutions).

their business firm and their careers.[37] While the cause of the misconduct here is at first glance individual, it is in fact organizational, insofar as institutions (schools) helped to form the individuals, and social, insofar as a group of like-minded others reinforces an individual's predispositions.

Group processes thus amplify, or restrain, misconduct. In the classic account of perverse group dynamics, known as "groupthink," social theorist Irving Janis examined dysfunctional groups at the highest levels of political decision-making.[38] According to this account, group members adhere so strongly and confidently to the group's perspective—they become almost pathologically cohesive—that they shut out opposing viewpoints and the learning

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37. *See* VARDI & WEITZ, *supra* note 18, at 40-41. There are certainly numerous examples of this from the corporate scandals. This model explains the situation in Enron, where a major criterion for being an executive was single-minded self-interest and where the collective pursuit of it led the firm to disaster. *See* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2004). Of course, organizational misconduct may be related to one's "disidentification" with an organization (rather than identification with it), if one feels that the organization's values do not correspond with those of the individual (e.g., sabotaging a firm whose products one thinks are harmful). *See, e.g.*, Li Ma et al., Being the Same and Being the Different Simultaneously: Identifying (or not) with the Organization 22 (Feb. 14, 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=913975.

38. *See* IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 174-77 (2d ed. 1983). Groupthink is by no means a theory accepted in all its aspects in social psychology and organizational studies. But, it is clearly viewed as a useful perspective, although in need of refinement and testing. *See* James K. Esser, *Alive and Well after 25 Years: A Review of Groupthink Research*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 116 (1998); Paul B. Paulus, *Developing Consensus About Groupthink After All These Years*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 362, 370-71 (1998). *But see* Sally Riggs Fuller & Ramon J. Aldag, *Organizational Tonypandy: Lessons from a Quarter Century of the Groupthink Phenomenon*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 163 (1998) (criticizing the theory as erroneous, without empirical support, and simplifying complex group processes). There is continuing debate as to the origins of groupthink. Janis thought that it came from the high cohesion of the group arising from personal attraction of the members and an esprit de corps, as opposed to group prestige (i.e., members did not want to offend other members because of their personal bonds). JANIS, *supra*, at 245. He reasoned that groups perform better when members care about reaching the best decision and about having a group with successful decisions, rather than pleasing other group members. *Id.* at 245-50. For some, groupthink is a group's response to dealing with uncertainty. *See* Clark McCauley, *Group Dynamics in Janis's Theory of Groupthink: Backward and Forward*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 142, 147 (1998).

that comes from the experience of challenges to their perspectives. The members discipline themselves, allowing no real dissent within the group and regarding outsiders with scorn.[39] A group under the sway of groupthink is generally hierarchical. This means that the leader is autocratic as to decisions (rather than being open to discussion) and actions, and enforces his or her unquestioned authority that prevents other, contrasting viewpoints ("cognitive conflict") from emerging.[40]

Groupthink can arise in any kind of group and does not necessarily lead to misconduct.[41] However, if a perspective condoning misconduct is part of the group's mindset, and if group members begin to engage in some misconduct, groupthink in the group, together with the other social processes discussed above, can magnify the misconduct unchallenged.[42] No viewpoint that would reveal the

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39. *See* JANIS, *supra* note 38, at 242-59. I say "real" dissent because, even in a group characterized by groupthink, members may appoint a "token" dissenter whose role it is to be critical of the group, but who never seriously challenges the group's perspective and whose existence gives the group an illusion of openness to outside viewpoints. *See id.* at 114-17. In the classical account, there are seen to be eight symptoms of groupthink: illusion of invulnerability, collective rationalization, belief in moral superiority, outgroup stereotyping, pressure on dissenters, self-censorship, illusion of unanimity, and self-appointed mindguards. *See id.* at 256-59.

40. *See* Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 499 (1999). Among those who have studied the groupthink model, some have found that the role of leadership is more nuanced. That is, a strong leader is not necessarily a negative factor for a group to have successful decision-making, so long as the leader is open to dissent. However, an absolute leader who comes to typify the organization can be significant in poor decision quality. *See* Randall S. Peterson et al., *Group Dynamics in Top Management Teams: Groupthink, Vigilance, and Alternative Models of Organizational Failure and Success*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 272, 291-92 (1998).

41. One can think of examples, as did Janis himself, from political decision-making (e.g., decision to invade Iraq) or simply from politics (e.g., CBS's airing of an erroneous program on George Bush's Texas National Guard service). *See* DICK THORNBURGH & LOUIS D. BOCCARDI, REPORT OF THE INDEPENDENT REVIEW PANEL ON THE SEPTEMBER 8, 2004 *60 MINUTES WEDNESDAY* SEGMENT "FOR THE RECORD" CONCERNING PRESIDENT BUSH'S TEXAS AIR NATIONAL GUARD SERVICE 211-16 (Jan. 5, 2005). All political parties are prone to groupthink.

42. For a discussion of the links between groupthink and unethical behavior in organizations, see Ronald R. Sims, *Linking Groupthink to Unethical Behavior in Organizations*, 11 J. BUS. ETHICS 651 (1992). Sims argues that groupthink

misconduct is allowed, for loyalty to the group trumps loyalty to alternative social values, and so the misconduct can lead to even greater misconduct.[43] Group members become overconfident (and unrealistic) in their ability to continue with the misconduct without detection.[44] For example, an executive group decides to anticipate sales from the next quarter to make the earnings numbers in this quarter, on the basis that making the numbers (rather than presenting an accurate view of the firm's results) and ensuring their own bonuses matter most in the short term. The process continues into the next quarter, as it must since sales have been taken from it, and so on until the entire scheme collapses, leading to the firm's demise, a result way out of proportion to the initial decision, but certainly predictable from an external perspective.

Of course, groups can restrain misconduct. Certainly, executive groups could have ethical leaders and mindsets based upon norms other than self-interest, although this would be rare in U.S. business today. In addition, Janis

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leads to misconduct when a business group adopts a "bottom-line mentality," when the group leaders support it and unethical practices that are profitable, and when there is no cognitive conflict in the group. *See id.* at 653-58. Groupthink has been explained in terms of social identity theory: a group's existence and identity is threatened, which causes the group to expend its resources in shoring up its social identity, rather than in making good decisions. *See* Marlene E. Turner & Anthony R. Pratkanis, *A Social Identity Maintenance Model of Groupthink*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 210, 220-21 (1998). These authors suggest that, because of the social identity bases for groupthink, one must be careful about easy solutions to groupthink in a particular group, for if the group is threatened by proposed reforms, it may react negatively to, or ignore, them. *Id.* at 222-24.

43. For a discussion of this process, see Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 89-90 (2002). Indeed, if the "norm" of the group becomes a kind of misconduct, group members try to equal or even exceed this norm, which leads to even greater misconduct. *See* Bertram H. Raven, *Groupthink, Bay of Pigs, and Watergate Reconsidered*, 73 ORG. BEHAV. & HUM. DECISION PROCESSES 352, 357 (1998).

44. *See* Vikas Anand et al., *Business as Usual: The Acceptance and Perpetuation of Corruption in Organizations*, 19 ACAD. MGMT. EXECUTIVE 9, 11-14 (2005) (listing rationalizations). From this perspective, a group engaged in misconduct provides a "social cocoon" for its members so that they isolate themselves from the outside world in their deviant practices. *See id.* at 16. Individuals compartmentalize their behavior when they are at work and do not consider it from the perspective of other "selves" that they might embrace outside work. *Id.*

offers several group processes that help a group avoid groupthink, such as having a leader allow free discussion of group action without signaling too early his or her own views.[45] This discussion of group dynamics is deferred to the account of organizational theory below, since the latter specifically deals with processes useful in countering misconduct.

B. *Organizational Theory*

1. *Misconduct from the Perspective of Organizational Theory.* Since, as noted above, organizational literature does not provide only one approach to the study of organizations, but incorporates theories from other disciplines, including social psychology, the discussion about organizational theory's insights into misconduct among senior decision-makers in business firms is related to the preceding social psychological review. Misconduct in organizations has not always been a subject of sustained interest in organizational studies.[46] The purpose of organizational studies, historically, was to design employment practices that would contribute to workplace efficiency, not to address aberrant employee attitudes and misconduct.[47] In addition, organizational studies found their academic home in the business schools, which became dominated by economics with that discipline's emphasis on rational efficiency in production and business strategies.[48] It is only over time, as well-publicized disasters and costly failures and scandals have occurred in organizations, that researchers in this field have explored the organizational factors in the misconduct. There is now a considerable organizational literature on the subject that the following can only briefly highlight.

The organization is theoretically one of the largest units of analysis for misconduct, other than the industry,[49] the

45. *See* JANIS, *supra* note 38, at 260-76.

46. *See* VARDI & WEITZ, *supra* note 18, at 8.

47. *See* PFEFFER, *supra* note 4, at 10-11.

48. *See id.* at 13-14.

49. Certain kinds of misconduct have been seen to be industry practices. One thinks of the various abuses in broker-dealers involving initial public

society, and the culture in which it is situated. The study of misconduct in organizations could thus focus on different levels within it, whether the individual, his or her position or role in the organization, the work group, or the organization. As already noted, individual factors or predispositions have an undeniable role in misconduct by senior decision-makers, but may also have a social and organizational origin. Again, for example, if executives are taught in business schools and then encouraged in business firms to see self-interested profit maximization as an acceptable goal, this affects their individual attitudes and conduct. To take another example, an individualistic culture, such as our own, makes executives think of themselves as responsible for their decisions and actions in business firms—a perspective, as discussed later, shared by regulators and prosecutors.[50] In other words, an organizational perspective helps explain why in our culture individuals, not organizations, are primarily blamed for organizational misconduct.[51]

Organizational theorists observe that occupying a position at the top of a business hierarchy isolates an individual and can reinforce and amplify his or her

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offerings in the late 1990s, such as a broker-dealer's provision of IPO shares to executives of firms with which the broker-dealer did business. *See generally* NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 13.07[H], at 13-64.1 to 13-69 (4th ed. 2007 & Supp. 2008).

50. *See* PFEFFER, *supra* note 4, at 41.

51. Organizational theorists suggest that one form of organizational corruption involves the spread of corrupt behavior, such as theft from the organization, from individual to individual. *See* Jonathan Pinto et al., *Corrupt Organizations or Organizations of Corrupt Individuals? Two Types of Organization-Level Corruption*, 33 ACAD. MGMT. REV. 685, 688-90 (2008). This kind of organizational corruption, which is individual-based, is contrasted with a "top-down" organizational corruption, which generally comes from those higher in the organization and at least ostensibly appears to be for the benefit of the organization (e.g., misrepresenting financial results to maintain the stock price). *See id.* at 689-90. The focus of this Article is on the "top down" version of organizational misconduct.

misconduct.[52] Since executives are at the summit of the organization, they do not always get feedback about the effects of their decisions and conduct, and, even more significantly, their inappropriateness.[53] Feedback can be filtered to tell an executive what he or she wants to hear, i.e., to confirm his or her own views, particularly if, as discussed earlier, the members of the group share the same perspective as the executive and are subject to groupthink or other group pathologies.[54] That is, position helps senior decision-makers believe that their views and actions are superior and acceptable, rather than flawed and even unethical or illegal. This isolation is all the more serious if, as is generally the case in an organization, the attitudes and conduct of the senior decision-maker influence, and are imitated by, those lower in the organization.[55]

This review of position as a factor in misconduct in senior decision-makers leads to a discussion of organizational culture and the role of board members and senior executives in creating it. Senior decision-makers in many ways maintain and develop the culture of a business firm, which permeates the organization and normalizes

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52. *See* VARDI & WEITZ, *supra* note 18, at 155. Positions with autonomy, which are generally occupied by senior decision-makers in business firms, have enhanced risk, if only because autonomous individuals have the freedom to misbehave without immediate oversight or check. *See id.* at 148. Since senior executives particularly identify with an organization because of their position, their misconduct may have benefiting the firm as one purpose (e.g., falsifying financial records to maintain a high stock price).

53. *See id.* at 155. Moreover, by occupying a high-level position, the executive or board member may think of the organization as an extension of himself or herself and thus not even recognize certain conduct as misconduct, but think of it as his or her due or privilege (e.g., the unapproved use of a company airplane). *See id.* Organizational theorists also observe that executive position reinforces certain personal attributes, such as the illusion of personal superiority that enables him or her to take exclusive credit for an organization's success, which can ultimately lead the executive to act outside ethical and legal bounds. *See* David M. Messick & Max H. Bazerman, *Ethical Leadership and the Psychology of Decision Making*, SLOAN MGMT. REV., Winter 1996, at 9, 17-18.

54. *See* KARL E. WEICK, MAKING SENSE OF THE ORGANIZATION 370-71 (2001).

55. *See id.* at 370.

certain conduct.[56] Organizational culture is constituted of the values and goals, and the ways of thinking and behaving, that typify the organization.[57] In all but extremely marginal institutions, this culture must make sense within the society in which the organization exists. The organizational culture does not arise overnight, but is created over the life of the organization and is renewed and changed, sometimes imperceptibly, almost daily. From one organizational perspective, organizations, with their beliefs, codes, roles, and culture, are social constructions to make sense of the activities to which the business organization is committed.[58] Yet, if the organizational culture that results over time from this process of repeated actions and reinforcing perspectives and justifications is flawed or improper, it can lead to a corruption of the organization, or to a spectacular mishap.[59]

Organizational culture persists because new members are indoctrinated into it—not unlike the way they are

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56. *See* VARDI & WEITZ, *supra* note 18, at 215-18; *see also* Linda Klebe Treviño et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, 41 CAL. MGMT. REV., Winter 1999, at 131, 141-42. A charismatic leader who helps an organization in a time of ambiguity and uncertainty may be particularly important in the development of organizational culture. *See* PFEFFER, *supra* note 4, at 132-33; *see also* WEICK, *supra* note 54, at 70 (observing that a leader is often someone who, in the face of uncertainty, is willing to make sense of circumstances and to take action; if the action does not work, the leader has at least benefited from the effort and can refine his or her interpretation of the uncertainty).

57. *See* PFEFFER, *supra* note 4, at 120-26.

58. *See* WEICK, *supra* note 54, at 19. Weick also proposes that organizations do not deliberate and arrive at grand designs about their business strategies, and then enact them into reality, but that they offer post-hoc justification or explanation for an organization's actions, reactions or events affecting it, which accounts then become the basis for further actions. *Id.* at 26-27.

59. In the former case, one thinks of Enron, with the gradual adoption and even celebration of a model of organizational behavior based upon self-interested, individualistic competition, which model was the creation of groups at the top of Enron, until the organization imploded from its widespread corruption. In a more benign, but still disastrous case, organizational theorists use as an example NASA's shift of emphasis from safety to lowering costs and tight scheduling of space flights, which led to a sacrifice of flight quality and the disasters of the *Challenger* and the *Columbia*. *See* Robert D. Dimitroff et al., *Organizational Behavior and Disaster: A Study of Conflict at NASA*, 36 PROJECT MGMT. J. 28 (2005).

socialized into groups.[60] They become "committed" to it, which is a process whereby an individual "bonds" with the organization, often through arduous recruiting and training strategies.[61] Organizational literature on commitment emphasizes that the process may amplify misconduct because members remain committed to the organization even when it is clearly engaged in unethical or illegal activity. This discussion is related to the previously discussed social psychological literature on groups, for individuals in organizations have essentially adopted organizational "selves," which identities are difficult to abandon while the individuals remain in the organization.[62]

Not unexpectedly, the organizational literature teaches that problems in an organization do not appear all of a sudden, only in moments of stress. Generally, the corruption of the culture in a business enterprise takes place over a long time and, in many cases, is almost imperceptible and, at first, occurs unconsciously.[63] As noted earlier, a senior executive in a business organization may make a decision or approve conduct that is marginally improper, but that is done for the organization's benefit.[64] Other senior decision-makers, or directors, go along with it, either because they do not even notice its impropriety[65] or because their organizational self blocks out any other

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60. *See* PFEFFER, *supra* note 4, at 120-26.

61. *See id.* at 116-20.

62. *See* Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1, 10 (2003); Linda K. Treviño et al., *Behavioral Ethics in Organizations: A Review*, 32 J. MGMT. 951, 968 (2006).

63. This corruption often takes place in highly competitive environments subject to relatively weak legal and ethical oversight. *See* Ashforth & Anand, *supra* note 62, at 5-6.

64. Again, this model would follow the paradigm of a corrupt organization, as opposed to an organization of corrupt individuals. *See* Pinto et al., *supra* note 51, at 689. On the role of the leaders as being the primary cause of corrupt organizational behavior, see Ashforth & Anand, *supra* note 62, at 6-8.

65. Psychologists present evidence, taken from laboratory experiments, that if unethical or improper actions are small in nature and are taken over time, people do not even notice them and that, if they do, they are less inclined to object to them than to an unethical action that is a major departure from past conduct. *See* Francesca Gino & Max H. Bazerman, *Slippery Slopes and Misconduct: The Effect of Gradual Degradation on the Failure to Notice Others' Unethical Behavior* (Working Paper No. 06-007, 2006), *available at* http://www.hbs.edu/research/pdf/06-007.pdf.

perspective (such as an "ethical" self) that would object to it.[66] The next impropriety is a repetition, or a slight extension, of the earlier one.[67] The misconduct then becomes "normal" and routine; it becomes part of the organizational culture.[68] When, often years later, the improprieties are detected and punished, they are then

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66. *See* Ann E. Tenbrunsel et al., *Why We Aren't as Ethical as We Think We Are: A Temporal Explanation* 10 (Working Paper No. 08-012, 2007), *available at* http://www.hbs.edu/research/pdf/08-012.pdf. As noted earlier, social psychological theory posits that individuals assume multiple "selves" according to the social context that they occupy. Some organizational theorists and psychologists reduce this framework by arguing that an individual is composed of two basic "selves," the one being devoted to short-term interests and impulses (which are emotionally and instinctually compelling) and the other having a long-term perspective, including ethics (which take more cognitive effort). They contend that misconduct and approval of misconduct occur because, at the time of the decision, conduct, or approval, the short-term self predominates and the long-term self is pushed to the background. They call this process "ethical fading." *See id.* at 19-24; Ann E. Tenbrunsel & David M. Messick, *Ethical Fading: The Role of Self-Deception in Unethical Behavior*, 17 SOC. JUST. RES. 223, 225 (2004). Moreover, from another perspective, self-interest may imperceptibly, and not rationally, affect a person's view as to the propriety of a particular action and then lead the person retrospectively to offer rational justifications for it, as opposed to acknowledging the self-interested basis for the action; in other words, individuals co-opt themselves into doing evil. *See* Ashforth & Anand, *supra* note 62, at 29; *see also* Thomas M. Jones & Lori Verstegen Ryan, *The Link Between Ethical Judgment and Action in Organizations: A Moral Approbation Approach*, 8 ORG. SCI. 663, 676 (1997) (proposing that unethical behavior by individuals in organizations is affected by four basic factors, which can bring forward, or push backwards, moral behavior: (1) severity of consequences (i.e., really bad outcomes induce moral behavior), (2) certainty of one's moral position (i.e., ambiguous or unclear situations will decrease moral behavior), (3) complicity in action or decision (i.e., if responsibility is diffused, moral behavior decreases), and (4) organizational pressure to conform (i.e., decreases ethical behavior)).

67. *See* Tenbrunsel & Messick, *supra* note 66, at 228. Other senior executives often accept the misconduct, as do their advisors, because they all want to maintain their position in and approval of the group and organization. *See* Gino & Bazerman, *supra* note 65, at 40-41.

68. *See* Ashforth & Anand, *supra* note 62, at 8-15; Vilmos F. Misangyi et al., *Ending Corruption: The Interplay Among Institutional Logics, Resources, and Institutional Entrepreneurs*, 33 ACAD. MGMT. REV. 750, 752 (2008). When corrupt action becomes a routine, individuals do not see its goal or moral implications; it becomes simply part of an organizational process that is not examined: "this is how things are done." Moreover, the corrupt action may even seem to be the action that *ought* to occur: "this is how things should be done." The deviant organizational culture becomes "rationalized" by fitting it into accepted social goals, with the rationalization following a pattern. *See* Anand et al., *supra* note 44, at 11 (listing rationalizations).

clearly seen as being improper, sometimes even by the perpetrators themselves, but only with a new, one might say an external, perspective.[69]

2. *Preventing Misconduct in Organizations.* Organizational literature provides guidance on how organizations can prevent, or at least reduce, misconduct. Not surprisingly, organizational culture figures prominently in this guidance. According to the literature, a well-functioning organization has an organizational culture, fostered by its leaders, that emphasizes "trust, honesty, and self-respect" among its members, who communicate honestly, openly, and respectfully with each other.[70] An organization must also be grounded upon ethics and morality, which reflect existing social values, and upon the long-term continuation of the society in which it exists. The basis for the organizational culture thus has to be something other than self-interested profit maximization.[71]

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69. This could be the ethical self's perspective, or that of any social self external to the self that the individual uses in the firm. In addition, it takes some effort for perpetrators of misconduct to acknowledge their wrongdoing, since individuals tend to distort their memories so that, in retrospect, the individual presents himself or herself as acting more morally and properly than he or she in fact acted at the time. *See* Tenbrunsel et al., *supra* note 66, at 24-30.

70. *See* WEICK, *supra* note 54, at 114. Thus, an organization member must have the freedom of action to challenge a questionable action that appears to be done for the benefit of the organization, but runs against social norms and even the law. *See* Russell Cropanzano et al., *The Management of Organizational Justice*, 21 ACAD. MGMT. PERSP. 34, 35-36 (2008) (discussing organizational justice); Donald Lange, *A Multidimensional Conceptualization of Organizational Corruption Control*, 33 ACAD. MGMT. REV. 710, 716-22 (2008) (discussing control mechanisms for organizational corruption, including the promotion of an environment where employees have the freedom to question decisions and actions and the internalization of organizational values in employees).

71. Organizations grounded upon self-interest have been found to be more likely to engage in unethical conduct. The organizational literature is uniform on this subject. *See* Treviño et al., *supra* note 62, at 966; *see also* Anand et al., *supra* note 44, at 18-19 (arguing that unethical behavior came from management systems that required divisions and subdivisions to meet financial goals, without concern about how this was achieved); LaRue T. Hosmer, *The Institutionalization of Unethical Behavior*, 6 J. BUS. ETHICS 439 (1987) (same); Ann E. Tenbrunsel et al., *Building Houses on Rocks: The Role of the Ethical Infrastructure in Organizations*, 16 SOC. JUST. RES. 285, 295 (2003) (hypothesizing that an organizational climate of respect for others places an emphasis on others and thus decreases a focus on self-interest in the organization); Treviño et al., *supra* note 56, at 132 (noting that employees

As discussed above, misconduct can occur in an organization when an executive or employee adopts from the organization's culture an organizational self or identity that accepts unethical or illegal conduct and that pushes aside and competes with the individual's other "selves," which have different origins and even ethical foundations.[72] A healthy organizational culture would not be opposed to, and should reinforce, these other selves in an individual while he or she is a member of an organization.[73] This reinforcement does not happen just because an organization has formal codes of ethics and policies stating that its members should be ethical and follow the law, but from, again, an organizational culture exemplified by its leaders and internalized by organization members that allows for this expression.

A goal of the organizational literature is to design specific procedures and policies to help organizations create an ethical culture.[74] Organizational theorists argue that an organization should allow ethics to be considered in decisions at all levels of an organization—again, a formal code of ethics does not suffice—and actual practices in the organizations should be regularly reviewed from an ethical perspective to prevent ethics from fading into the

identify firms that place the most emphasis upon self-interest and unquestioned obedience to authority to be unethical).

72. Here is where the individual level and organizational level interact. Certain individuals who do not have strong moral selves developed from other contexts may be particularly prone to an organizational environment that advocates unethical action, since their stage of moral development tells them to follow the prevailing organizational culture, not simply to do what is right in a larger social or abstract sense. *See* Neal M. Ashkanasy et al., *Bad Apples in Bad Barrels Revisited: Cognitive Moral Development, Just World Beliefs, Rewards, and Ethical Decision-Making*, 16 BUS. ETHICS Q. 449 (2006) (presenting empirical evidence that, among other things, those with the lowest cognitive moral development and with a high belief in a just world were most likely to approve unethical decisions in business settings).

73. *See* Treviño et al., *supra* note 62, at 962.

74. Treviño notes that the Federal Sentencing Guidelines acknowledge the importance of organizational culture. *See id.* at 979.

background.[75] Executives should use ethical considerations in decision-making (i.e., making ethics salient to decisions),[76] pre-commit to ethical action before making a decision, and even decrease the pressure on and increase the simplicity of a particular decision (because it takes intellectual capacity and effort to introduce ethical considerations into the decision-making).[77] An organization must also anticipate the effects of its decisions from an ethical perspective.[78]

If an organization does not have an ethical culture, during the inevitable times of stress that all organizations encounter, other goals fill the void. Given the prevalent business training, its members are likely to base their conduct upon values, such as self-interest, that conflict with larger organizational and social values; worse, the

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75. *See* Ashforth & Anand, *supra* note 62, at 39. Having a code of ethics without ethical practices may in fact lead to more misconduct. *See* Anand et al., *supra* note 44, at 19. It sends a kind of perverse signal that ethics is window dressing to be disregarded. Scholars of business ethics observe that organizational ethics involves, from an analytical perspective, three levels in the organization, in the following order of increasing importance: (1) formal systems of stating ethical goals for the organization, monitoring compliance with these goals, and sanctioning (i.e., rewarding compliance, punishing non-compliance), (2) informal systems of the same, and (3) organizational climates (a part of organizational culture) built upon and promoting ethics, respect, and procedural justice. *See, e.g.*, Tenbrunsel et al., *supra* note 71, at 287. The most ethical organization will be one that has a fundamental ethical foundation or "values orientation." *See* Treviño et al., *supra* note 56 (explaining the characteristics of such an organization, which includes ethical leadership, fair treatment of employees, ethical matters raised in ordinary decisions, and ethics being a matter in performance reviews, not unquestioning obedience to authority).

76. This is based on the theory that, although individuals may have considerable moral development, they may not foreground their moral decision-making in certain settings, where organizational factors push it into the background. *See* Treviño et al., *supra* note 62, at 956; *see also* Tenbrunsel & Messick, *supra* note 66, at 232.

77. *See* Tenbrunsel et al., *supra* note 66, at 35-36.

78. *See* Chun Wei Choo, *Information Failures and Organizational Disasters*, MIT SLOAN MGMT. REV., Spring 2005, at 8, 10. This is just another way of saying that an organization must anticipate different scenarios and not simply go with a decision that "feels" right, and honestly evaluate the effects of its action on all its constituencies.

organization will magnify the pursuit of self-interest. This, then, can lead to organizational disasters.[79]

C. *Lessons from Social Psychology and Organizational Theory*

The purpose of the preceding discussion was to identify, through a broad review of only some of the relevant literature in social psychology and organizational studies, several group and organizational causes of and factors in misconduct by senior decision-makers in business organizations. This review was necessary because the remainder of this Article considers how well corporate law and the enforcement of the securities law takes account of these causes and factors in their approaches to this misconduct.

A few lessons emerge from the review. First, both social psychology and organizational studies suggest that a group's mindset and an organization's culture can significantly contribute to misconduct of an organization member. This lesson rests on the assumption that an individual assumes a social identity, in a work group and business organization, that orients his or her thinking and conduct in that setting. If this mindset or culture is corrupt in some way, which means that it is based upon improper, unethical, or illegal goals, it often offers its members nothing more than the pursuit of self-interest, it encourages conduct in keeping with these goals, and the group or organization member is more likely to engage in misconduct. The literature also explains that, while misconduct in organizations can be instigated by a corrupt individual, which means that an individual knows what is right or legal and does the opposite (he or she is the proverbial "bad apple"), a group or organization member who is not a "bad apple," but whose moral development is not the strongest, may engage in misconduct almost unconsciously in line with his or her organizational self, even though his or her actions would be in conflict with the other social identities or selves that the group or organization member possesses. For example, a senior

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79. *See* WEICK, *supra* note 54, at 141. This kind of organizational rigidity also characterizes "groupthink," which may go hand in hand with it. *See id.* at 276.

executive who engages in fraud in his or her company may be an excellent father or mother, a pillar of the community, and a strong supporter of charitable causes.[80] In other words, misconduct is often amplified by the group and organization, rather than only being due to defects in the individual; it is also a question of a "bad barrel."[81] Moreover, organizational misconduct may also not be easily traceable to one bad act; rather, it is made up of small decisions or actions that may be at first ethically or legally equivocal and that are the bases for later decisions or actions that eventually and cumulatively are clearly unethical and illegal.

Second, both social psychology and organizational studies emphasize the significance of the leader in perpetuating and shaping a group's mindset and an organization's culture and thus in checking or promoting misconduct. This role is based upon the fact of the leader's importance in decision-making and power in hierarchical business organizations, although a leader's effectiveness does not just turn on his or her position in the group or organization. The leader also embodies the views and aspirations of the group and organization and, again given his or her importance, the leader can push the mindset or culture in a new direction, for good or bad. Obviously, there are limits to how far the leader can move the group or organization, especially since the mindset and culture generally precede the leader, have a social identity apart from him or her, and are the reason why he or she was selected in the first place. But, given the leader's special position, both social psychology and organizational studies would find it appropriate to put some blame on the leader for misconduct by group or organization members, and of course by the leader himself or herself.

Third, how the group or organization functions clearly affects whether it checks or amplifies misconduct by its members. In both the group and organization contexts, it is important that open, honest, and respectful participation by

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80. *See* Ashforth & Anand, *supra* note 62, at 3 ("Our analysis suggests an answer to the intriguing question of how a person who is a loving parent, thoughtful neighbor and devout churchgoer is able to engage in workplace corruption.").

81. *See* Tenbrunsel & Messick, *supra* note 66, at 229 ("[T]he system [ ] is the real culprit.").

its members be allowed—even if the leader ultimately makes the decision—and that there be dissent and "cognitive conflict." These procedures allow members to challenge attitudes or actions that a member feels are improper and/or may corrupt the group or organization. Proper group or organizational dynamics contrast with ones, such as groupthink, that impose silence (or the equivalent of silence) upon participants, which shuts out dissent, and reinforces the group's or organization's perspective, even if it is flawed. The functioning of the group or organization is connected to its mindset or culture, for either the mindset or culture evolves so as to permit its members to identify and resist misconduct, or it pushes them to resist change and amplify bad behavior. It is difficult to imagine how a group or organization that is properly functioning in these terms would allow misconduct to persist and grow. A properly functioning organization thus has an "institutional logic" that resists misconduct, which includes the organizational belief system, its identities, roles, and practices, not just routine and formal procedures for considering ethical issues and preventing misconduct (i.e., formal compliance programs). To produce this kind of organization thus requires a social, cultural approach, not limited to changing incentives for individual actors, which is the perspective of the economic model.[82]

Fourth and finally, what is clear from the above discussion is that the group and organization must be based upon social, ethical, and legal foundations and cannot be sustainable if built only or primarily upon the self-interest of its individual members. This lesson may underscore a major difference between these disciplines and economics, whose theoretical model of human behavior as the self-interested profit-maximizer has permeated, and corrupted, finance and business. The view from social psychology and organizational studies is that a group or organization built upon self-interest exhibits the structural and functional failings identified above and is prone to unethical and illegal conduct. This is a pessimistic conclusion, for it suggests that, so long as U.S. business espouses this model, corruption will constantly occur and be magnified in business organizations, for the model affects how people

82. *See* Misangyi et al., *supra* note 68, at 763.

think and behave.[83] Indeed, it suggests that, since senior decision-makers in public business firms are the product of U.S. business schools and the business "culture," which embodies the most extreme version of this model, the outlook for business firms is exceedingly grim. Therefore, social psychology and organizational studies caution that a fundamental reform to the orientation of business and business training may be necessary to reduce misconduct by senior decision-makers in business organizations.

II. ANALYSIS OF LEGAL PERSPECTIVES ON MISCONDUCT OF SENIOR DECISION-MAKERS

This Part conducts a targeted review of several legal areas in order to see how well they take into account the group or organizational causes of or factors in senior-level misconduct that were just discussed. It first briefly considers corporate law only because this law establishes the governance structure for the corporation and the duties for the executives and directors, and it is the foundation upon which all law concerning the public business firm is built. This Part then examines federal securities law, which historically has complemented corporate law by imposing additional duties upon senior decision-makers when their company is public. The focus of this examination is less on the substance of the laws than on their enforcement by the SEC. Finally, this Part looks at federal criminal prosecution of the decision-makers for federal securities law violations. The analysis of civil and criminal enforcement of the federal securities laws particularly considers organizational liability, in conjunction or in contrast with individual liability, for holding a public firm liable for the acts of its directors, officers, and employees squarely raises the issue of group and organizational causes of their misconduct. It must be again emphasized that this Part is not intended to be a comprehensive review of corporate law or securities law enforcement. Rather, it establishes succinctly how the law neglects group or organizational factors, as highlighted in the previous Part, in dealing with senior-level misconduct.

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83. *See id.* at 764-65.

A. *Corporate Law*

To put it bluntly, corporate law is tailor-made for a consideration of group and organizational factors in or causes of misconduct by senior decision-makers, but the jurisprudence has generally not explored, and has in fact closed down, this kind of analysis. Under basic corporate law, a group, the board of directors, is at the apex of corporate governance, which is the structure of decision and power in a corporation; the board is the ultimate decision-maker in a public corporation.[84] Therefore, group processes should be a focus of corporate law jurisprudence. Even more suggestive from the perspective of social psychology and organizational studies, this jurisprudence generally views the board of directors as a group when it performs its classic action: making decisions.[85] Thus, whenever a court reviews a shareholder challenge to a board's decision, it generally looks at it as a group action and would impose liability upon all group members. This was certainly true in the case known to all law students who take the basic corporations course, *Smith v. Van Gorkom*, where the board members were blamed for being too passive and hasty in approving a sale of their company that the Chairman/CEO proposed and advocated.[86] As in *Smith*, courts occasionally and intriguingly raise issues of group dynamics and processes. For example, the jurisprudence alludes to group passivity in the face of a dominant, authoritarian leader, points to group acquiescence in a questionable action, even if individual members privately had reservations about the decision that they never brought up in group

84. *See* MODEL BUS. CORP. ACT § 8.01(b), at 8-3 (2008).

85. There are, in effect, two basic legal tasks of the board: to make business decisions, which usually involves approving a proposed strategy of senior executives, and to ensure that the corporation has in place the proper internal control and operational systems. On this latter focus, see *Stone v. Ritter*, 911 A.2d 362, 368-69 (Del. 2006). The board's specific duties, as understood by business practitioners are numerous. *See* JAMES A. FANTO, DIRECTORS' AND OFFICERS' LIABILITY § 2:2.1 (2d ed., Release No. 2, Oct. 2007). Since Delaware corporate law jurisprudence is the most significant in the United States for public corporations, because most of them are incorporated in Delaware, I shall refer only to it and to model corporate codes in this subsection.

86. 488 A.2d 858 (Del. 1985).

deliberations,[87] and signals group dynamics that make it difficult for directors—as members of a cohesive group—to judge one another.[88] Generally, an individual director is not singled out unless he or she distinguished himself in some way, e.g., by being the inside director (like Van Gorkom) who was actively engaged in or directed the misconduct. Even here this means that the targeted director or executive is juxtaposed against the *group* of other directors.

Why, then, has nothing much come of this jurisprudential acknowledgement of the importance of this group of senior decision-makers in the public firm? The simple answer is that directors have almost no risk of liability under corporate law when they make their group decisions. As is well-known, corporate law imposes liability for flaws in the board's decision-making only if the board fails to meet a very low standard of conduct, gross negligence. In other words, directors are liable only if they neglect to make a decision or if they make a completely irrational decision.[89] Moreover, even if a board fails to satisfy this low standard of conduct, corporate law statutes protect directors from liability for money damages from a violation of the duty of care.[90]

The point here is not to enter into a longstanding debate among corporate scholars as to whether this freedom

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87. *See, e.g.*, ATR-Kim Eng Fin. Corp. v. Araneta, No. CIV.A. 489-N., 2006 WL 3783520, at *21 (Del. Ch. Dec. 21, 2006).

88. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).

89. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368-70 (Del. 1993). That is, if directors go through the decision-making process, which means gathering information and deliberating for a long enough time, and if the decision is not irrational, the courts accord their decision "business judgment" deference, which means that they dismiss any shareholder complaint about the substance of the decision. *See generally* PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994). There are, of course, exceptions to this business judgment deference: it does not apply if directors approve a violation of the law, act in bad faith, or engage in self-interested behavior.

90. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (Delaware's exculpatory statute). Directors are also provided with contractual rights to have their defense expenses advanced and ultimately paid by the corporation, either through its own funds or through directors' and officers' (D&O) insurance. Amounts paid in settlement are similarly indemnified by the corporation or covered by insurance. *See generally* TY R. SAGALOW, DIRECTORS AND OFFICERS LIABILITY INSURANCE: A DIRECTOR'S GUIDE (2000).

from liability for directors is the correct outcome.[91] The main point is that this liability protection for directors in the due care context short-circuits any development of jurisprudence on group dynamics in the boardroom. That is, if plaintiffs were to allege that poor group dynamics led a board to make a poor decision—such as waiving a conflicts policy to allow a company executive to do a transaction with a firm—or not to exercise appropriate supervision over executives, the lawsuit would likely not even survive a motion to dismiss, much less get past summary judgment.[92]

An analysis of group or organizational factors in or causes of misconduct equally does not emerge from jurisprudence on executives, like the CEO, who work in executive teams. Courts apply the same standard of conduct (i.e., gross negligence) to an executive who makes a business decision.[93] The executive who is a director—in corporate law parlance, an inside director—receives the same statutory relief from liability as does any other director. While non-director executives do not benefit from the absolute relief from money damages provided by the statutes, they have legal and contractual indemnification rights, defense expense advancement, and directors' and

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91. Common reasons given for not making outside directors liable for their gross negligence are that they are only part-time supervisors, that they should not be discouraged from taking risks, and that it is often inappropriate to judge people in hindsight. *See, e.g.*, PRINCIPLES OF CORP. GOVERNANCE § 4.01 cmt. d. For a flavor of the debate about courts' deference to directors' decisions, see, for example, STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 251-69 (2002).

92. There is, of course, jurisprudence suggesting that the statutory relief from liability must be used as an affirmative defense by the directors. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1223 (Del. 1999). However, even this line of jurisprudence would hold that a complaint can be dismissed for this reason if it articulates only a duty of care complaint (i.e., there are no allegations concerning violations of the directors' other duties). *See* Malpiede v. Townson, 780 A.2d 1075, 1093 (Del. 2001).

93. *See* PRINCIPLES OF CORP. GOVERNANCE § 4.01, at 138 (making no distinction between standards applicable to directors and officers). *See generally* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (arguing that officers should be held to an agent's standard of care, which is negligence, and not be accorded business judgment deference). *But see* Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 865 (2005) (contending that the same standard of conduct should apply to directors and officers).

officers' insurance, which may together amount to the same protection.[94]

The other major standard of conduct imposed upon a director or executive is the duty of loyalty, also known as the duty to avoid conflicts of interest and to deal fairly with the corporation.[95] By definition, this duty is the foundational agency mandate for an *individual* fiduciary to avoid *self*-interested transactions and thus not to benefit himself or herself at the corporation's expense.[96] Thus, a group and organization is, as a definitional matter, irrelevant in the jurisprudence on the duty; the focus of the analysis is whether the individual behaved fairly, defined in both procedural and substantive terms, towards the corporation.[97] Historically, courts recognized, in a commonsense kind of way, that group dynamics were present in conflicts cases. Under the common law, an officer's or director's transaction with his or her firm was void, partly because it was acknowledged that fellow directors and officers might be inclined, for group reasons, to favor the director or officer at the expense of the

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94. For officers, as well as directors, indemnification and insurance works as follows. Generally, corporate statutes authorize a corporation to indemnify, and to provide insurance for, directors and officers and, in some cases, they mandate that the corporation indemnify a director or officer (e.g., where he or she has prevailed in a lawsuit). A corporation then typically provides for the indemnification in its bylaws and in contracts with the officer or director, and it purchases a D&O policy, which may cover some of its indemnification expenses as well as additional liabilities. *See generally* FANTO, *supra* note 85, at 8-1 to 8-5.

95. *See* PRINCIPLES OF CORP. GOVERNANCE cmt. a, at 199.

96. As the jurisprudence on this duty has developed, it has become sophisticated enough to recognize that the "self" includes the interests of those close to the director or officer, such as family members. *See* MODEL BUS. CORP. ACT § 8.60, at 8-109 to 8-111 (2008).

97. This is a complicated area, which the above greatly simplifies, as every student of corporations knows. Generally, under their equity jurisprudence, courts will examine the fairness of a self-interested transaction. Corporate statutes provide both that the transaction is not automatically voidable because of the involvement of the director or officer and that there are ways to insulate it from later challenge, such as by having prior approval of the disinterested directors or the shareholders, or a ratification by the shareholders. Depending upon the jurisdiction, these pre-approvals have considerable effect: they may lessen the court's standard of review of the transaction. *See* MODEL BUS. CORP. ACT §§ 8.62, 8.63 & Official Cmts., at 8-122 to 8-130; PRINCIPLES OF CORP. GOVERNANCE § 5.02 reporter n.7, at 242 (for discussion of Delaware's approach).

corporation. Yet that ancient social psychological insight was put aside in favor of economic efficiency (i.e., a transaction that might be economically beneficial for both the director or officer and the corporation should not be prohibited), and corporate law statutes have overridden the common law prohibition, substituting for it approval by a disinterested board or shareholders. This means that, when there is a self-interested transaction engaged in by one director or officer, courts generally uphold the transaction so long as directors or shareholders who are not themselves *self*-interested, generally defined to mean financially interested, approved it.

Thus, in the statutes and in the jurisprudence interpreting them, a director is barred from approving another's self-interested transaction only if he or she is also self-interested, which means that there is no legal recognition of how a group or organization may affect a director's approval in these circumstances. Sometimes courts acknowledge that group dynamics might play a role in the approval, as when a director—such as one who is also a controlling shareholder and CEO—dominates or influences other directors so that they go along with a transaction that benefits himself or herself, but that does not directly advantage the others.[98] Yet, there is no more development here than there was in the duty of care jurisprudence because the focus of analysis is always primarily on the financially interested director or officer.[99] If the passivity, inaction, or complicity of the other directors is challenged at all, it will not be examined in any detail because, again, they will not be liable for what amounts to nothing more than a violation of their duty of care, with the consequences that have been explained above.

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98. In such cases, the focus is on the controlling shareholder and director, rather than on the other related directors, who are seen as his or her proxies. *See* Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1061-62 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005). *But see In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004) (finding directors liable because they made their decision to please the controlling shareholder). Under Delaware jurisprudence, the transactions of a controlling shareholder are examined for fairness, no matter what the decision-making structure (e.g., approval of a special committee of independent directors). *See* Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983) (holding that fairness includes an analysis of fair price and fair dealing).

99. *See* PRINCIPLES OF CORP. GOVERNANCE § 7.18, at 222-23.

For a time, a third duty of directors and officers, the duty of good faith, had potential for allowing courts to recognize group and organizational factors or dynamics in senior-level misconduct.[100] From the reverse perspective, a lack of good faith, or bad faith, appears to mean an intentional or reckless failure on the part of directors or officers to perform their tasks, such as when directors fail to make a necessary decision or to implement an appropriate monitoring system for their firm.[101] Thus, one could imagine that jurisprudence on the duty of good faith could develop, in the way that duty of care jurisprudence never could, to explore problematic director or executive group and organizational dynamics and pathologies that resulted in serious harm to the firm and its shareholders. For example, bad faith could be exemplified by directors' allowing a Chair/CEO to set the board's agenda and to dominate its discussions, i.e., by their remaining too passive in the face of, and not objecting to, an improper board deliberative structure. More importantly, exculpation of liability would not be an obstacle to the development of jurisprudence on this duty, for the exculpatory statutes by their terms do not apply to violations of it.[102]

The problem is that the Delaware courts have been reluctant to read the good faith duty expansively, even in circumstances that were arguably favorable to this reading. The example that comes to mind is the *Disney* case, where there were allegations, and considerable evidence, that the board of Walt Disney had flawed group dynamics, partly because of an imperious, highly domineering, and almost psychotic CEO, the notorious Michael Eisner. When one of his major gaffes, the hiring and almost immediate termination of his friend, Michael Ovitz, as Disney president became the basis for a shareholder lawsuit alleging, among other things, a violation of the good faith duty by the board compensation committee and the entire board, both the Delaware Chancery Court, after a trial on the merits, and the Delaware Supreme Court, on appeal,

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100. On this duty, see generally Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004).

101. For this definition, see *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006).

102. *See id.* at 67.

did not find a violation of this duty.[103] Rather than focusing on the dynamics of committee and board conduct, the courts each transformed the potential "group" good faith analysis into an individual question, i.e., whether the circumstances suggested that a *particular* Disney director was reckless in fulfilling his or her tasks.

The Delaware Supreme Court has since reinforced this individualistic focus of the good faith analysis in its most important statement on the duty in *Stone v. Ritter*.[104] In a case involving the issue whether the board had ensured that the firm had proper internal monitoring systems in place, the Court explained that the duty of good faith was in fact part of the duty of loyalty.[105] As discussed above, this latter duty by definition deals with issues of *self*-interest. By situating the duty of good faith within the duty of loyalty, the jurisprudential import is that the focus on self-interest of the latter effectively blocks the possibilities of exploration of group and organizational causes for senior decision-maker misconduct that might otherwise exist in the former (as happened in *Disney*). More will be said about this in Part III below, which discusses legal reforms to push recognition of group and organizational causes in the law. But this overview of corporate law jurisprudence shows that the foundation of public firm corporate governance ignores the social side of misconduct.

B. *Enforcement of the Federal Securities Laws*

Federal securities law is ultimately more promising than corporate law in taking account of group and organizational factors in senior-level misconduct in public firms. As seen by numerous corporate scandals, the fraud in public companies that is actionable under the federal securities laws is rarely due to the misconduct of one person, even an important person such as the CEO. Rather, it is a product of many people and groups within a

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103. *See id.* at 67-68. For the lower court decision, see 907 A.2d 693, 755-56 (Del. Ch. 2005).

104. 911 A.2d 362 (Del. 2006).

105. *Id.* at 370.

particular business firm.[106] As discussed in this and the following sections, in enforcing the securities law, the SEC, in civil enforcement proceedings, and the Department of Justice (DOJ), in criminal proceedings, pursue both individuals and organizations, thus squarely raising the issue of group and organizational responsibility for fraud. However, this enforcement activity is disappointing from a social psychological and organizational perspective since the focus of the SEC and the DOJ is almost exclusively on individuals, with organizational responsibility and reform as something of an afterthought. This section offers a quick overview of the federal securities law and an analysis of the SEC's approach to organizational liability, which focuses on individual responsibility for fraud. The next section looks at the similar approach of the DOJ.

1. *Generalities.* As is common knowledge to every student of business organizations, the federal securities laws are all about disclosure from a public company in two basic contexts: when the company is doing a public offering of its securities[107] and when it is providing information to the securities markets, whether as mandated by law or otherwise.[108] In either case, the law's focus is on accurate disclosure of material information about the company and is thus designed to prevent fraud in the disclosure; to have

106. This was my point in *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, *supra* note 11.

107. This is the focus of the Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (2006), and its accompanying SEC rules. Officers and directors also have certain disclosure duties when their company is engaged in a private securities offering.

108. These duties are found in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78nn (2006), and its accompanying SEC rules, which regulate the securities markets. To simplify things, companies whose securities are traded in these markets are participants therein and thus are subject to regulation under that Act. A public company has multiple disclosure obligations, including the filing of an annual report on Form 10-K, the filing of quarterly reports on Form 10-Q, the filing of "special" reports on Form 8-K whenever one of the events enumerated in the Form occurs, and the filing of a proxy statement for the annual shareholders' meeting. Companies also regularly make public disclosures that are not required by the Exchange Act (i.e., they simply talk to the market), and this disclosure is also subject to Exchange Act liability as discussed below.

a company present itself to investors as it really is.[109] Senior decision-makers in the company, directors and officers, are part of the disclosure process: they must provide accurate information about themselves, for this is a mandatory subject of disclosure.[110] They must also oversee the disclosure process to ensure that the company portrays itself in a materially accurate way.

The federal securities laws and regulations recognize that disclosure is an organizational product. To take the public offering, the Securities Act and the accompanying SEC rules regulate in detail the manner in which the process occurs and reflect the business practice of taking a company to market.[111] This detailed regulation acknowledges that the process is an organizational and group undertaking by providing guidelines to the standard participants in the offering, the company, its accountants, and the broker-dealer firms marketing the offering, to name the major ones. The recognition of the public offering as an organization or group product particularly appears in the liability provisions of the Securities Act dealing with a public offering. Under the key liability provision, Section

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109. Materiality has been defined to refer to a fact that "there is a substantial likelihood that a reasonable shareholder would consider . . . important . . . ." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). As is well known, the disclosure that a company makes under the Securities Act and the Exchange Act has been harmonized in Regulation S-K, 17 C.F.R. § 229.10 (2008).

110. The disclosure about management is extensive and includes a person's position, age, arrangements pursuant to which he or she received the position, family relationships with other officers and directors, involvement in certain kinds of legal proceedings, their compensation, their holdings of securities of the company, and their transactions with the company. *See generally* 17 C.F.R. subpt. 229.400 (2007).

111. The statute thus regulates the three periods of the offering process: the pre-filing period while a company prepares for the offering, the post-filing marketing period for the offering, and the sales period. *See* 15 U.S.C. § 77e (the statute accomplishes this regulation in a convoluted way by prohibiting offers before the registration statement has been filed (in (c), the pre-filing period), by requiring that written offers use the statutory prospectus (in (b)(1), the marketing period), and by allowing sales and delivery of securities only once the registration statement has been declared effective (in (a), the post-effective period)). The SEC had made adjustments to this regulation in its own rules as, over the years, technology has changed the way public offerings are conducted. *See, e.g.*, Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005) (most recent reform of offering process).

11,[112] the firm, all directors (and those who are named as about to become directors), all those who sign the registration statement (which includes major executives and a majority of directors),[113] any expert who has certified a part of the statement (this generally means the accounting firm that certifies the company's financial statements), and all "underwriters," which means the broker-dealers marketing the offering, are *jointly and severally* liable for fraud in the offering.[114]

It is true that Securities Act liability becomes an individual question. Each potentially liable person has the well-known "due diligence" defense pursuant to which he or she can be absolved of liability if he or she acted reasonably in the circumstances (i.e., without negligence).[115] This reasonableness analysis, moreover, takes into account the background, qualifications, and training of the person in

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112. *See* 15 U.S.C. § 77k. There are additional liability provisions in the Securities Act dealing with a public offering: one concerns the failure to follow the Act in conducting the offering, 15 U.S.C. § 77*l*(a)(1), and the other focuses on the actual seller of the securities to the investor (e.g., broker), 15 U.S.C. § 77*l*(a)(2).

113. The "registration statement" of a public offering requires a signature of the CEO, the CFO, the controller or principal accounting officer, and a majority of the board. *See, e.g.*, Form S-1, Signatures, Instruction No. 1, *available at* http://www.sec.gov/about/forms/secforms.htm; *see also* 17 C.F.R. § 239.11 (2008). The registration statement is the document filed with the SEC, which includes the selling document, known as a prospectus, that is distributed to investors, other disclosures that are publicly filed, but not distributed, and exhibits.

114. *See* 15 U.S.C. § 77k(a)(1)-(5). A person who is found liable—without a due diligence defense (discussed below) and not guilty of fraudulent misrepresentation—however, can seek contribution from the others. *See* 15 U.S.C. § 77k(f)(1). Again, there are more complications here that need not be discussed. *See* 15 U.S.C. § 77k(f)(2); 15 U.S.C. §78u-4(f)(2) (2006) (stating that liability of an outside director, rather than being joint and several, is proportionate to his or her responsibility for the fraud, unless trier of fact determines that such director "knowingly committed a violation of the securities laws").

115. *See* 15 U.S.C. § 77k(b)(3), (c). Again, matters get complicated here because the defense is slightly different depending upon whether the misleading part of the registration statement was prepared by an expert and upon whether one is the expert who prepared it. But generally the issue comes down to negligence in most cases. There are other defenses as well. *See* 15 U.S.C. § 77k(b)(1), (2) (stating that the individual is required to resign in protest and notify the SEC of the fraud, or simply report that the registration statement became effective without his or her knowledge).

question.[116] However, the company itself has no such defense and is thus strictly liable for any material misrepresentation in the public offering. This would appear at least to raise the issue of organizational processes and factors that resulted in fraud.

Once a company becomes public and is required to make its periodic reports to the SEC and otherwise to make regular disclosure to the securities markets, the organizational and group nature of the disclosure becomes even more pronounced, and securities law and regulation recognize this. A prominent example is the firm's internal controls. In a large business firm, an accurate account of its operations and financial results and position are based upon a firm's internal controls, which basically check that business operations are conducted in particular ways and that all transactions are properly and accurately recorded. Both the financial and non-financial disclosure of a firm depends upon the appropriateness of the internal controls for a firm and their design and application. Internal controls cannot be the work of one person: they must be decided upon by the senior executives under the supervision of the board, put in place by internal auditors, followed by everyone in the firm, and checked for implementation by outside auditors. The law reflects this fact: it mandates that a public firm have internal controls;[117] independent accountants must give an opinion about the controls; and the two top executives must certify as to the adequacy of the controls for producing materially accurate disclosure.[118]

It is true that, for materially inaccurate Exchange Act disclosure, the liability focus is individual and has even

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116. *See* 17 C.F.R. § 230.176 (2008) (discussing the circumstances that help to determine what constitutes a reasonable investigation); *In re* WorldCom Sec. Litig., 2005 U.S. Dist. LEXIS 4193, at *24-*25 (S.D.N.Y. Mar. 21, 2005); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 684-97 (S.D.N.Y. 1968).

117. *See* 15 U.S.C. § 78m(b)(2) (2006).

118. *See* 15 U.S.C. § 7241 (2006); 17 C.F.R. § 240.13a-14 (2008) (for officer certification requirement). Knowingly (or willfully and knowingly) filing a false certification can result in criminal liability for the officer. *See* 18 U.S.C. § 1350(c) (Supp. V 2000). Management must also give a report on the internal controls, and outside auditors must provide a yearly assessment of a public company's internal control structure. *See* 15 U.S.C. § 7262 (2006); 17 C.F.R. § 240.13a-15 (2008). Again, these are highly complicated and controversial requirements, which the SEC has phased in gradually for public companies.

become more so in recent years in the private securities lawsuits that are a main way in which this disclosure is policed. As noted above, the focus here is on SEC enforcement of the securities laws, not on these third party actions, but it is worth mentioning them very briefly to underscore the individual liability in the securities laws that echoes the one in corporate law. The main anti-fraud liability provision for a company's Exchange Act filings and public statements is the catch-all Section 10(b)[119] and Rule 10b-5[120] under this provision. In private securities lawsuits, this liability is highly individualized since, under jurisprudence on Section 10(b) and Rule 10b-5, a person is liable only if he or she had scienter or bad intent in making a fraudulent statement or omission.[121] Moreover, even this individualized liability has become more difficult to establish as a result of legislative developments and jurisprudence intended to rein in private securities lawsuits. Most notably, in the Private Securities Litigation Reform Act of 1995, Congress imposed heightened pleading requirements on plaintiffs bringing these lawsuits, which made it harder for a plaintiff to produce a sufficient complaint that would survive a motion to dismiss on the scienter issue.[122]

Furthermore, the focus on individual liability, coupled with more impediments to establishing it, has been accompanied by considerable restrictions of any group liability for fraud in these private lawsuits. Over ten years ago, the Supreme Court struck down aiding and abetting, or

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119. 15 U.S.C. § 78j-1(b) (2006). If, moreover, a director or officer makes, or causes to be made, a materially false statement in an Exchange Act filing, he or she can be liable to a purchaser or seller of the company's securities relying upon such statement. *See* 15 U.S.C. § 78r(a) (2006).

120. 17 C.F.R. § 240.10b-5 (2008).

121. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

122. *See* 15 U.S.C. § 78u-4(b)(2) (2006). Moreover, at the pleading stage, to survive a motion to dismiss, a plaintiff should plead facts that establish an inference of scienter that is as compelling as any other explanation of the facts pertaining to the defendant's state of mind. *See* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2508-10 (2007).

secondary, liability in private anti-fraud lawsuits.[123] Other liability provisions and doctrines would appear more promising to reach a group or an organization and, thus, to confront organizational factors, but they have not proven to be such—at least with respect to third party lawsuits. Senior decision-makers can be liable as controlling persons for the acts of their underlings,[124] but there are individualized defenses available to the controlling person (i.e., no knowledge of the violation and due care in the supervision of the controlled person).[125] Most useful as a way to raise organizational factors in senior-level misconduct is vicarious liability of the public firm under Section 10(b) through the application of the doctrine of respondeat superior; for fraud by a corporate agent, such as

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123. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994). Debate continued on the import of this decision, which turned on the distinction between the meaning of primary and secondary liability. Most courts interpreted it to mean that an anti-fraud claim could be brought against only the person making the fraudulent statement, not to those assisting him or her in the fraud. For a discussion of this jurisprudence and an argument that primary liability under Section 10(b) should extend to those who participate in fraudulent conduct, even if they did not make a fraudulent statement, see Robert A. Prentice, *Scheme Liability, Federal Securities Fraud, and John Wayne's i-Pod* (Univ. of Tex. at Austin, McCombs Sch. of Bus. Research Paper Series, Paper No. IROM-02-07, 2007), *available at* http://ssrn.com/abstract=1014658. Another theory of liability reaching participants in a fraud other than the actual speaker, known as "scheme liability," was based upon subsections (a) and (c) of Rule 10b-5 and was developed after courts began to limit the scope of primary liability under subsection (b) of that Rule following the *Central Bank* decision. However, the United States Supreme Court recently rejected this theory and refused to impose liability under Rule 10b-5 beyond those making the materially false statement (or omission). *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008). Moreover, the "group pleading" doctrine, whereby plaintiffs will plead that executives are responsible for misleading statements that they did not directly make, is not widely accepted in securities law jurisprudence and may no longer be good law after *Stoneridge*. *See* Southland Sec. Corp. v. Inspire Ins. Solutions Inc., 365 F.3d 353, 363-64 (5th Cir. 2004); William O. Fisher, *Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the "Group Pleading" Protocol in 10b-5 Cases*, 56 BUS. LAW. 991, 1049-53 (2001).

124. *See* 15 U.S.C. § 78t (2006). There is a comparable provision in the Securities Act. 15 U.S.C. § 77o (2006).

125. *See* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1472-74 (2d Cir. 1996). This form of liability does not require knowing participation in the fraud. *See In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 392-97 (S.D.N.Y. 2003).

an officer, director, or other agent. Organizational liability here has to be based on the agent's misconduct, which leads back to issues of individual intent and to the typical pleading burdens for a third party lawsuit.[126] But organizational liability can be a significant weapon in the hands of the SEC and the DOJ to pursue organizational corruption, the subject of the next subsections.

2. *SEC's Prosecution of Organizations.* The SEC is not hampered by many of the limitations facing private litigants relating to group prosecution. In an administrative proceeding or a court action, it can pursue groups of individuals engaged in fraud based upon aiding and abetting,[127] and it does not have to establish scienter, since it can bring an action under Section 17(a) of the Securities Act on the basis of negligence.[128] It has a wide array of sanctions against both individuals—it can impose upon them almost quasi-criminal sanctions, such as barring them from serving as officers and directors of public firms,[129]—and public firms—it can assess considerable fines against them,[130] seek injunctions that can restrict and direct the business of the firm,[131] and appoint a corporate monitor to oversee the firm's business and compliance with the law.[132]

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126. *See* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 631-32, 649-50 (2007).

127. 15 U.S.C. § 78t(e) (2006). Moreover, it has been contended that the SEC can bring actions against groups engaged in a fraudulent scheme (i.e., the limitation on scheme liability discussed above does not apply to SEC enforcement actions). *See* Rachel McTague, *Securities Fraud Liability: Attorney Says SEC May Retain Ability to Allege Scheme Liability*, 6 Corp. Accountability Rep. (BNA) 108 (Feb. 1, 2008).

128. *See* 15 U.S.C. § 77q(a) (2006); *see also* Langevoort, *supra* note 126, at 652 (citing Aaron v. SEC, 446, U.S. 680, 695-97 (1980)).

129. *See* 15 U.S.C. §§ 77t(e), 78u(d)(2) (2006). Professor Langevoort suggests, however, that, in all but notorious cases, the SEC generally lets off executives without great penalty and finds it easier to assess a fine against the corporation. *See* Langevoort, *supra* note 126, at 654.

130. *See* 15 U.S.C. §§ 77t(d), 78u(d)(3) (2006) (granting the SEC the power to impose three tiers of civil monetary penalties).

131. *See* 15 U.S.C. §§ 77t(b), 78u(d)(1) (2006) (granting the SEC authority to bring judicial action seeking injunctions).

132. *See* 15 U.S.C. § 77h-1(a) (2006) (granting the SEC injunction powers).

Its large Enforcement Division investigates and brings civil enforcement actions for violations of the securities laws by participants in the markets, which would include public firms.

More importantly, since the SEC's mandate is to develop and safeguard the securities markets, it addresses group and organizational misconduct and is concerned with organizational reform. Certainly, judging from corporate scandals surfacing in recent years, the SEC is not reluctant to bring enforcement proceedings against organizations on the basis of respondeat superior. The SEC seeks not only restitution for investor losses, fines, and penalties, but often requires (itself or through a corporate monitor) targeted organizations to change their governance structure, policies, and compliance procedures, among other things.[133] Indeed, the SEC's statements about the rationale for its enforcement against organizations are the best place to locate the SEC's understanding of the importance of group and organizational factors upon senior-level misconduct.

There is no better place to look than the SEC's statement on factors that it considers in determining whether to bring an enforcement action against an organization, which is known as the "Seaboard Release."[134] The SEC issued the Release in a context typical of organizational liability: the controller of Seaboard Corporation had falsified books and records of the company so that its SEC reports were materially inaccurate. Under the principle of respondeat superior, Seaboard was liable for the controller's fraud. However, the SEC determined not to bring an action against Seaboard, given its conduct in the matter. Upon learning of the misconduct, other senior executives had immediately informed the board, launched a preliminary and then a more thorough investigation (with

133. A recent example of SEC prosecution of, and settlement with, organizations deals with the involvement of their agents in option backdating. *See, e.g.*, SEC v. Brooks Automation, Inc., Litigation Release No. 20,584 (May 19, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20584.htm; SEC v. Marvell Tech. Group, Ltd., Litigation Release No. 20,559 (May 8, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20559.htm.

134. Report of Investigation Pursuant to Section 21(a), Exchange Act Release No. 44,969, 76 SEC Docket 296 (Oct. 23, 2001). The Release dealt with an employee of the Seaboard Corporation and never in fact mentions the firm by name.

an outside law firm), fired the controller and her immediate supervisors, informed the SEC and the securities markets about the fraud, fully cooperated with the SEC investigation, and entirely revamped its financial reporting processes.[135] The SEC observed that this self-reporting, self-rectification of the problem, and cooperation saved SEC enforcement and shareholder resources.[136]

The SEC saw the Release as an opportunity to set forth the criteria that it uses in determining whether to prosecute an organization for the actions of its agents. The criteria show that the SEC's views on organizational causes of senior misconduct are out of step with the findings of the social psychology and organizational literature, mainly because the SEC considers misconduct as basically an individual phenomenon. Admittedly, some of the criteria are interesting from an organizational perspective. Under the second criterion, the SEC asks how the misconduct arose and continued, questioning whether it was "the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control of the company" and why existing compliance procedures did not prevent it.[137] Here, the SEC suggests that enforcement against an organization is justified because of a corrupt culture attributable to its leaders. This approach makes sense in organizational terms because, as we have seen, the literature emphasizes the importance of an organization's leaders in maintaining the culture of the organization. Similarly, under the third criterion, the SEC asks how high up in the organization did participation in or knowledge (or willful ignorance) of the misconduct occur and whether the misconduct was systemic and characteristic of the firm (i.e., "symptomatic of the way the entity does business") or

135. *See id.* at 296.

136. *See id.* at 297.

137. *See id.* at 298. The first criterion is the state of mind involved in the misconduct, ranging from an honest mistake to venality, which suggests that an organization would likely be liable only for reckless or intentional fraud by its agents, particularly if they misled the auditors. *See id.*

isolated.[138] Again, the suggestion is that, if leaders are involved in or condone misconduct, particularly systemic misconduct, the SEC must make the organization itself an enforcement target and reform it, if possible.

Yet, the next organizational enforcement criteria identified by the SEC, which deal with self-reporting and self-punishment, undercut the focus on organizational attributes. After asking how the misconduct was discovered and how quickly the company responded to it,[139] the SEC considers in its enforcement calculus the company's remedial actions: whether the misconduct was stopped, whether those involved still remain with the company, whether the misconduct was promptly disclosed to the public and to regulators, whether the company cooperated with regulators and law enforcement personnel, and whether it identified the losses caused and recompensed those harmed.[140] Significantly, the SEC identifies in more detail what constitutes appropriate organizational cooperation: the firm hands over to the SEC the results of its investigation, even pointing the SEC to additional violations that have come to light, and asks (and compels) its employees to cooperate with the investigation—including waiving the attorney-client privilege or other privileges it might have as to the results of internal investigations.[141]

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138. *See id.* The fourth criterion is also related since the SEC asks how long the misconduct lasted (one quarter or several years) and whether it occurred before the company went public (and thus was a basis for a fraudulent capital raising). *See id.* The fifth criterion relates to the market's judgment: a significant drop in the stock price. *See id.* Enforcement action against the organization is justified if the market judges it as an untrustworthy entity and one in need of reform.

139. *Id.* (criteria 6 & 7).

140. *Id.* at 298-99 (criterion 8). As additional criteria, the SEC evaluates whether outsiders (meaning outside directors not involved in the misconduct), assisted by law firms and forensic accountants that had not previously worked for the firm, had supervised the investigation and decided upon the remedial actions. *See id.* at 299 (criteria 9 & 10).

141. *See id.* (criterion 11). The SEC also considers whether the company adopted internal policies and controls to ensure that the misconduct will not recur. *Id.* (criterion 12). Its final criterion is whether the company is the same, or whether it has merged or come out of bankruptcy, with the implication that a transformed company should not be blamed for past faults. *See id.* (criterion 13).

On the one hand, the SEC's approach as to self-reporting and self-reform is organizationally astute insofar as it wants the company to demonstrate that it is viable because its current senior decision-makers were not involved in the misconduct. In organizational terms, this helps ensure that those most associated with the corrupt organizational culture are no longer with the firm and that new leaders can take the firm in a new cultural direction. On the other hand, the approach is weighted too much towards individual, rather than organizational, liability. As noted in the organizational literature discussion, it is unlikely that sustained and widespread misconduct in an organization, which reflects a corrupt organizational culture, is ever entirely the creation of one or a few persons, even senior executives, despite their importance in maintaining and changing an organizational culture.[142] Thus, judging whether a firm should be prosecuted primarily by whether it has investigated and expelled those directly involved in the misconduct reinforces the view that group and organizational factors are minor in misconduct. Indeed, using as enforcement criteria a firm's cooperation with regulators and law enforcement authorities—including the waiver of privileges, and pressuring employees themselves to cooperate (or be disciplined)—emphasize that the firm (the proverbial "barrel") exists completely apart from its executives and employees (some of whom may be the "bad apples" in it), which flies completely in the face of the organizational literature.

In the Release, therefore, the SEC presents a view of public firms as either housing a few bad apples, who must be identified and punished, or being entirely corrupt, almost in the realm of a criminal enterprise. Since nearly all public firms do not fall into the latter category, the result is unsatisfactory from an organizational perspective, for it means that the enforcement process will rarely focus on group, organizational, and even industry factors in misconduct. For a firm not to be prosecuted, and/or for it to reach a settlement with the SEC, it must demonstrate that new compliance policies and procedures have been adopted, and a monitor may be charged with overseeing their

142. *See supra* notes 56-60 and accompanying text.

implementation. However, while necessary, such policies and procedures are no substitute for organizational reform.

It may be that the SEC is doing the best that it can under the circumstances, considering its institutional position and resources, and it does not have a mandate to change the organizational culture of U.S. public firms. The best that it may be able to do with respect to group and organizational factors in misconduct is to leave them to a corporate monitor to address, after seeking the appointment of such for an appropriately flawed firm. More will be said on the proper role of the SEC regarding organizational reform in Part III. This section simply emphasizes that in its major pronouncement on organizational liability, the SEC shows a flawed (albeit understandable, given our cultural emphasis upon the individual) understanding of the importance of group and organizational factors in senior-level misconduct.[143]

C. *Federal Prosecution of Securities Law Violations*

To inquire into federal prosecutors' recognition of group and organizational influences on misconduct by senior decision-makers is a daunting and inherently non-promising task. The criminal law that is the focus here,

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143. The SEC recently reaffirmed this position in a statement on assessing financial penalties against organizations. *See* Press Release, U.S. Sec. & Exch. Comm'n, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), http://sec.gov/news/press/2006-4.htm. It issued the statement because of concern by firms about when it was likely to assess a large financial penalty against a firm, again on the basis of misconduct by corporate agents. The SEC observed that the penalty power, which came into effect in 1990, was intended to penalize shareholders who gained from misconduct, to deter corporations from engaging in certain kinds of misconduct, and to push corporations to adopt compliance programs. *See id.* (referring to the Securities Enforcement Remedies and Penny Stock Reform Act and to Sarbanes-Oxley's change that allowed funds from penalties to be used to recompense injured investors). Again focusing on individuals, the SEC observed that a penalty is appropriate when "responsible persons" have participated in the offense in a pervasive way, although whether they have been removed from the firm will weigh in the SEC's penalty decision. *See id.* The SEC also noted, somewhat contradictorily, that fraudulent intent and difficulty of detection of the fraud weigh in favor of a corporate penalty; if there is an extremely clever fraudulent employee, should the entire organization suffer? As in the Seaboard Release, the SEC asked whether the corporation has taken remedial steps to address the fraud (i.e., new compliance procedures) and whether it reported the offense and cooperated with the SEC and law enforcement authorities. *See id.*

which is based upon securities law violations, is voluminous because it has expanded in recent years as additional crimes have been enacted as a result of the corporate scandals.[144] Moreover, by definition federal prosecutors generally discount group and organizational influences since criminal liability is often based upon bad intent of the individual.[145] They do pursue groups of senior executives, as they do in other contexts. Indeed, a classic prosecutorial move is to prosecute less significant participants in a business scandal so that they will be "convinced" to take a reduced sentence in a plea deal in return for implicating their superiors.[146]

There is, however, an area of federal prosecution that, like the SEC's enforcement against organizations, is ready-made for the analysis of group and organizational factors in senior-level misconduct. This is the criminal liability of business organizations, which are legal persons, for securities law violations.[147] The basis for this liability is the doctrine of respondeat superior under which an employer is liable for the tortious acts of its employees that are done in the course of the employer's business or that otherwise

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144. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 906, 116 Stat. 745, 806 (codified as amended at 18 U.S.C. § 1350 (Supp. V 2005)) (subjecting executives to criminal penalties for false certifications of the accuracy of their companies' SEC filings).

145. *See* WAYNE R. LAFAVE, 1 SUBSTANTIVE CRIMINAL LAW § 5.1 (2d ed. 2005).

146. Essentially, this has been the pattern followed in all of the corporate scandals: prosecutors go after lower-ranking executives and then, through plea deals, get them to act as witnesses against senior executives. *See* Samuel W. Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1646-47 (2007). In the most famous of such cases, Andrew Fastow, who was arguably one of the main architects of Enron's fraud, received a sentence of only six years in comparison of the 24 years given to Enron's CEO Jeffrey Skilling, because Fastow cooperated with the prosecutors. *See* Plea Agreement, United States v. Fastow, No. H-02-0665 (S.D. Tex. Jan. 14, 2004), *available at* http://news.findlaw.com/hdocs/docs/enron/usafastow11404plea.pdf. There are crimes that target group or concerted illegal activity, such as conspiracy, 18 U.S.C. § 371 (2000), wire and mail fraud, 18 U.S.C. § 1341 (Supp. V 2005), and the Racketeer Influenced and Corrupt Organizations (RICO) Act violations, 18 U.S.C. §§ 1961-63 (2000 & Supp. V 2005). *See also* 18 U.S.C. § 1349 (Supp. V 2005) (crime of attempt and conspiracy to commit criminal fraud offenses). But in these cases, the prosecutorial focus must initially be on the individual, even if he or she advances an illegal activity that is accomplished through a group.

147. The constitutionality of this liability has long been upheld. *See* N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481 (1909).

benefit the business.[148] Thus, if the agents of a business organization engage in criminal securities law violations, the organization may be criminally liable as well.[149] As in tort, where the tortfeasing-agent is liable as well as the organization, the individuals in a business firm who commit the crimes are also prosecuted for their actions.[150] Naturally, a business firm cannot be imprisoned, but it can be significantly fined.[151] Not only might the fines be massive enough to threaten an organization's continued existence, but a business firm may be prohibited from engaging in certain regulated activities and may suffer significant reputation damage from the fact of an indictment against it—whether or not the firm is eventually convicted.[152]

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148. *See* RESTATEMENT (THIRD) OF AGENCY § 2.04 (2006).

149. *See N.Y. Cent.*, 212 U.S. at 495-96. *See generally* Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 474-76 (2006). Scholars have contended that organizational criminal liability under respondeat superior is extremely broad and federal prosecutors have considerable discretion in applying it. *See* Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 877-79 (2007); *see also* John Hasnas, *Ethics and the Problem of White Collar Crime*, 54 AM. U. L. REV. 579, 598-99 (2005) (stating that prosecutors can attribute "group" intent to an organization through a doctrine that considers that an organization has the collective knowledge of its members). Although an organization may be criminally liable, moreover, it does not have all the rights of an individual defendant. For example, it has no Fifth Amendment right against self incrimination. *See* Hale v. Henkel, 201 U.S. 43, 74 (1906), *overruled in part by* Murphy v. Waterfront Comm'n of N.Y. Harbor, 378 U.S. 52 (1964).

150. In fact, it is rare to have a situation where the firm is prosecuted, but not the individuals.

151. *See* 18 U.S.C. § 3571(c) (2000) (specifying fines for organizations guilty of securities fraud). Nearly one-third of all criminal convictions of an organization involve fraud and, of those convicted of fraud, nearly all receive a fine and/or restitution. U.S. SENTENCING COMMISSION, SOURCEBOOK OF FEDERAL SENTENCING STATISTICS tbls.51-52 (2006), *available at* http://www.ussc.gov/ANNRPT/2006/SBTOC06.htm. The average restitution is $1,538,826 and the average fine is $4,693,861. *Id.* at tbl.52.

152. This was the case with Arthur Andersen, even though its criminal conviction was overturned by the U.S. Supreme Court. Arthur Andersen LLP v. United States, 544 U.S. 696 (2005). *But see* Buell, *supra* note 146, at 1664-66 (questioning evidence on the drastically adverse effects of an indictment of the firm). For an example of collateral consequences of criminal indictment of firms, see 15 U.S.C. § 78o(b)(4)–(6) (2006) (suspension of broker-dealer as a result of criminal conviction).

As a result of the corporate and financial scandals at the turn of the century, federal prosecutors have particularly pursued business organizations.[153] Yet, rather than indicting a public firm and taking it to trial, federal prosecutors frequently defer prosecution or do not charge the corporation at all—a deferred or non prosecution agreement—provided that the firm agrees to certain undertakings.[154] The DOJ's policies with respect to organization prosecution (and decisions to defer or not to undertake it) should help reveal its views on group and organizational causes of senior-level misconduct, much in the same way that the Seaboard Release did for the SEC.[155] Yet, a brief review of these policies, which is undertaken

153. Indeed, in July 2002, the DOJ formed, at the direction of President George Bush, a Corporate Fraud Task Force to respond to the corporate scandals. Exec. Order No. 13,271, 67 Fed. Reg. 46,091 (July 9, 2002), *available at* http://www.usdoj.gov/dag/cftf/execorder.htm; *see also* CORP. FRAUD TASK FORCE, FIRST YEAR REPORT TO THE PRESIDENT iii (2003), *available at* http://www.usdoj.gov/dag/cftf/first_year_report.pdf. The renewed focus upon the prosecution of business firms dates from that period. For a history of this prosecution and the background to the prosecutorial policies to be discussed below, see Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095 (2006).

154. *See* CORP. CRIME REP., CRIME WITHOUT CONVICTION: THE RISE OF DEFERRED AND NON PROSECUTION AGREEMENTS (2005), *available at* http://www.corporatecrimereporter.com/deferredreport.htm; Lawrence D. Finder & Ryan D. McConnell, *Devolution of Authority: The Department of Justice's Corporate Charging Policies*, 51 ST. LOUIS U. L.J. 1 (2006); Candace Zierdt & Ellen S. Podgor, *Corporate Deferred Prosecutions Through the Looking Glass of Contract Policing*, 96 KY. L.J. 1 (2007-2008) (discussing a way to address current absence of limitations on prosecutorial discretion with respect to these agreements); *see also* Garrett, *supra* note 149, at 919-35 (reviewing federal prosecution of business organizations that results in non prosecution and deferred prosecution agreements, and arguing that this activity is subject to little oversight from the judiciary or from anyone else).

155. Moreover, prosecutorial policies are significant, for, as is well known, federal prosecutors decide to prosecute cases for various reasons; they cannot prosecute all offenses by individuals or organizations. *See* U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL, PRINCIPLES OF FEDERAL PROSECUTION § 9-27.220 (2002), *available at* http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/27mcrm.htm#9-27.220 (listing grounds whereby federal prosecutors may decline to prosecute: no substantial federal interest, subject to prosecution by another authority, and adequate non-criminal alternative to prosecution); *id.* § 9-27.230(A) (discussing federal interest issue); *id.* § 9-27.250 (discussing non-criminal alternatives). The guidelines for prosecuting business organizations are built upon these principles.

below, shows them to pay little attention to these causes. In fact, the policies have been controversial primarily because of the way in which organizational prosecution, or the threat of this prosecution, has been used by federal prosecutors to make a business firm a significant tool in the prosecution of its culpable directors, officers, and other employees.[156] If, as appears to be the case, federal prosecutors use the prosecution of business organizations in this way, they show that, in their view, misconduct of senior decision-makers is primarily an individual, rather than a group or organizational, matter.

1. *Sentencing Guidelines for Organizations.* Before examining the most recent federal prosecutorial policies concerning business organizations, it is necessary to refer briefly to the U.S. Sentencing Guidelines, which have a chapter on organizational liability and sentencing.[157] By all

156. It is not necessary for me to describe in detail this development, which has produced considerable practitioner and academic debate, although I shall mention aspects of it below. For a description of federal prosecutors' "coercion" of business organizations to facilitate prosecution of employees and the debates concerning it, see Elkan Abramowitz & Barry A. Bohrer, *White Collar Crime: Waiver of Corporate Attorney-Client and Work Product Protection*, N.Y. L.J., Nov. 1, 2005, at 3; ABA TASK FORCE ON ATTORNEY-CLIENT PRIVILEGE, REPORT TO THE ABA HOUSE OF DELEGATES ON AUDIT ISSUES (2006), http://www.abanet.org/buslaw/attorneyclient/materials/hod/0806_report.pdf; ABA PRESIDENTIAL TASK FORCE ON ATTORNEY-CLIENT PRIVILEGE, REPORT TO THE ABA HOUSE OF DELEGATES ON EMPLOYEE RIGHTS 9 (2006), http://www.abanet.org/buslaw/attorneyclient/materials/hod/emprights_report_adopted.pdf; *see also* Buell, *supra* note 146, at 1618-22. In his article, Professor Buell (a former Enron prosecutor) takes a pro-prosecutor position that there may well be justifications for, and not a wholesale rejection of, some of the pressures that federal prosecutors place on business organizations in this context.

157. *See* U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2008), *available at* http://www.ussc.gov/2008guid/CHAP8.pdf. It appears that the discussion in an earlier version of the Guidelines about determining the appropriate sentence for corporations, and particularly about probation, influenced the DOJ's approach to the *prosecution* of business firms. That is, the DOJ adopted a probationary approach to business firms, if they wished to avoid prosecution. This resulted in the deferred and non prosecution agreements whereby firms were overseen for a set period of time, generally by a compliance monitor. *See* Finder & McConnell, *supra* note 154, at 3-7. The Guidelines were amended in 2004, primarily as a result of the Sarbanes-Oxley Act, which required them to be enhanced to address, among other things, organizational criminal liability. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 805, 116 Stat. 745, 802 (2002)

accounts, this chapter, which was the foundation for the prosecutorial policies and was added in 1991, provides the grounds for the imposition of a sentence on an organization that is criminally liable. As in all parts of the Guidelines, the chapter guides the sentencing judge's discretion by enabling him or her to calculate an appropriate sentence through first establishing a base offense level and then adjusting it upward or downward as a result of factors dealing with the offense, its effects, and the offender. The Guidelines observe that the fine—the main form of punishment of an organization—is determined by the "seriousness of the offense," defined in terms of pecuniary gain acquired from it, pecuniary loss caused, or otherwise determined by the Guidelines, and then enhanced or reduced by, respectively, aggravating or mitigating factors.[158] The mitigating factors are "(i) the existence of an effective compliance and ethics program; and (ii) self-reporting, cooperation, or acceptance of responsibility."[159]

The factor of an effective compliance and ethics program is promising from an organization perspective because it would appear to reward an organization for having an appropriate organizational culture, and thus underscore its significance in preventing individual misconduct. Indeed, under the Guidelines, this program should encourage personnel to "exercise due diligence to prevent and detect criminal conduct" and "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."[160] This means that the organization has compliance standards and procedures, the company's board is knowledgeable about and exercises oversight over the program, at least one member of "high-level personnel" (i.e., a director, officer, or senior executive) is directly responsible for it, and there is an adequate compliance staff operating the program and reporting to the high-level personnel and the board about the program and its effectiveness.[161] In addition, an

(reviewing federal sentencing guidelines for obstruction of justice and extensive criminal fraud, clarifying 28 U.S.C. § 994).

158. U.S. SENTENCING GUIDELINES MANUAL ch. 8, introductory cmt.

159. *Id.*

160. *Id.* § 8B2.1(a).

161. *See id.* § 8B2.1(b)(1)-(2).

effective program requires that an organization exclude from authority positions individuals who have recently engaged in illegal or unethical actions, conduct regular training in the program for everyone in the organization, monitor compliance with the program and regularly evaluate its effectiveness, provide for confidential reporting of legal and ethical violations, have a compensation structure that rewards compliance with the program and disciplines noncompliance, appropriately respond to criminal misconduct, including modifying the program as a result, and conduct periodic assessments of risks of criminal conduct in the organization and modify the program to address them.[162] In sum, for this mitigating factor to apply, ethics and legal compliance must be part of the fabric of the business organization.

In contrast to this mitigating factor that focuses on characteristics of the organization in an organization's sentencing, other factors look to individuals. With respect to aggravating factors, the Chapter recommends enhancing the culpability for a large firm (one with more than 5,000 employees) if a director, officer, or senior executive participated in the misconduct (or condoned it or was willfully ignorant of it),[163] or if tolerance of the offense by supervisory personnel or persons with discretion in the firm was pervasive in the organization.[164] The rationale appears to be that this misconduct reveals the lack of the necessary professional management in the large business firm.[165]

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162. *See id.* § 8B2.1(b)(3)-(7), (c).

163. Condoning means that "the individual knew of the offense and did not take reasonable steps to prevent or terminate the offense." *Id.* § 8A1.2 cmt. n.3(e). Being willfully ignorant means that "the individual did not investigate the possible occurrence of unlawful conduct despite knowledge of circumstances that would lead a reasonable person to investigate whether unlawful conduct had occurred." *Id.* § 8A1.2 cmt. n.3(j).

164. *See id.* § 8C2.5(b)(1). For smaller organizations, the enhancement to culpability is less on account of this participation. *See id.* § 8C2.5(b)(2)-(5). Pervasiveness is measured, again, by the involvement of high-level and supervisory personnel; it takes fewer instances of such involvement by a senior executive to make the tolerance pervasive. *See id.* § 8C2.5 cmt. n.4.

165. The following quotation from the commentary to this part of the Guidelines underscores the importance that the Guidelines place upon an organization's management with respect to the amount of its liability:

Moreover, the mitigating factor of an effective compliance and ethics program is not available if a high-level person or a significant unit in the organization participated in the offense, or condoned it, or was willfully ignorant of it.[166] The message here is that, since professional, law-abiding, and ethical high-level management is a necessary organizational characteristic for the public firm, its absence is a reason for enhancing, or at least not mitigating, the firm's criminal sentence.

The other significant mitigating, or aggravating, factor deals with the organization's cooperation in the prosecution of the individuals engaged in the misconduct. The organization's culpability is enhanced if it willfully obstructed justice, or assisted in another's obstruction, or failed to take steps to prevent such, all which could be

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> *The increased culpability scores under subsection (b) are based on three interrelated principles. First, an organization is more culpable when individuals who manage the organization or who have substantial discretion in acting for the organization participate in, condone, or are willfully ignorant of criminal conduct. Second, as organizations become larger and their managements become more professional, participation in, condonation of, or willful ignorance of criminal conduct by such management is increasingly a breach of trust or abuse of position. Third, as organizations increase in size, the risk of criminal conduct beyond that reflected in the instant offense also increases whenever management's tolerance of that offense is pervasive. Because of the continuum of sizes of organizations and professionalization of management, subsection (b) gradually increases the culpability score based upon the size of the organization and the level and extent of the substantial authority personnel involvement.*

See id. § 8C2.5. The culpability enhancement is reduced if a firm has a compliance program, but only if no supervisory personnel were involved in the violations or if there was no unreasonable delay in reporting the offense to authorities. *Id.* § 8C2.5(f).

166. There is a rebuttable presumption of ineligibility if a lower ranking executive did the same. *Id.* § 8C2.5(f)(3)(B). Participation by high-level personnel in the misconduct also raises the likelihood of probation for the firm if the high-level personnel have been convicted of a similar criminal offense in the preceding five years. *Id.* § 8D1.1(a)(5). Probation for the firm, which, for a felony, can run from one to five years, includes supervision by the court, regular inspection by and reporting to a court and a probation officer, and establishment of an effective legal compliance and ethics program. *Id.* § 8D1.2-.4.

understood to be assistance to the culpable individual(s).[167] By contrast, its sentence would be reduced if it reported the offense to authorities, cooperated with government investigation and prosecution, and acknowledged its own responsibility for the misconduct.[168] As in the Seaboard Release, this focus on organizational cooperation in the prosecution of its members reviews a perspective on misconduct as being due to "bad apples." Although there will certainly be situations where this is the case and where an organization that opposes and cooperates in the prosecution of individual misconduct should not be held criminally liable for it, the organizational literature tells us that the more common situation will be where the organization and groups within it contribute to this misconduct. The structure of the Guidelines, however, encourages organizations, when faced with criminal liability, to deny their responsibility (i.e., to assert that they are not "bad barrels") by joining with the government in the prosecution of individuals, especially senior decision-makers, because the organizations cannot rely upon the mitigating factor of an effective compliance program in this case. This focus on individual culpability, rather than organizational responsibility and reform, becomes acute in federal prosecution of business organizations.

2. *DOJ Approach on Prosecuting Organizations.* The Sentencing Guidelines laid the foundation for federal policies on prosecuting organizations for the actions of their agents. These policies became important at the turn of the century as a result of the corporate scandals, which involved violations of the federal securities laws. Like the guidelines, these policies encourage prosecutors to view organizations as either irremediably flawed (a rare

167. *See id.* § 8C2.5(e). *See generally* Hasnas, *supra* note 149, at 627 ("But the Guidelines do much more than merely discourage organizations from mounting a defense to charges brought against it as a corporate entity. To a great extent, they turn organizations into an auxiliary in the prosecution of its employees as individuals.").

168. This generally means pleading guilty to any charges. *See* U.S. SENTENCING GUIDELINES MANUAL, § 8C2.5(g). As the Commentary states, "A prime test of whether the organization has disclosed all pertinent information is whether the information is sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct." *Id.* § 8C2.5 cmt. n.12 (italics omitted).

outcome) or irrelevant to the misconduct of the senior decision-makers. An organization demonstrates to prosecutors that it falls into the second category—an outcome in fact desired by the prosecutors—by assisting them in going after individuals in the organization. Accordingly, the prosecutorial policies downplay that an organization generally contributes to senior-level misconduct.

This perspective is demonstrated by the most recent prosecutorial guidelines, known as the McNulty Memorandum after its author.[169] The Memorandum first

169. *See generally* Memorandum from Paul J. McNulty, Deputy Attorney Gen., to Heads of Dep't Components and U.S. Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf [hereinafter McNulty Memorandum]. Basically, the Deputy Attorney General who headed the DOJ's Corporate Fraud Task Force established guidelines for the prosecution of business organizations. The first set was known as the Thompson Memorandum after its author, and was the most controversial since it emphasized that a firm had to cooperate with prosecutors to avoid prosecution and that this cooperation included waiving important privileges, including the attorney-client privilege and work product, and refusing to advance defense expenses to targeted firm employees and directors. Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't Components and U.S. Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm [hereinafter Thompson Memorandum]; *see also* Memorandum from Robert D. McCallum, Jr., Acting Deputy Attorney Gen., to Heads of Dep't Components and U.S. Attorneys (Oct. 21, 2005), *available at* http://lawprofessors.typepad.com/whitecollarcrime_blog/files/AttorneyClientWaiverMemo.pdf. Before the formation of the Task Force, there were DOJ policies on prosecuting organizations, which the subsequent guidelines built upon. *See* Memorandum from Eric H. Holder, Jr., Deputy Attorney Gen., to All Component Heads and U.S. Attorneys (June 16, 1999), *available at* http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html. The McNulty Memorandum replaced, and was issued in response to the widespread dissatisfaction with, the Thompson Memorandum. This latter Memorandum was strongly criticized in a case involving the prosecution of former partners of the accounting firm, KPMG, which entered into a deferred prosecution with the government. *See* United States v. Stein, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) (indictment against certain KPMG employees dismissed because of violations), *and* 435 F. Supp. 2d 330, 364-66 (S.D.N.Y. 2006) (prosecutors' conduct, based upon the Thompson Memorandum, constituted a violation of the employee's Sixth Amendment right to counsel), *and* 440 F. Supp. 2d 315, 333-37 (S.D.N.Y. 2006) (conduct coerced their Fifth Amendment right against self-incrimination). For a general discussion of the evolution of these memoranda, see Crystal Joy Carpenter, Comment, *Federal Prosecution of Business Organizations: The Thompson Memorandum and Its Aftermath*, 59 ALA. L. REV. 207 (2007); Daniel Bolia, McNulty Machine-Guns the Thompson Memo: Death or Just a Flesh Wound? (Mar. 22, 2007) (unpublished manuscript, on file with author), *available at* http://ssrn.com/abstract=980482.

offers what appears to be a valuable organizational perspective, providing as its initial principle that prosecuting corporations can change corporate culture, alter corporate conduct, and punish and deter white collar crime.[170] The Memorandum reasonably observes that organizational liability is rarely a substitute for individual criminal liability, for federal prosecutors must always prosecute the individuals in business organizations if there is evidence of their culpability.[171]

The Memorandum lists the factors for prosecutors to consider in determining whether to prosecute an organization. Several of these factors focus on organizational characteristics: "the pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation of, the wrongdoing by corporate management" (factor 2), "the corporation's history of similar conduct" (factor 3), disclosure of the wrongdoing and cooperation in the investigation (factor 4), pre-existing compliance programs (factor 5), and a corporation's remedial actions (factor 6).[172] It observes that an indictment of an organization is appropriate where misconduct is widespread in the organization, and condoned by

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For a criticism that the McNulty Memorandum fails to provide any real compliance guidance to corporations, see Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1055-60 (2008).

170. McNulty Memorandum, *supra* note 169, at 2. The commentary to this principle observes that prosecution of a business firm can have a massive deterrence by altering corporate conduct in an entire industry as well as the culture and conduct of a particular targeted firm. *Id.*

171. *See id.* This policy is different from the prosecutorial approach that predates the recent orientation discussed in note 168, which approach was to allow corporations to protect their employees in some cases often by taking the blame for them (i.e., paying a fine). The Memorandum also sets forth the theoretical basis for corporate liability, the theory of respondeat superior, and explains that, for organizational liability, the agent must be acting in the course of employment and, at least partly, for the benefit of the corporation. *Id.* at 2-3. This agent activity that makes an organization liable is as sensitive an area in criminal liability as it is in torts because an agent may be acting against the policies of the firm, but may be still benefiting the firm by his or her actions, which would justify prosecution of the firm. *See* RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006). For example, if executives engage in fraud to keep a company's stock price high, they may be acting against the company's policies, but for its benefit, because it may need a high price to maintain its credibility in the capital markets.

172. McNulty Memorandum, *supra* note 169, at 4.

management, even if the instances of individual misconduct are not great.[173] This points to the DOJ's astuteness, from an organizational studies' perspective, of recognizing that there may be a corrupt corporate culture that fosters widespread misconduct, even if the Memorandum does not spell out the relationship in theoretical terms, and that the involvement of management, either in, or in the acquiescence of, the misconduct, is critical to maintaining this culture.[174]

Certainly, firms with pervasive misconduct should be prosecuted, and put out of business, but the problem is that such firms are likely to be few in number. The Memorandum thus highlights factors that allow the firm to escape liability where it is not irremediably corrupt. As in the Sentencing Guidelines, the existence of an effective corporate compliance program is critical in this regard. After observing that, as a legal matter, the existence of such a program, which aids in the detection of individual misconduct, does not relieve an organization of liability,[175] the Memorandum points out that its existence weighs against an indictment of the organization if it is effective in deterring and revealing misconduct, as opposed to being "window dressing" that has no effect on the actual operations of the firm.[176]

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173. *Id.* at 6. The Memorandum acknowledges that there might be collateral consequences (i.e., harm to innocent employees or shareholders) from prosecution of the firm, and these consequences weigh against this prosecution. But it explains that organizational corruption may be so widespread in the firm that these consequences have little significance in the prosecution decision (and that, in fact, the firm should be put out of business). *See id.* at 16-17. The DOJ also considers whether it should defer to regulators like the SEC to punish an organization. *See id.* at 17.

174. *See id.* at 6. This perspective agrees with the emphasis that organizational research places upon the importance of management in defining an organization's culture. *See supra* Part II.C. Admittedly, the DOJ oversimplifies the relationship between management and corporate corruption, as if it were unidirectional: culture is not entirely a creation of management, but a collective creation. In a related point, the Memorandum reiterates that a history of misconduct also points to a corrupt corporate culture, which is in agreement with the organizational literature. McNulty Memorandum, *supra* note 169, at 6-7.

175. *Id.* at 12-14.

176. *Id.* at 14 ("Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed and implemented in an effective manner. In addition, prosecutors

But, what if the compliance program has not been as effective, as where senior executives prevented its use to detect their own misconduct? Again, as in the Sentencing Guidelines, the Memorandum points out that the corporation's only course of action is disclosure of the misconduct and cooperation in the investigation.[177] Cooperation here includes the controversial actions, mentioned above, of requiring the firm to waive the attorney-client and work product privileges.[178] The firm

should determine whether the corporation has provided for a staff sufficient to audit, document, analyze, and utilize the results of the corporation's compliance efforts. In addition, prosecutors should determine whether the corporation's employees are adequately informed about the compliance program and are convinced of the corporation's commitment to it."). On this point, the Memorandum relies upon Delaware corporate law jurisprudence that requires independent directors of companies to have an adequate supervisory system providing them with information about officers' and other employees' compliance with firm policies and the law. *See, e.g., In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

177. It justifies such disclosure and cooperation on the ground that prosecutors need the disclosure and cooperation to understand the complexities of the corporation's organization and decision-making. McNulty Memorandum, *supra* note 169, at 7. The emphasis on cooperation first appeared in the Thompson Memorandum. *See* Wray & Hur, *supra* note 153, at 1102-03. Firms may willingly cooperate and self-disclose because, once a criminal problem is revealed, these are the few actions that they can take to affect the prosecutors' discretion. Firms cannot affect other factors considered by the prosecution. *See id.* at 1171.

178. In response to the controversy, the Memorandum sets up a more formal procedure for when a prosecutor can ask for a waiver: the federal prosecutor must have a "legitimate need" for the desired information in order to seek a waiver, which also means that the prosecutor cannot obtain the information elsewhere without the waiver, the company's voluntary disclosure is incomplete, and the collateral consequences of a waiver to the corporation are not significant. McNulty Memorandum, *supra* note 169, at 8-9. It counsels prosecutors, when seeking a waiver, first to request purely factual information (Category I) as to the underlying violation (e.g., copies of key documents, witness statements, and factual summaries by company counsel), which "may or may not be privileged." *Id.* at 9. If obtaining this information requires a corporation to waive attorney-client privilege or work product protection, the prosecutor must receive the approval of the local U.S. Attorney, who must consult with the Assistant U.S. Attorney General for the Criminal Division in granting it. *Id.* A corporation's failure to comply with this demand for the waiver can be considered as non-cooperation with the investigation. *Id.*

escapes prosecution by handing over, and assisting the federal prosecutors in the prosecution of, culpable

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Only if this factual information is inadequate for investigative purposes can the federal prosecutor seek attorney-client communications or non-factual work product (e.g., legal advice given to the corporation, or legal determinations made by counsel as to an investigation) (Category II). *Id.* at 10. To request a company to divulge this information, which request should be made only in "rare circumstances," the applicable U.S. Attorney must obtain the written authorization of the Deputy Attorney General. *Id.* If the corporation refuses to waive its privileges, this refusal may not be considered in the prosecutor's decision whether to charge the firm, although the prosecutor may take into account, as cooperation, the corporation's willingness to waive. *Id.* Of course, a corporation may voluntarily cooperate with the investigation and provide privileged information without any government request. *Id.* at 11.

It remains to be seen whether the McNulty Memorandum will satisfy the critics of the Department of Justice's prosecutorial policies with respect to business organizations. A bill was introduced into the U.S. Senate to protect the attorney-client privilege and attorney work product, among other things, by prohibiting prosecutors from using waiver of the privilege or disclosure of work product as a factor in a charging decision. Attorney-Client Privilege Protection Act of 2007, S. 186, 110th Cong. (2007). For the companion bill in the U.S. House of Representatives, see H.R. 3013, 110th Cong. (2007). If enacted, the bill would bar many of the federal prosecutorial practices that criminal defense attorneys have found objectionable (e.g., essentially prohibiting a corporation from sharing information with a charged employee).

Moreover, to forestall legislation on the subject, the Deputy Attorney General has recently stated that the McNulty Memorandum will be further modified to address the concerns of critics. Letter from Mark Filip, Deputy Attorney Gen., to Senators Patrick J. Leahy and Arlen Specter (July 9, 2008), *available at* http://www.gibsondunn.com/publications/documents/filipletter070908.pdf. Among other things, it will reflect that a corporation's cooperation is measured by the timely disclosure of facts about the misconduct, not its waiver of attorney-client or work product privileges. *Id.* at 2. Prosecutors also cannot demand the Category II information (i.e., privileged information) as a condition of a corporation's receiving cooperation credit. *Id.* In addition, prosecutors will no longer consider whether a corporation has advanced attorneys' fees to targeted employees in deciding whether it has cooperated with prosecutors. *Id.* at 3. A corporation's cooperation will also not be evaluated in reference to whether it has entered into a joint defense or similar agreement with other persons (although prosecutors may ask the corporation not to disclose sensitive information about the investigation to others) and to whether it has retained or disciplined the employees in question (although its actions with respect to the latter will be relevant to an evaluation of its remedial measures and compliance program). *Id.* Moreover, after completion of this article, the DOJ revised its corporate charging policies in line with Filip's explanation. *See* Press Release, Dep't of Justice, Justice Department Revises Charging Guidelines for Prosecuting Corporate Fraud (Aug. 28, 2008), *available at* http://www.usdoj.gov/opa/pr/2008/August/08-odag-757.html.

individuals.[179] The firm shows that it has repaired itself by having disciplined, and generally expelled, the employees involved, no matter how senior,[180] and by accepting responsibility, changing its compliance practices, and offering restitution to those harmed by its practices.[181]

Thus, the structure of the Memorandum, as that of the Sentencing Guidelines, is to compel a business organization to align itself with the federal prosecutors against the targeted individuals as a way of demonstrating that it is not the kind of completely corrupt organization deserving of prosecution. But, this emphasis serves to shift attention to individual responsibility for misconduct and away from any attention to, and exploration of, the organizational factors that contributed to the misconduct. The Memorandum acknowledges that a firm might need a complete organizational reform, and it explains that this should be part of a plea agreement (if a decision to charge has been made).[182] But even here the focus is not on the substance of the reform as on the prosecution of individuals, when the Memorandum asserts that a plea agreement generally cannot be a substitute for an indictment of the individuals involved.[183]

The reality of prosecutions of business organizations reflects the substance of the Memorandum. Organizations are rarely prosecuted, and when they are, the prosecution has been used primarily as a way to reach individual violators in an organization. After the backlash to the prosecution of Arthur Andersen, federal prosecutors go out of their way to avoid the collateral consequences of organizational prosecution by entering into deferred

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179. The message is that accused individuals should not be retained in, nor assisted in their defense by, the firm. McNulty Memorandum, *supra* note 169, at 11-12. As a result of *United States v. Stein*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007), the DOJ did have to acknowledge that it was proper for firms to agree beforehand to indemnify employees for litigation expenses, and to advance them defense costs.

180. *See* McNulty Memorandum, *supra* note 169, at 15.

181. *Id.* at 16.

182. These plea agreements were originally advocated by the Thompson Memorandum. *See* Wray & Hur, *supra* note 153, at 1103-05.

183. McNulty Memorandum, *supra* note 169, at 18-19. This again has its origin in the individualized focus of the Thompson Memorandum. *See* Wray & Hur, *supra* note 153, at 1106.

prosecution or non-prosecution agreements with firms.[184] As a result of these agreements, organizations cooperate in the prosecution of their former executives and employees and continue their organizational life. Organization reform is stipulated in these agreements, which generally involves the appointment of new executives, and a commitment to take responsibility for the harm caused and to enhance compliance and control procedures. Generally, a corporate monitor is appointed for several years to supervise the reform.[185] Organizational research would agree that new leaders and enhanced compliance will aid in the creation of an appropriate corporate culture. However, if the prosecutorial focus is so much on individuals, one suspects that the organizational reform is superficial, for it involves what organizational studies tells us are the least effective in creating an ethical culture—formal procedures and oversight by an outsider. A flawed corporate culture is likely to persist in a firm in the absence of any in-depth attention to the organizational causes of the misconduct.

D. *Taking Stock of Legal Approaches*

The above targeted review of relevant laws and of their enforcement and prosecution reveals that, by and large, group and organizational causes or factors are given little attention in corporate law jurisprudence, and by the SEC and federal prosecutors in securities law enforcement. Corporate law jurisprudence, the basis for public firm governance, all but closed off its most promising avenue of inquiry in the duty of good faith. Federal securities laws reflect that disclosure is a group product and in their enforcement of these laws against organizations the SEC recognizes the significance of an organizational culture in senior-level misconduct. But, the SEC uses the threat of organizational liability to reach individual bad actors, particularly high-level decision-makers, in the firm. Federal criminal prosecution of business firms takes this approach to the extreme. Prosecutorial policies on charging

184. *See* Finder & McConnell, *supra* note 154, at 16-17.

185. *See* Garrett, *supra* note 149, at 908-910; Wray & Hur, *supra* note 153, at 1138-43. For an examination of the history and features of corporate monitors, see Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713 (2007).

organizations, themselves based on organizational sentencing guidelines, are written with individual liability in mind, with the reform of organizations as an afterthought. Once again, in organizational parlance, the legal emphasis is on "bad apples" rather than "bad barrels."

What accounts for this resolutely individualistic focus in the law and its enforcement with respect to senior decision-maker misconduct? While no complete answer can be given here, it is fair to say that this legal outcome is over-determined by numerous factors. From a purely psychological standpoint, this focus is another example of a common human tendency to attribute complex social events or phenomena—such as a massive corporate fraud—to decisions or actions by individuals.[186] The U.S. culture also makes "natural" an individualist explanation of misconduct, as well as good conduct, including in business organizations.[187] Moreover, as noted previously, the dominant view of conduct within business organizations is that individuals, who are rational profit maximizers, alone matter and that a business is a hierarchy of individuals. From this perspective, misconduct requires an appropriate punishment of culpable individuals that will also deter other rational individuals who may be tempted to engage in similar misconduct.[188] In this context, it makes perfect sense—and it is a goal that can be achieved—for the SEC

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186. This is known as the fundamental attribution error. *See* BROWN, *supra* note 21, at 169-94 (quoting Lee Ross, *The Intuitive Psychologist and His Shortcomings: Distortions in the Attribution Process*, *in* 10 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 173 (Leonard Berkowitz ed., 1977)); HASLAM, *supra* note 26, at 48; PFEFFER, *supra* note 4, at 129-30; Ashforth & Anand, *supra* note 62, at 37.

187. Indeed, the essentially highly individualist Judeo-Christian religious traditions common in American society have no doubt added their weight to this individualist perspective. This point about the connection between religion and capitalist business, which is so prevalent in the United States, was made long ago by Max Weber. *See* MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM 155 (Talcott Parsons trans., 1958).

188. *See supra* note 51. It is interesting that even the "founder" of agency theory, Michael Jensen, arguably feels that the economic approach has been taken too far in business organizations and has been used to justify excessive benefits for executives and financiers. *See* Michael C. Jensen, *Putting Integrity into Finance Theory and Practice: A Positive Approach*, (Harvard NOM Research Paper No. 06-06, April 15, 2006), *available at* http://ssrn.com/abstract=876312.

and federal prosecutors to pursue the "responsible" individuals.

To show how culturally ingrained this individualist perspective on senior-level misconduct is, imagine one alternative. Serious high-level misconduct occurs in a business organization, which the SEC and/or federal prosecutors pursue à la Arthur Andersen. The entire organization is punished, which includes those actively involved in the misconduct, those who, like superiors and members of the immediate offenders' groups, knew about and acquiesced in it, and those who, whatever their positions, had no knowledge about or responsibility for it. Justifications could be offered for this widespread punishment: from this Article's social psychological and organizational perspective, group and organization members contributed to the misconduct by being part of the group and organization mindset or culture, at the very least.[189] Yet, this approach is jarring and seems primitive, almost tribal, since one is punishing a group for the faults of a few.[190] SEC enforcement personnel and federal prosecutors take this approach only in unusual circumstances where a business organization is seen to have been organized for corrupt purposes (e.g., is a front for the Mafia or a drug cartel) and thus it can be presumed that all the individuals involved in it are corrupt.[191]

Accordingly, the dominant legal—as well as business or even societal—approach to senior-level misconduct in business organization is the "bad apples" one: the direct malefactors are prosecuted, as are executives (if they are not the same) for their lack of supervision over those

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189. From one social psychological perspective, working in a corrupt organization might be seen to have an indelible influence upon the individual's social identity, thus necessitating the widespread punishment. *See* John M. Darley, *Social Organization for the Production of Evil*, 3 PSYCHOL. INQUIRY 199, 208-11 (1992) (arguing that socialization to evil occurring in a firm can irreparably corrupt individuals). To be frank, I have adopted this kind of approach in the past. *See* Fanto, *supra* note 11, at 502.

190. Indeed, social psychologists suggest that this approach is often taken when ingroup members consider actions towards members of an outgroup. *See* HASLAM, *supra* note 26, at 30.

191. The approach of the Sentencing Guidelines in this case is to impose a large enough fine on the organization essentially to put it out of business. *See* U.S. SENTENCING GUIDELINES MANUAL ch. 8, introductory cmt. at 487 (2008).

involved in the misconduct. The law (i.e., the SEC and federal prosecutors) assumes that other organization members who are not directly involved in the misconduct will go on as before, although often with new leaders.[192] To the prosecution of certain individuals and the replacement of leaders are added organizational reforms, but this just means that the organization must adopt reformist policies and procedures, statements of value, and ethics codes, and enhance its compliance and monitoring. If the misconduct was particularly serious, or if there is some continuing suspicion about past leaders who remain in place, an outside monitor may be appointed for a limited period to ensure that the organization's members, particularly its leaders, do not return to their old ways.[193] This formal and surface reform, however, does not take the group and organizational causes of misconduct seriously.

III. ENHANCING SOCIAL PSYCHOLOGICAL AND ORGANIZATIONAL SOPHISTICATION

The current state of affairs in corporate and securities law, as discussed in the preceding Part, should be reformed to reflect the group and organizational causes of senior decision-maker misconduct. There are reasons for this reform. As noted at the beginning of this Article, it is inequitable for senior decision-makers, in the absence of something like intentional fraud on their part, to shoulder most of the punishment for organizational practices and culture that are not their creation.[194] Although organizational researchers see senior decision-makers as having a significant role in defining the culture of their

192. This view is reinforced by the social psychological tendency not to blame individuals for their failure to act, but only for their acts. *See* JONATHAN BARON, THINKING AND DECIDING 200-201 (3d ed. 2000) (describing the "omission bias").

193. A good example here is Bristol-Myers, where a monitor was appointed because of organization corruption at a senior level. Ultimately, the monitor removed the CEO and chief legal counsel on account of new misconduct by them. *See* John Carreyou & Barbara Martinez, *Board Members at Bristol-Meyers Told to Fire CEO*, WALL ST. J., Sept. 12, 2006, at A1. This is reminiscent of what was done with Germany and Japan in World War II (and even Iraq today): new leaders watched by occupying monitors took over and no effort was made to condemn all individuals in the defeated countries.

194. *See supra* Part I.

firm, given the hierarchical setting of U.S. business, they believe that it is mistaken to attribute this culture and any misconduct arising from it entirely to these individuals.[195]

This may be a difficult justification for reform, given the excessive compensation of senior executives in public firms.[196] In fact, they are the paragons of the self-interest ideology: they demonstrate how the ideology encourages individuals to set no bounds to their acquisitiveness. Moreover, as noted earlier, they face insignificant risks of personal liability, whether under corporate law or even securities law enforcement and federal prosecution, even though at times individual executives became scapegoats for an entire organizational scandal. In other words, why should we be concerned if, to take only one example, Jeffrey Skilling, former CEO of Enron, took more blame for Enron's scandal than he deserved?[197] This small risk of extraordinary liability goes hand in hand with the extraordinary compensation. Indeed, to make an argument for decreasing the liability or prosecution risk for senior executives would be to participate in the current movement to roll back Sarbanes-Oxley for their benefit.[198]

Rather, the more convincing justification for reform has to be organizational and social, not individual. The basic argument is that, unless the law recognizes the group and organizational factors in senior-level misconduct, organizational reform will be superficial and will not address the culture and practices that contributed to the misconduct. Without a more socially and organizationally sensitive reform, misconduct will resurface in an organization, despite the existence of new leaders. This

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195. *See supra* Part II.B.1.

196. For a general discussion of executive compensation and market failings that lead to its excessiveness, see LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

197. Skilling was sentenced to 24 years and four months in prison. *See* John R. Emshwiller, *Skilling Sentenced to 24 Years in Prison for Role in Enron Collapse*, WALL ST. J., Oct. 23, 2006. Andrew Fastow, its former CFO and arguably the architect of the fraud, received a sentence of only six years in prison and two years of community service, primarily because he cooperated in the prosecution of Skilling.

198. On this movement, see James Fanto, *A Social Defense of Sarbanes-Oxley*, 52 N.Y.L. SCH. L. REV. 518 (2007/08). Admittedly, the voices for this reform have fallen silent during the financial crisis now gripping the country.

Part thus considers the possibilities of reform within the legal areas already examined and the impediments to it. The analysis also considers the problem posed in each legal area by the larger issue of the self-interest ideology.

A. *Abandoning All Hope for Corporate Law Reform*

As discussed earlier, Delaware corporate law jurisprudence shut off the most promising development for recognizing group and organizational factors: the duty of good faith. One could certainly spend time speculating about how this duty could be expanded to impose an obligation upon a member of a group or organization for its flawed dynamics, if they result in damage to the corporation. For the board member, this could mean that he or she would be responsible for dysfunctional board dynamics, for example, one that routinely accedes to a dominant leader, even if the board otherwise satisfies its duty of care to make informed decisions. Even more generally, a revised duty might demand that a board member have reasonable grounds for believing, not only that the corporation have legal and ethical compliance codes and policies, but also that the organization have in fact an appropriate culture to deter misconduct. This would require directors to be informed about and to monitor organizational practices, not simply to rely upon compliance systems.

It is questionable whether it is worthwhile, although it is interesting, to engage in this speculation if it is unlikely—which is the case—that the Delaware courts will ever go along with this jurisprudential suggestion. What are the reasons for this pessimism? As noted earlier, the Delaware courts reflect business reality in their jurisprudence and are reluctant to offer any perspective that runs against it. Despite the legal structure of corporate governance, these courts recognize that, in reality, directors are secondary to executives and especially to the CEO. They are thus reluctant, under the rubric of good faith or otherwise, to find directors liable for anything to do with the firm. Moreover, the courts have learned their lesson from *Smith* about expanding liability for directors; the state legislature is ready to reverse this kind of decision by

changing the law.[199] Furthermore, as noted throughout this article, legal responsibility for corporate affairs ultimately reflects a culture that espouses individual responsibility. Thus, courts focus their jurisprudential analysis upon the conduct of an individual executive, as opposed to a group within the firm or the firm itself, when misconduct occurs because this focus seems "just right" to them (and to us).

Self-interest also plays a role as, to put it crassly, Chancery Court judges do not want to jeopardize the lucrative "Of Counsel" or other positions with a corporate law firm in Delaware or New York that await them once they leave the bench.[200] As noted previously, the application of the self-interest ideology is nuanced because it is self-fulfilling: when individuals are formed in it, they model their conduct upon it so as to create the necessary psychological harmony between their views and conduct. Delaware judges and justices were themselves trained in this ideology and, as frequent guest speakers at elite law schools, have this training reinforced by the law and economics model that dominates business law scholarship at these schools and that is squarely built upon that ideology.[201] It is no surprise, then, that they apply the ideological model in their jurisprudence and in their professional lives.

In addition, a main assumption of this Article is that human beings have social and organizational identities as well. Thus, any innovations in the Delaware corporate law jurisprudence must be in line with these identities of the judges. The Delaware legal community, of which they are

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199. That is, they understand that the state legislatures will quickly move to protect the corporate establishment. Moreover, there is always the threat that corporations will move their legal seat from Delaware if its laws are unduly burdensome to the corporate elite. On these issues, see Mark J. Roe, *Delaware's Competition* (Harvard Public Law, Working Paper No. 49, 2008), *available at* http://papers.ssrn.com/abstract=354783.

200. For example, the well-known former Chancellor of Delaware, William T. Allen, is a law professor at New York University and Of Counsel to the law firm, Wachtell, Lipton, Rosen & Katz, the premier law firm defender of the corporate establishment. *See* Wachtell, Lipton, Rosen & Katz, http://www.wlrk.com (follow "Attorneys" hyperlink; then follow "View by Name" hyperlink) (last visited Dec. 5, 2008).

201. As a demonstration of this, one has simply to note the presence of law and economics centers or institutes at the "top" law schools (e.g., Harvard, Yale, Columbia, and Stanford).

among the chief representatives, values the preeminence of Delaware law for public corporations and the law's current approach, which is ultimately based upon a non-interference with business arrangements and perspectives.[202] Under social identity theory, the judges are leaders of this community and thus prototypical of it. Therefore, their legal views are highly constrained and they will be unlikely to acknowledge a model that looks beyond the individual to social and organizational factors in misconduct.

B. *The Promises and Limitations of Securities Law and SEC Enforcement*

What about federal securities law and SEC enforcement? Although here reform to recognize group and organizational factors is more promising than in the case of corporate law, serious limitations exist.[203] Congress is reluctant to make being a public company more costly at a time when the U.S. capital markets are perceived to be losing out to international competition.[204] Even in dire circumstances—which are those of today—law reform directed at public companies will likely have an individual

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202. On the corporatist mentality of the Delaware judiciary, see Lawrence A. Hamermesh, *Panel Three: Sarbanes-Oxley Governance Issues: The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006).

203. Although it has not been the focus of the Article, little can be expected from private securities lawsuits. As noted above, courts have rejected doctrines, such as scheme liability and group pleading, which would acknowledge that fraud is a group or organizational product and which, if implemented, might encourage directors and executives to take responsibility for their groups and organizations with dysfunctional dynamics that condone, or are engaged in, misconduct.

204. On current complaints about how federal securities laws are hurting our capital markets, see, for example, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT 5 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf. *See also* COMM'N ON THE REGULATION OF THE U.S. CAPITAL MARKETS IN THE TWENTY-FIRST CENTURY: REPORT AND RECOMMENDATIONS 6–7 (2007), *available at* http://www.uschamber.com/publications/reports/0703capmarketscomm.htm (follow "Download the full report" hyperlink); SUSTAINING NEW YORK'S AND THE U.S.' GLOBAL FINANCIAL SERVICES LEADERSHIP 13–17 (2007), *available at* http://www.nyc.gov/html/om/pdf/ny_report_final.pdf (report commissioned by New York City mayor Michael R. Bloomberg and Senator Charles E. Schumer). Again, these voices have fallen silent during the current crisis.

focus, as was the case in Sarbanes-Oxley with its punitive measures against CEOs.[205]

The SEC's enforcement and other powers are more promising with respect to reforms dealing with group and organizational factors. The SEC could highlight group and organizational causes of senior-level misconduct in its enforcement actions, which could be a forum to raise these issues as well as the kind of group and organizational reform needed to address the misconduct. Since the SEC can pursue organizations in these actions, it could place equal emphasis on organizational reform through settlements or judgments as upon prosecuting individual bad actors. Now the focus is on an organization's assistance in the investigation of employees; the SEC hands off organizational reform to the limited term corporate monitor who has an often superficial mandate. The SEC could insist upon a more thorough organizational reform as a condition to settlement: one thinks of the all-encompassing institutional reform undertaken by the corporate monitor in WorldCom, where even executive compensation contracts needed the monitor's approval and the monitor made an effort to produce an entirely different kind of organization.[206]

Moreover, the SEC might even bring the issue of organizational reform to the forefront in its market regulation activities, particularly in company disclosure. Although the SEC's jurisdiction over companies primarily involves their disclosure to the securities markets, it is well recognized that, as a result of this disclosure and Sarbanes-Oxley's enhancement of its powers, it has indirect jurisdiction over companies' corporate governance and organization. To take only one example of possible reform, the SEC now requires public companies to disclose whether they have legal compliance programs and ethical codes—

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205. *See generally* James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 859, 890-95 (2006).

206. *See* RICHARD C. BREEDEN, RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. (Aug. 2003), *available at* http://www.thedirectorscollege.com/images/downloads/Breeden Report Restoring Trust.pdf (describing the policies of creating a new organization).

and if they have no such code, they must explain why.[207] At the very least, it could introduce disclosure requirements about the effectiveness of these programs and codes in creating an organizational culture that deters misconduct, as opposed to just disclosure about their existence. This approach would be in line with the SEC's introduction of more qualitative, principles-oriented disclosure in company disclosure and thus would be familiar to companies.[208] Certainly, the SEC would have to give guidance to companies on this disclosure so that it would require them to do more than offer the kind of empty platitudes about ethical conduct that they provide now in annual reports and to demonstrate the effectiveness of their policies with reference to actions and results.[209] The SEC now provides for this kind of "results" disclosure when it requires companies rapidly to disclose and discuss amendments to or waivers of their codes of ethics as to executive officers.[210] As it does for any new item of disclosure, through the rule-making process it would engage in a dialogue with the stock

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207. *See* 17 C.F.R. § 229.406 (2008); *see also* Sarbanes-Oxley Act of 2002 § 406, 15 U.S.C. § 7264 (2006). Although the SEC imposes only disclosure requirements, stock exchanges make the codes mandatory. *See, e.g.*, N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.10 (Nov. 3, 2004), *available at* http://www.nyse.com/regulation/listed/1182508124422.html.

208. For example, it recently revised the entire approach to executive compensation disclosure, with the purpose of having companies discuss, in a new Compensation Discussion and Analysis section of an annual report, their overall policies on and approach to executive compensation. *See* 17 C.F.R. § 229.402(b)(1)(vi) (2008) (requiring company to discuss "[h]ow each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements"); Executive Compensation and Related Party Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006).

209. Again, this is the goal of the reforms to the executive compensation disclosure: to link actual compensation decisions and results to policies and principles.

210. They must make this disclosure on Form 8-K, which is for disclosure of special events and which must be filed within four business days of the occurrence of the event, or on the company's web site in the same time frame. *See* Form 8-K, General Instructions B.1 & Item 5.05, *available at* http://www.sec.gov/about/forms/form8-k.pdf (last visited Dec. 5, 2008).

exchanges, companies, and other interested parties to develop this disclosure.[211]

Yet, recently the pendulum has swung against SEC organizational enforcement, leaving it to focus upon "bad apples" and to use the threat of organizational liability to enlist the organization in this task.[212] As in the case of the Delaware judiciary, the SEC and its staff face personal, social, and organizational pressures that militate against a reform that would recognize group and organizational factors in misconduct. Again, many of its members accept the self-interest perspective on business institutions and conduct, living as they do in the financial world; this is part of their own social and organizational identity. It is completely natural for them, moreover, to use their expertise to move into the private sector and not to want to be known for having radical views on business and financial organizations, which would impede this movement.[213] In addition, there are institutional obstacles for the SEC to champion broad organizational reform. It is, after all, an agency of limited resources, which are not even enough for it to pursue the numerous "bad apples" operating in the investment markets. As noted earlier, the SEC also faces

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211. Moreover, the SEC also regulates firms, such as broker-dealers and investment advisers, and has direct powers over their governance and organizational structure. With the help of the self-regulatory organization for broker-dealers, the Financial Institution Regulatory Authority (FINRA), for example, it could develop and mandate substantive reforms to address organizational culture, and these reforms could serve as models for public companies. On the extent of the SEC's and FINRA's regulation of broker-dealers, see generally POSER & FANTO, *supra* note 49, at 4-1 to 4-51.

212. This retreat is exemplified by an SEC decision to require the Commission itself to pre-approve the range of financial penalties that could be sought in settlement by the Enforcement Division in an action against a particular public corporation, as opposed to its previous policy of allowing that Division to propose the appropriate settlement. *See* Christopher Cox, Chairman, SEC, Address to the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *available at* http:/www.sec.gov/news/speech/2007/soch0412-2cc.htm.

213. A notorious example of this involves the SEC's investigation of John Mack, now CEO of Morgan Stanley, for insider trading. The SEC investigator was deterred by senior SEC staff members from pursuing the investigation and ultimately fired. One of the senior staff members sought a position with the law firm for Mack's counsel at the same time. *See* STAFF OF S. COMM. ON FIN. & S. COMM ON THE JUDICIARY 110TH CONG., THE FIRING OF AN SEC ATTORNEY AND THE INVESTIGATION OF PEQUOT CAPITAL MANAGEMENT 28 (Comm. Print 2007).

the constant concern about the continuing viability of the U.S. capital markets. This concern is emotionally charged because it suggests that the status quo of U.S. dominance in this sector is being lost.[214] Finally and significantly, there is the issue of expertise and competence: if SEC Commissioners and staff have competence in any disciplines, these are accounting, finance, and business law—the latter with its law and economics foundation—not in social psychology, organizational studies, and related fields that provide a basis for the necessary reform.

C. *Reform of Organizational Prosecution*

Finally, reform of federal criminal prosecution of public companies and senior-level decision-makers that is based upon securities law violations is at once both problematic and necessary. It is problematic because requiring prosecutors to consider social and organizational factors in misconduct runs counter to the entire orientation of criminal law that prosecutors apply, which is built upon individual mens rea. If, moreover, the SEC is limited in its resources and competence to conduct meaningful organizational reform, the same is even truer for the DOJ and federal prosecutors, which have no mandate to oversee the operation of business organizations and whose prosecutorial resources cannot reach even all individual violators. Furthermore, politicians, the media, and the general public, all subject to the fallacy of attributing complex problems to individuals, put considerable pressure upon prosecutors to identify and to punish *individuals* responsible for corporate and financial scandals. And, of course, the self-interest of prosecutors will always tempt them to accede to this pressure by making a reputation, which can be translated into financial and political rewards, for instigating notable prosecutions of senior executives.[215]

But, the answer is not to abandon organizational criminal liability. To do so would be to reaffirm that senior-level misconduct is only a matter of "bad apples." If, as is

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214. *See supra* note 204.

215. The most notable example is Rudolph Giuliani, who parlayed his position as a U.S. Attorney who prosecuted business crimes into a political career. *See generally* DANIEL FISCHEL, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION 98-102 (1996).

clear, organization and group factors contribute to this misconduct, it is necessary that they be addressed.[216] Organizational criminal liability must be maintained because it is societal acknowledgement of this social and organizational truth and because it is one of the few tools that allow society, through prosecutors and regulators, to address group malfunctioning and pathological organizational culture.[217]

Clearly, however, the way organizational prosecution is currently conducted has to change. Strong arguments can be made that businesses need to cooperate in the prosecution of individual executives and others.[218] However, using prosecution of the organization only to reach individuals in it may injure the organization itself, as employees lose faith in the organization to represent their interests.[219] That is, an organization that joins with

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216. *See, e.g.*, Ashforth & Anand, *supra* note 62, at 39 (contending that a corrupt organization needs a complete overhaul by outsiders, for corruption will have become so much part of the routine that those in the organization often do not even see their behavior and attitudes as corrupt).

217. This position contrasts with that of scholars who wish, for varying reasons, to abolish or to limit organizational liability. *See, e.g.*, Hasnas, *supra* note 149, at 631-55 (arguing that organizational liability makes no sense under the standard liberal justifications for criminal liability and that it often forces an organization to act in unethical ways); Ellen S. Podgor, *A New Corporate World Mandates a "Good Faith" Affirmative Defense*, 44 AM. CRIM. L. REV. 1537 (2007) (arguing that the new emphasis on corporate criminal liability requires that corporations be allowed a defense that they acted in good faith in setting up and maintaining a compliance program); Hamdani & Klement, *supra* note 9 (contending that, where organizational liability would have serious collateral consequences, prosecutors should make special efforts to prosecute only the individuals responsible). For references to standard criticisms about organizational liability, see Buell, *supra* note 149, at 475 nn. 8-14. Professor Buell makes an argument related to mine insofar as he contends that organizational prosecution is necessary because the "blaming" function of it helps to transform organizations.

218. Professor Buell convincingly contends that this cooperation is necessary in light of the fact that fraud in large organizations is difficult to detect and to understand. *See* Buell, *supra* note 146, at 1625-27.

219. Professor John Hasnas makes this point forcibly, arguing that corporate compliance programs and cooperation with prosecutors mandated by the Sentencing Guidelines and prosecutorial guidelines like the McNulty Memorandum run counter to organizational research as to the best ways of deterring unethical and illegal behavior, such as making people identify with the organization. *See* John Hasnas, Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics 13-21 (Georgetown Public Law

prosecutors only in order to avoid being itself prosecuted undermines the confidentiality, trust, and openness of its employees. Moreover, if the prosecution of an organization results in a deferred or non prosecution agreement with a fine, surface compliance changes, and a monitor to oversee the implementation of policies and codes, it presents only superficial reform without ever reaching the fundamentals of organizational behavior that led to the misconduct.[220] As organizational theorists have observed, having a weak ethical program may be worse than having none at all.[221]

Accordingly, reforming an organization cannot be treated as an afterthought in federal prosecution of organizations. It makes sense for the DOJ to continue its current policy of preferring deferred or non prosecution agreements to organizational prosecution and conviction, for it is impossible as a practical matter in our culture to put "innocent" employees out of work from this prosecution and conviction. However, it is possible for the DOJ and federal prosecutors to give more importance to organizational reform in their agreements with organizations. For reasons of its lack of institutional

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Research Paper No. 1020101, 2007), *available at* http://www.ssrn.com/sol3/papers.cfm?abstract_id=1020101.

220. This conclusion is underscored by the DOJ's recent "formalization" of its corporate monitor policy, which was done in response to criticisms that the DOJ was appointing former U.S. Attorneys to these lucrative positions. On these criticisms, see Steven R. Peiken, *New Guidelines for Corporate Monitors*, N.Y. L.J., Mar. 27, 2008, at 4. This memorandum lists principles that should be followed in the appointment and conduct of monitors (several of them are designed to address the issue of former DOJ officials receiving these appointments). Memorandum from Craig S. Morford, Acting Deputy Attorney Gen., Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations (Mar. 7, 2008), *available at* http://www.usdoj.gov/dag/morford-useofmonitorsmemo-03072008.pdf. The third principle, in particular, observes that the primary purpose of the monitor is to ensure compliance with that part of the agreement dealing with the recurrence of misconduct in the corporation. Although the monitor is not empowered to investigate past misconduct (fourth principle) and his or her appointment is limited in duration to ensuring that the firm has rehabilitated itself (eighth principle), the monitor is to report previously undisclosed misconduct or new misconduct to the government (seventh principle) and can in fact communicate separately with the government at its discretion (fifth principle). In other words, while separate from the DOJ, the monitor is, for all practical purposes, a DOJ representative who must keep his or her eyes open for misconduct, rather than a specialist in organizational reform.

221. *See* Tenbrunsel et al., *supra* note 71, at 304.

competence and limited resources, the DOJ would not be expected to enhance or to develop its own role in this reform.[222] When prosecuting, and arriving at settlements with, organizations with respect to securities matters, it generally works together with the SEC's Enforcement Division. The DOJ could add its support, through coordinated settlements, to reforms proposed by the SEC, which, as discussed in the previous section, is better situated to propose responses to industry-wide and firm specific practices that contributed to the senior-level misconduct.[223] A settlement responding to prosecution, moreover, helps rehabilitate the organization in the eyes of society by having it publicly acknowledge its wrongs, accept appropriate punishment, and undertake reform.[224] Yet, the nagging problem of what constitutes appropriate organizational reform and who has the competence to propose it remains, even if the DOJ and the SEC can be lined up behind it.

D. *The Role of Social Psychologists and Organizational Scholars*

A central problem for appropriate reform is that, for the most part, social psychology and organizational learning are at the periphery of business law scholarship in the United States and thus not well known to legal practitioners. It is little wonder, then, that the SEC and the DOJ do not recognize group and organizational factors in

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222. *Cf.* Treviño et al., *supra* note 56, at 146-47 (contending that, given their disciplinary focus, lawyers are not particularly well suited to design and manage an appropriate compliance and ethics program and that this role belongs to someone with operational responsibilities).

223. *See* Wray & Hur, *supra* note 153, at 1186-87.

224. *See* Michael D. Pfarrer et al., *After the Fall: Reintegrating the Corrupt Organization*, 33 ACAD. MGMT. REV. 730 (2008) (presenting a theory of this reintegration based upon legitimacy theory, i.e., that, to be reintegrated, an organization must recover its legitimacy, and explaining that, to do this, the organization must pass through four stages: (1) revealing the wrong, (2) explaining it, (3) receiving punishment, and (4) rehabilitating itself as well as dealing with certain factors (e.g., salience of the organization, repeated violations) that could retard or stop altogether the reintegration); *see also* Anand et al., *supra* note 44, at 20-21 (concluding that this kind of reintegration can generally be accomplished in a seriously flawed organization only through the intervention of an external party).

senior-level misconduct nor use social psychological and organizational literature in thinking about organizational reform. One has only to contrast this situation with the influence of economics and financial economics. Not only are economists on the SEC's staff, but financial economists follow closely financial regulation (read broadly to mean legislation and agency rules) and its enforcement and their work often inspires the SEC staff and prosecutors.[225] Moreover, law professors in the business and financial areas are conversant with the work of financial economists, and do similar research themselves, and thus their own direct and indirect dialogues with legislators and regulators reinforce the economic perspective. But these disciplines have little to say about group and organizational factors in misconduct, given that they are built upon a rational actor model.

How can this situation be remedied? Certainly, law professors in business and financial law could become familiar with the relevant social psychological and organizational research and suggest how it can be used in law and regulation pertaining to organizational reform. That approach is obviously the goal of this Article, which is part of a trend of organizationally-influenced scholarship.[226] However, it should be recognized that this trend must overcome group and organizational factors in business law scholarship. That is, as noted above, those with an economic and financial economic orientation control the discipline's

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225. The most notable recent example of this contact concerns stock option backdating, which led to numerous SEC enforcement actions and federal prosecutions. *See supra* notes 30, 133. The investigation into this practice was started because of an article by a financial economist. *See* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).

226. For an example of this alternative approach, see James A. Fanto, *Corporate Misbehavior by Elite Decision-Makers Symposium: Perspectives from Law and Social Psychology*, 70 BROOK. L. REV. 1165 (2005) (symposium designed to promote conversations between social psychologists, organizational scholars, philosophers, and law professors). *See also* The Business Firm as Social Entity at Brooklyn Law School's Center for the Study of Law, Language and Cognition, http://www.brooklaw.edu/centers/cognition/ (last visited Dec. 5, 2008) (an online course/resource to be used in law schools, among other places, to promote the use of social sciences, other than economics, in business law studies). For a similar approach to organizational corruption that also proposes to alter the orientation of the SEC and the DOJ, see David Hess & Cristie L. Ford, *Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem*, CORNELL INT'L L.J. (forthcoming 2008).

research agenda and dominate its hierarchy and, like all groups, seek to reproduce themselves at the expense of scholars with other perspectives, particularly approaches based upon disciplines that are in a contentious relationship with economics.

Yet law professors, who are, with a few exceptions, not social psychologists or organizational theorists, cannot alone undertake the work of promoting organizational learning and translating it into policy guidance for legislators and regulators. Researchers in these disciplines have to bring their knowledge of group and organizational factors in senior-level misconduct (and other subjects, such as the design of organizational reform) to the forefront, which means making connections with the legal academy that can prove useful in translating the knowledge into law and regulations. In other words, they must compete with economists and financial economists in public policy debates over regulation of business and finance. All too often, however, by all reports they have been reluctant to be assertive in bringing their learning to the public and have even allowed economists to dominate the institutions (i.e., the business school) where they work.[227]

In the short term, to the extent possible legal scholars in business and financial law have to bring social psychological and organizational research to the legal policy debates, and even to urge scholars in these fields to be directly involved in on-the-ground corporate reform as well. An example of this application would be the organizational reform of a corporation where a major scandal occurred and where the firm itself is the target of federal criminal prosecution and SEC enforcement. The current practice of a deferred prosecution agreement and appointment of a corporate monitor could be continued; a monitor need not be an organizational studies professor, any more than he or she should be a former prosecutor. But just as monitors engage management consulting firms, accounting firms, and law firms to help them perform their appointed tasks of revising a firm's business, financial, and accounting practices, they should have the power to engage in serious organizational reform and be allowed to appoint an

227. I owe this insight to Professor John Conley of the University of North Carolina law school, who is a law professor and a trained anthropologist.

organizational expert to study the group and organizational factors that contributed to the misconduct and to make recommendations that would eliminate them. Certainly, if there is a demand for their expertise, organizational scholars will be forced onto the public stage and may even begin to form consulting arrangements with the DOJ and the SEC that will help them translate their knowledge into practical applications. Their involvement in actual institutional reform will stimulate further organizational research, as well as give support to, and inspire, related legal scholarship.

This kind of involvement of organizational scholars is necessary in order to overcome resistance to the application of organizational knowledge and research. Organizational change based on this research is difficult now because organizational practices have become embedded.[228] As one of the most well-known organizational scholars recently observed, organizational research has shown that many current organizational practices are ineffective and in fact make firms less profitable than they could be had the research been followed and the practices modified. Asking himself why firms had not adopted the better practices, the scholar observed that, since these practices were based upon assumptions about human conduct that were in conflict with the self-interest model, executives could not imagine implementing them, because they simply refused to believe that people acted in any way other than in accordance with the accepted model.[229] In a similar way, if organizational scholars propose reforms to firms to address organization and group factors that led to misconduct and if, as is likely to be the case, they base their reforms on perspectives on human thinking and conduct other than the self-interest model, their proposals will undoubtedly encounter resistance. Giving them an official role in the reform and requiring monitors to use their suggestions would help overcome the embedded resistance.

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228. *See* Misangyi et al., *supra* note 68, at 757-58.

229. *See* Jeffrey Pfeffer, *Human Resources from an Organizational Behavior Perspective: Some Paradoxes Explained*, 21 J. ECON. PERSP. 115, 128-30 (2007).

CONCLUSION

This Article argued that laws dealing with business associations do not adequately address the group and organizational factors in misconduct by senior decision-makers of public firms. The law essentially adopts a "bad apple," rather than a "bad barrel," perspective: it considers senior-level misconduct to be essentially an individual matter, and group or organizational causes or factors to be insignificant in it. This Article contends that this approach contradicts the learning of those who study groups and organizations, social psychologists and organizational theorists. Since senior-level misconduct is often attributable to group and organizational factors, a response that focuses only upon punishing the individuals involved leaves problematic organizational attitudes and practices unaffected and makes misconduct likely to recur.

This Article first reviewed representative social psychological and organizational literature to set forth an understanding of its basic teachings about group and organizational factors in and causes of misconduct by senior decision-makers of public firms. It drew four lessons from that review. First, social psychology and organizational studies suggest that a group's mindset and organization's culture can significantly contribute to misconduct by an organization member. This lesson rests on the assumption that an individual assumes a social identity, in a work group and business organization, that orients his or her thinking and conduct (including misconduct) in that setting. Second, they emphasize the significance of the leader in perpetuating and shaping a group's mindset and an organization's culture and thus in checking or promoting misconduct. Third, how the group or organization functions clearly affects whether it contributes to, or restricts, misconduct by its members. In particular, dissent or "cognitive conflict" allows members to challenge attitudes or actions that a member feels are improper and/or may corrupt the group or organization. Fourth and finally, the group and organization must be based upon social, ethical, and legal foundations and cannot be sustainable if built only or primarily upon the self-interest of its individual members. The view from social psychology and organizational studies is that a group or organization built

upon self-interest is simply prone to unethical and illegal conduct.

This Article's targeted legal review revealed that, by and large, group and organizational causes or factors are given little attention in corporate law jurisprudence and in securities law enforcement by the SEC and federal prosecutors. Corporate law jurisprudence, the basis for public firm governance, all but closed off its most promising avenue of inquiry in the duty of good faith. Federal securities laws reflect that disclosure is a group product, and in their enforcement of these laws against organizations the SEC recognizes the significance of an organizational culture in senior-level misconduct. But the SEC uses the threat of organizational liability primarily to reach individual bad actors, particularly high-level decision-makers, in the firm. Federal criminal prosecution of business firms takes this approach to the extreme. Prosecutorial policies on charging organizations, themselves based on organizational sentencing guidelines, are written with individual liability in mind, with the reform of organizations as an afterthought. Once again, in organizational parlance, the legal emphasis is on "bad apples" rather than "bad barrels."

This Article argues that the current state of affairs in corporate and securities law should be reformed to reflect the group and organizational causes of and factors in senior decision-maker misconduct. The basic argument is that, unless the law recognizes the group and organizational factors, organizational reform will be superficial and will not address the culture and practices that contributed to the misconduct, which will likely resurface in the organization, despite any imposed reforms. After noting that, for jurisprudential and institutional reasons, there is little hope from future developments in Delaware corporate law jurisprudence, this Article contends that the SEC could highlight group and organizational factors in senior-level misconduct in its enforcement actions, which could be a forum to raise these issues as well as the kind of necessary group and organizational reform to address the misconduct. Since the SEC can pursue organizations in these actions, it could place equal emphasis on organizational reform through settlements or judgments as upon prosecuting individual bad actors. Moreover, the SEC might even bring the issue of organizational reform to the forefront in its

market regulation activities, particularly in company disclosure. This Article, however, acknowledges that the SEC staff faces personal, social, and organizational pressures that militate against this kind of reform.

This Article also argues that, while the perspective, competence, and resources of federal prosecutors impede reform, organizational criminal liability must be maintained because it is a societal acknowledgement that social and organizational factors contribute to misconduct and because it is one of the few tools that allow society, through the prosecutors, to address group malfunctioning and pathological organizational culture. It contends that federal prosecutors should continue the current policy of preferring deferred or non prosecution agreements to organizational prosecution and conviction, but should give more attention to organizational reform in them. The recommendation is that, not only should they work together with the SEC in designing these agreements, but social psychologists and organizational theorists should be enlisted in the reform, for example, by being retained as consultants by corporate monitors. This Article concludes by asserting that this kind of involvement of organizational scholars is necessary in order to overcome resistance to the application of organizational knowledge and research to the problem of senior-level misconduct and thus to push the law to go beyond the "bad apples" perspective. It has the added benefit of encouraging social psychologists and organizational scholars to enter more visibly the policy debates about the regulation of business and financial firms.