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Corporate Liability, Risk Shifting, and the Paradox of Compliance

William S. Laufer

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Corporate Liability, Risk Shifting, and the Paradox of Compliance

William S. Laufer

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The evolution of corporate criminal law is explained by the shifting risks of liability and loss between corporations and their agents in accommodating the illogic of vicarious liability. A vivid example of the effects of this risk shifting is seen with the recent emergence of the good citizen corporation movement. This movement encourages prosecutors with vast discretion to leverage indictments and convictions of subordinate agents, resort to civil and administrative actions against large and medium-sized corporations in place of criminal indictments, compromise agent indemnification, and enforce corporate self-regulation through elaborate plea agreements. Not surprisingly, organizations tend to conceive of corporate compliance, no less corporate ethics, as matters of risk management that serve an important insurance function.

Corporations that purchase only the amount of compliance necessary to effectively shift liability away from the firm encourage moral hazards. After risks are transferred, the firm's incentive to maintain high levels of care decreases. Crimes once imputed to the firm remain with "wayward" agents. Given equivocal evidence of compliance effectiveness, the rise of the good corporate citizenship movement risks undermining the objectives and spirit of the corporate criminal law.

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*William S. Laufer**

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I. INTRODUCTION

With recent criminal cases brought against some of the most respected corporations in the Fortune 500, it seems reasonable to conclude that large, publicly traded companies have become favored targets of a new breed of aggressive prosecutors.¹ Add to this the oft-repeated observation that corporations are more vulnerable than ever before to an expanded scope of criminal liability and draconian fines meted out by judges bound by restrictive federal guidelines.² These

1. Commentators often refer to the costly resolution of civil and criminal charges against large corporations as evidence of the emergence of a draconian corporate criminal law. Large, publicly traded corporations, however, are most often spared conviction and typically are routed through civil and administrative proceedings. See *infra* notes 178-94 and accompanying text. On average, small privately held businesses account for more than 95% of all corporate convictions each year. See William S. Laufer, *A Study of Small Business Compliance Practices*, in PROCEEDINGS OF THE SECOND SYMPOSIUM ON CRIME AND PUNISHMENT IN THE UNITED STATES, CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION 135 (Sept. 7-8, 1995) [hereinafter PROCEEDINGS]; William S. Laufer & Donald L. Darnell, *Corporate Compliance and the Small Firm*, WHITE-COLLAR CRIME REP., Oct. 1995, at 1, 2 (discussing the results of a U.S. Sentencing Commission-sponsored study of compliance practices of small firms).

2. Data from the United States Sentencing Commission ("Commission") are inadequate to support the conclusion that prosecutions following the passage of the Sentencing Guidelines for Organizations ("Guidelines") have resulted in an increased number of convictions with significantly higher fines. See U.S. SENTENCING COMM'N, 1996 SOURCEBOOK OF FEDERAL SENTENCING STATISTICS (1997). So, too, are studies that consider only a small subset of cases, such as sentences given to publicly held firms, e.g., Cindy R. Alexander et al., *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, J.L. &

observations and the conventional wisdom that attends them are touted along with a new corporate law gospel in practitioner conferences on the "good citizen" corporation.³

The spirit of this gospel is summed up in such catch phrases as "organizational due diligence," "corporate compliance," and "proactive" or "reactive" ethics initiatives.⁴ An elaborate cottage industry of ethics compliance and preventive law experts lay claim to dramatically reducing the likelihood of criminal liability by maintaining an organizational commitment to ethical standards.⁵ Corporations need only commit the necessary capital and human resources to insure against the devastation of a criminal investigation, indictment, and conviction.⁶ Unfortunately, the reality of corporate compliance and criminal liability is far more complex than most of these experts suggest.⁷

ECON. (forthcoming). Commentators, though, appear convinced of a dramatic rise in liability despite a lack of supporting evidence. See, e.g., Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 833 (1994) ("Both the maximum allowable criminal fines for corporate crime and the fines actually imposed on corporations have increased dramatically in the last ten years."); Kevin B. Huff, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1252 (1996) ("Corporations increasingly face the daunting spectre of being held criminally liable for the illegal acts of their employees."); Philip A. Lacovara & David P. Nicoli, *Vicarious Criminal Liability of Organizations: RICO As An Example of a Flawed Principle in Practice*, 64 ST. JOHN'S L. REV. 725, 732 (1990) ("[P]articularly in the last several decades, society has witnessed a 'sweeping expansion' of organizational criminal liability."); Dan K. Webb et al., *Understanding and Avoiding Corporate and Executive Criminal Liability*, 49 BUS. LAW. 617, 617-18 (1994) ("In the last two decades, the increase in criminal and regulatory investigations and prosecutions of corporations has been staggering.")

3. See generally CORPORATE COMPLIANCE: AFTER CAREMARK (Carole L. Basri et al. eds., 1997); CORPORATE COMPLIANCE: CAREMARK AND THE GLOBALIZATION OF GOOD CORPORATE CONDUCT (Carole L. Basri et al. eds., 1998); CORPORATE COMPLIANCE: HOW TO BE A GOOD CITIZEN CORPORATION THROUGH SELF-POLICING (Joseph E. Murphy & Gregory J. Wallance eds., 1996); JEFFREY M. KAPLAN ET AL., COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES: PREVENTING CRIMINAL AND CIVIL LIABILITY (1998).

4. For articles using these phrases, see, e.g., Huff, *supra* note 2; William S. Laufer, *Corporate Culpability and the Limits of Law*, 6 BUS. ETHICS Q. 311 (1996); Note, *Growing the Carrot: Encouraging Effective Corporate Compliance*, 109 HARV. L. REV. 1783 (1996).

5. See generally ALI-ABA, ORGANIZING FOR CORPORATE COMPLIANCE: AVOID CORPORATE LAWBREAKING THROUGH PREVENTIVE LAWYERING (1992); William S. Laufer & Diana C. Robertson, *Corporate Ethics Initiatives as Social Control*, 16 J. BUS. ETHICS 1029 (1997). For a wonderful discussion of the discovery of compliance as a growth industry, see Stuart Auerbach, *Company Lawyers in Shadows at Seminar on Crime*, WASH. POST, Oct. 16, 1977, at A4.

6. See George P. Stamas & Joanne F. Catanese, *Compliance Programs Create a Shield from Corporate Wrongs*, LEGAL TIMES, Feb. 24, 1997, at S37. See generally PROCEEDINGS, *supra* note 1.

7. See generally Steven Walt & William S. Laufer, *Corporate Criminal Liability and the Comparative Mix of Sanctions*, in WHITE-COLLAR CRIME RECONSIDERED 309 (Kip Schlegel & David Weisburd eds., 1992) (discussing the relation between liability rules and corporate sanctions); Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319 (1996); William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647 (1994) (suggesting

The first part of this Article argues that the evolution of corporate criminal law in the United States, as well as the dramatic rise of the compliance industry, is understood best by examining the shifting risks of liability and loss between corporations and their agents in accommodating the illogic of vicarious liability.⁸ Over the last century, courts have imposed joint and several liability on firms and their agents in a series of distinctly different phases.⁹ These phases range from the ideal of a shared liability risk between the firm and its agents at the turn of the twentieth century to a risk of liability and loss that has been pushed down the corporate hierarchy from senior managers to subordinate "wayward" employees.¹⁰ Throughout

how corporate culpability and liability may be reconceptualized as constructive fault); William S. Laufer, *Integrity, Diligence, and the Limits of Good Corporate Citizenship*, 34 AM. BUS. L.J. 157 (1996) [hereinafter Laufer, *Integrity*] (arguing that the Sentencing Guidelines have shifted discretion from the judiciary to prosecutors and regulators).

8. Notably, the hypotheses that guide this Article are specific to the risks and costs of corporate criminal liability. Much of the literature on commercial risks, and risks of the economic system generally, extend well beyond its scope. See, e.g., VIRGINIA HAUFLE, DANGEROUS COMMERCE: INSURANCE AND THE MANAGEMENT OF INTERNATIONAL RISK (1997). The notion of principal-agent risk shifting and sharing has been discussed at length in tort law. See generally Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); William O. Douglas, *Vicarious Liability and Administration of Risk I*, 38 YALE L.J. 584 (1929); Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 (1980). For a consideration of risk in relation to various regimes of corporate criminal liability, see Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997). Analogous issues at different levels of analysis are considered in economics. See generally FRANKLIN ALLEN & DOUGLAS GALE, FINANCIAL INNOVATION AND RISK SHARING (1994); STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987); Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981) (discussing the hypothesis that managers engage in conglomerate mergers to decrease their employment risk); Alan J. Marcus, *Risk Sharing and the Theory of the Firm*, 13 BELL J. ECON. 369 (1982) (discussing the effects of deviating from perfect risk sharing where managers make decisions for owners); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979) (discussing Pareto optimal fee schedules in relation to the risk assumed by agents and principals). For a general discussion of the reciprocity of risks, see JULES L. COLEMAN, RISKS AND WRONGS 252-69 (1992).

9. The standard of vicarious liability poses unique challenges to the administration of the criminal law. See FRED A. ADLER ET AL., CRIMINAL JUSTICE 38-39 (1994); Laufer, *supra* note 4. Its place in tort law, though, is rarely challenged. See *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 14 (1991) ("Imposing exemplary damages on the corporation when its agent commits intentional fraud creates a strong incentive for vigilance by those in a position 'to guard substantially against the evil to be prevented.'") (quoting *Louis Pizitz Dry Goods Co. v. Yeldell*, 274 U.S. 112, 116 (1927)); see also A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869 (1998). For an excellent discussion of the etiology of vicarious liability, see G. EDWARD WHITE, TORT LAW IN AMERICA: AN INTELLECTUAL HISTORY 50-55 (1980).

each period, liability risks reflect the divergent interests and risk concerns of principals and agents.¹¹

Part II concludes with a discussion of the evolution away from entity liability in the latter part of this century, an evolution underwritten through concessions offered by state and federal courts, to the strictures of vicarious liability.¹² Most of these concessions were prompted by initiatives inside the firm, such as legal strategies that shift risk of liability and loss.¹³ Organizations also have engaged in a number of initiatives outside the firm to shift corporate liability through the active lobbying of legislative bodies and law commissions.¹⁴

10. The distinction between risk shifting and sharing was described by one court as follows: "Risk shifting involves one party's shifting its risk of loss to another, whereas risk sharing involves the party onto whom risk is shifted distributing a portion of that risk among others." *Black Hills Corp. v. Commissioner*, 101 T.C. 173, 182 (1993); see also Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563 (1988).

11. See *infra* notes 60-64 and accompanying text. The discussion of agency issues in relation to criminal liability assumes that both principal and agent are utility maximizers. The usual litany of contract assumptions apply as well, such as to the importance of the equity contract, limited liability, and diversified investment portfolios as risk bearing devices for shareholders. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (discussing the importance of market and contract controls that, at least in theory, are designed to align the divergent interests of owners and managers).

12. Other sociopolitical forces have influenced corporate criminal law enforcement during this century. Edwin Sutherland, whose exposition in 1949 on "White-Collar Crime" gave the term its current meaning, wrote extensively about the shift in liability away from businesses caused by forces external to the firm. See EDWIN SUTHERLAND, *WHITE COLLAR CRIME* (1949). For a fascinating analysis of the role of politics in shaping the substantive criminal law, see generally John P. Heinz et al., *Legislative Politics and the Criminal Law*, 64 NW. U. L. REV. 277 (1969).

13. Organizations, for example, shift risks of liability entirely to agents by asking courts to reconsider the reasoning of imputing liability to an entity that has engaged in a good faith effort of organizational due diligence. Corporations have defeated the strict attribution of criminal liability by actively avoiding or eliminating risks through diligent business practices. Firms regularly provide director and officer insurance for a vast array of losses. This is not to say, of course, that courts have not contributed to evisceration of vicarious liability. Rather, the point is that firms have taken a definitive and strategic role in countering the risk of liability. For a discussion of such practices in the context of risk shifting and risk management, see generally Whitney Adams, *New Rules on Corporate Sentencing*, RISK MGMT., May 1992, at 52 (discussing the effects of the Guidelines on internal controls and risk management); George S. Oldfield & Anthony M. Santomero, *Risk Management in Financial Institutions*, 39 SLOAN MGMT. REV. 33 (1997). Risk shifting is also discussed in a host of analogous contexts. See, e.g., Benjamin C. Esty, *A Case Study of Organizational Form and Risk Shifting in the Savings and Loan Industry*, 44 J. FIN. ECON. 57 (1997); T. Harikumar, *Leverage, Risk-Shifting Incentive, and Stock-Based Compensation*, 19 J. FIN. RES. 417 (1996); Robert M. Wiseman & Anthony H. Catanach, Jr., *A Longitudinal Disaggregation of Operational Risk Under Changing Regulations: Evidence from the Savings and Loan Industry*, 40 ACAD. MGMT. J. 799 (1997).

14. See *infra* notes 43-49 and accompanying text.

In Part III, the emergence of the "good citizen" corporation movement over the past decade is discussed as the culmination of intracorporate risk shifting away from the entity and toward subordinate agents.¹⁵ Following Congressional passage of the Sentencing Guidelines for Organizations ("Guidelines") in 1991, there has been a notable shift of liability risk away from the entity, one that now reflects a risk disequilibrium between firms and their agents.¹⁶ This is attributable, at least in part, to a number of strong incentives generated by the Guidelines to push liability down to subordinate employees. The most significant incentive may be traced to the method by which culpability is determined and the way in which the effectiveness of compliance is assessed. Both are simple functions of the involvement of top management in the illegality.¹⁷

Evidence of a risk disequilibrium is seen in corporate counsel assisting prosecutors in developing criminal cases against "wayward" employees in an attempt to minimize allocation of liability to the entity; elaborate and costly compliance initiatives that result in grants of corporate amnesty or immunity by prosecutors; and compliance programs that, in the unlikely event of a settlement or conviction, are held out by corporations in an effort to significantly mitigate criminal fines and, thus, losses to the firm.¹⁸ The compliance movement encourages prosecutors and regulators with vast discretion to aggressively leverage indictments and convictions of subordinate

15. It will be argued that efforts to shift liability suggest that organizational compliance is no more than strategic risk management. See *infra* Part III.D. This view is consistent with Peter Cane, TORT LAW AND ECONOMIC INTERESTS 411-12 (2d ed. 1996) ("Risk management is 'loss prevention', or 'quality control'; it is a management or 'administrative' technique for minimizing legal liability.").

16. Christopher Stone describes the balance of risk between principal and agent as the "indemnification equilibrium." See Stone, *supra* note 8, at 46-49. For an excellent discussion of risk differentials, see generally Robert M. Wiseman & Luis R. Gomez-Mejia, *A Behavioral Agency Model of Managerial Risk Taking*, 23 ACAD. MGMT. REV. 133 (1998). For a consideration of the cost differential between principals and agents, see Kornhauser, *supra* note 8, at 1348-52; Note, *An Efficiency Analysis of Vicarious Liability Under the Law of Agency*, 91 YALE L.J. 168 (1981). In Part III, it is argued that the corporate compliance movement has given organizations a prescription for criminal law immunity. This movement was prompted by investigations of major defense contractors during the 1980s that resulted in the Defense Industry Initiative on Business Ethics and Conduct—a set of six principles drafted by the representatives from eighteen defense contractors that called for specific compliance procedures, policies, and programs, e.g., codes of ethics, ethics training, and internal reporting practices. See Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205 (1993).

17. See *infra* notes 185-86 and accompanying text.

18. See generally Edward Correia & Lee P. Breckenridge, *State Enforcement and Settlement Policies Regarding Internal Compliance Programs*, 5 CORP. CONDUCT Q. 61 (1997); Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743 (1992).

agents,¹⁹ resort to civil and administrative actions against large and medium-sized corporations in place of criminal indictments,²⁰ compromise agent indemnification,²¹ and enforce corporate self-regulation through plea agreements.²² In recent years, legal strategies relying on the Guidelines have been used by corporate counsel as both a shield and a foil to combat the near unbridled discretion of prosecutors to force the corporate hand through the initiation of parallel proceedings against the entity.²³ All of this has moved many large corporations to think of corporate compliance, no less corporate ethics, as matters of risk management.²⁴

A discussion of the effects of the divergence of interests between the firm and its risk-bearing agents on matters of compliance appears in Part IV. What was once conceived of as a necessary safeguard against the abuses of corporate power in interstate commerce, the rise of complex corporate bureaucracies, and the divergence of interests resulting from the separation of ownership and control, is now a carefully conceived and arguably overpriced form of risk management that serves an insurance function.²⁵

19. See generally Ilise L. Feitshans, *Through the Looking Glass: The Ethics of Internal Investigations by In-House Corporate Counsel*, in CORPORATE COMPLIANCE: HOW TO BE A GOOD CORPORATE CITIZEN THROUGH SELF-POLICING, *supra* note 3, at 711; Joseph E. Murphy, *Handling the Risks: How to Respond to Compliance Failures*, in ORGANIZING FOR CORPORATE COMPLIANCE, *supra* note 5, at 281; John F. Savarese & Carol Miller, *Employee Issues in Internal Corporate Investigations*, in CORPORATE COMPLIANCE: AFTER CAREMARK, *supra* note 3, at 1043.

20. See MARVIN G. PICKHOLZ ET AL., GUIDE TO WHITE COLLAR CRIME: A PRACTICAL GUIDE FOR THE CORPORATE COUNSELOR 119-25 (1986); Joseph F. Savage, Jr. & Stephanie A. Martz, *How Corporations Spell Relief: Substituting Civil Sanctions for Criminal Prosecution*, CRIM. JUST., Spring 1996, at 10.

21. See *Modern Pressures to Cooperate with Prosecutors Almost Make 'Defending a Corporation' Oxy-moronic*, Prevention of Corp. Liab. (BNA) 7 (Apr. 15, 1996).

22. See generally ALI-ABA, *supra* note 5; CORPORATE COMPLIANCE: HOW TO BE A GOOD CORPORATE CITIZEN THROUGH SELF-POLICING, *supra* note 3.

23. The strategic use of parallel civil and criminal proceedings has been discussed at length in *Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1333-40 (1979).

24. The arguments and conclusions in this Article are far more modest yet run parallel to the general debate over corporate judgment proofing. See generally Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996). LoPucki's thesis turns on the idea that businesses are increasingly using judgment proofing strategies like the exploitation of the widespread availability of credit for debtors; asset securitization; and the spreading of assets among subsidiaries. This Article advances the notion that corporations seek to immunize themselves by actively shifting liability down the firm's hierarchy using the institutionalization of ethics as preventive law and a means of internal control. Moral hazards are an unintended effect of this strategy. See *supra* notes 259-67 and accompanying text. For a devastating critique of LoPucki's thesis, see James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's The Death of Liability*, 107 YALE L.J. 1363 (1998).

25. It would be both unfair and untrue to say that only a few corporations go beyond prophylactic compliance efforts for reasons of risk management. See Laufer & Robertson, *supra*

Firms have been extraordinarily successful in shifting both the locus of liability risk and the enforcement function down the corporate hierarchy—all under the banner of corporate self-regulation and “good corporate citizenship.” Many corporations simply purchase only the amount of compliance necessary to effectively shift liability away from the firm. After risk of liability and loss is transferred, the firm’s incentive to maintain high levels of care decreases. Crimes once imputed to the firm remain with “wayward” agents. In a light most favorable to organizations, this has minimized agency costs by reducing monitoring expenditures and, over time, the bonding costs borne by agents.²⁶ In a more reasonable light, the rise of the “good corporate citizenship” movement risks the creation of moral hazards that, given equivocal evidence of compliance effectiveness, undermines the objectives and spirit of corporate criminal law.²⁷ The Article concludes with a caution about the fall of vicarious liability and the rise of the paradox of compliance, i.e., corporate compliance that targets corporate crime may yield greater individual “white-collar” deviance. Unfortunately, the solutions to this paradox are limited, requiring significant constraint of prosecutorial discretion or the discovery of reliable and valid indicators of compliance effectiveness.

II. VICARIOUS FAULT AND CORPORATE STRATEGY

The debate over corporate liability for crimes is long-standing and reveals, if nothing else, a remarkable ambivalence among scholars and jurists as to how best to convey the criminal law’s unique message of condemnation to the organizational offender.²⁸ Every so

note 5, at 1033. A significant number of surveys, however, reveal that many compliance initiatives are not integrity-based or ethics-based. See, e.g., Mark Pastin, *A Study of Organizational Factors and Their Effect on Compliance*, in PROCEEDINGS, *supra* note 1, at 175, 177-78 (observing that 86% of his sample of 660,000 employees from 203 large companies (mean number of employees per company equalled approximately 3,500) reported that the codes of conduct adopted by their corporation were “legalistic” and not effective; 69% reported that ethics hotlines were “defensive or not effective”; 51% claimed that compliance related training was ineffective; and 62% found the impact of the Guidelines to have a limited, insignificant, or negative impact on compliance efforts).

26. See *infra* notes 60-64 and accompanying text.

27. See *infra* Part III. For a review of the law as well as economics literature on moral hazards, see generally Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996); John M. Marshall, *Moral Hazard*, 66 AM. ECON. REV. 880 (1976).

28. For well-formed, consistently critical views of corporate criminal liability, see generally Jeffrey S. Parker, *Rules Without . . . : Some Critical Reflections on the Federal Corporate Sentencing Guidelines*, 71 WASH. U. L.Q. 397 (1993).

often, commentators call for its abolition or modification because the attribution or imputation of criminality to an entity has little if no theoretical foundation in extant law, or is unnecessary given other less "costly" liability regimes.²⁹

A few recalcitrant academics have never accepted the fictional attribution of blame, and in spite of extant law, question the need for a debate over such an untenable anthropomorphic abstraction.³⁰ In commenting on the fiction of corporate criminal liability, the late Professor Salmond once quipped: "Ten men do not become in fact one person, because they associate themselves together for one end, any more than two horses become one animal when they draw the same cart."³¹ The very idea that an inanimate entity may be charged with a crime has prompted many to question whether corporations are appropriately thought of as moral or legal persons.³² Consider Baron Manwood's syllogism, "[N]one can create soules but God, but the King creates them, and therefore they have no soules"³³

29. See generally Gerhard O.W. Mueller, *Mens Rea and the Corporation: A Study of the Model Penal Code Position on Corporate Criminal Liability*, 19 U. PITT. L. REV. 21, 21 (1957) ("Many weeds have grown on the acre of jurisprudence which has been allotted to the criminal law. Among these weeds is . . . corporate criminal liability. . . . Nobody bred it, nobody cultivated it, nobody planted it. It just grew."); Jeffrey S. Parker, *Doctrine for Destruction: The Case of Corporate Criminal Liability*, 17 MANAGERIAL & DECISION ECON. 381 (1996).

30. See generally John Braithwaite & Brent Fisse, *On the Plausibility of Corporate Crime Theory*, in 2 ADVANCES IN CRIMINOLOGICAL THEORY 15 (William S. Laufer & Freda Adler, eds., 1990); Donald R. Cressey, *The Poverty of Theory in Corporate Crime Research*, in 1 ADVANCES IN CRIMINOLOGICAL THEORY 31 (William S. Laufer & Freda Adler eds., 1989); V.S. Khanna, *Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea*, 79 B.U. L. REV. 355 (1999).

31. SALMOND ON JURISPRUDENCE 432 (J.L. Parker ed., 9th ed. 1937); see also George F. Canfield, *The Scope and Limits of the Corporate Entity Theory*, 17 COLUM. L. REV. 128 (1917); Harold J. Laski, *The Personality of Associations*, 29 HARV. L. REV. 404 (1916); Arthur W. Machen, Jr., *Corporate Personality*, 24 HARV. L. REV. 253, 266 (1911) ("But although corporate personality is a fiction, the entity which is personified is no fiction. The union of the members is no fiction. The acting as if they were one person is no mere metaphor. In a word, although corporate personality is a fiction, yet it is a fiction founded upon fact.")

32. See generally John J. Flynn, *The Jurisprudence of Corporate Personhood: The Misuse of a Legal Concept*, in CORPORATIONS AND SOCIETY: POWER AND RESPONSIBILITY 131 (Warren J. Samuels & Arthur S. Miller eds., 1987); Steven Walt & William S. Laufer, *Why Personhood Doesn't Matter: Corporate Criminal Liability and Sanctions*, 18 AM. J. CRIM. L. 263 (1991) (arguing that human and corporate persons are indistinguishable in law, and may be so in fact).

33. *Tipling v. Pexall*, 80 Eng. Rep. 1085, 1085 (K.B. 1614); see also *Pharmaceutical Soc'y v. London and Provincial Supply Ass'n*, 5 App. Cas. 857, 869 (1880):

I quite agree that a corporation cannot, in one sense, commit a crime—a corporation cannot be imprisoned, if imprisonment be the sentence for the crime; a corporation cannot be hanged or put to death if that be the punishment for the crime; and so, in those senses a corporation cannot commit a crime. But a corporation may be fined, and a corporation may pay damages. . . .

Cf. Donald R. Richberg, *The Imprisonment of Criminal Corporations*, 18 CASE & COMM. 527 (1912). Is there a justification for these metaphysical musings? Corporate criminal liability

For those commentators who allow for a corporate criminal liability, the question most often considered is which liability regime offers the optimal allocation of risk of financial loss and liability.³⁴ Arguments turn on matters such as cost internalization, incentive maintenance, inducing policing measures, and reducing sanction costs. The objective is singular: resolve which liability regime maximizes or enhances social welfare by minimizing the net social costs of law violation and its prevention.³⁵ Discussion proceeds as if the choice is dichotomous, a decision of entity or agent liability.³⁶ The former is considered optimal in its ability to deter, spread risks, and distribute losses.³⁷ The latter is seen by some as inefficient.³⁸ The two variables that largely determine an optimal allocation of liability include the agents' and principals' perceptions or attitudes toward bearing risk, and the relative incentives given to risk-bearing agents to avoid criminal conduct and to their principal to engage in both proactive and reactive diligence.³⁹

raises profound questions about the government's role in regulating corporations. Jurisprudential and regulatory questions are inextricably tied to some basic concerns of corporate-human equivalence and ontology raised by Salmond, Manwood, and Blackburn. The reason for this rests with the highly individualistic common law requirements of the criminal law. The individualistic nature of the criminal law has led many to ask: Should human personhood stand as an impenetrable barrier to the attribution of criminal blame? *See generally* Gilbert Geis, *A Review, Rebuttal, and Reconciliation of Cressey and Braithwaite and Fisse on Criminological Theory and Corporate Crime*, in 6 *ADVANCES IN CRIMINOLOGICAL THEORY: THE LEGACY OF ANOMIE THEORY* 399 (Freda Adler & William S. Laufer eds., 1995).

34. *See, e.g.*, Arlen & Kraakman, *supra* note 8.

35. *See id.* at 691. Professor Coffee states the objective clearly: "From this perspective, the only policy issue is how heavily the law should tax the corporation in order to induce it to monitor its agents more closely to prevent future illegality." *See* John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"? Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 *B.U. L. REV.* 193, 228 (1991).

36. *See* Arlen & Kraakman, *supra* note 8.

37. *Cf.* Arlen & Carney, *supra* note 8, at 692.

38. *See* Kraakman, *supra* note 8, at 865.

39. In order to address apparent disincentives and inefficiencies, Arlen & Kraakman, *supra* note 8, at 735, have called for mixed or multi-tiered liability regimes, incorporating aspects of the common law rule of vicarious liability and what they call "duty-based rules" derived from the Sentencing Guidelines for Organizations. Compliant firms will have a greater commitment to ethics, it is argued, now that there are both incentives to self-police and appropriate residual penalties. *See id.* Lured by the carrot of leniency, mitigation, and perhaps even amnesty from liability, organizations will develop clearly stated policies and procedures, and carefully monitor and audit employee behavior. *See id.* at 736. Where firms fail, a residual penalty will be assessed that makes the organization internalize the costs of undeterred conduct. *See id.* This shift from vicarious liability to duty-based or mixed liability regimes raises far-reaching questions of law and regulatory policy. Have courts departed from extant liability rules or have prosecutors simply exploited their broad discretion to encourage corporate admissions of guilt, voluntary disclosures, and plea agreements by holding out the prospects of a lengthy investigation, the humiliation of an indictment, and the devastation of a possible conviction? Has this prosecutorial discretion compensated for the inherent weakness and inefficiencies of vicarious liability? Did the Guidelines shift discretion from judicial to

A. Strategic Posturing

Yet absent from the scholarly consideration of human-corporate equivalence and optimal allocation of liability are references to the strategic efforts of corporate entities and employees to respond to the costs of externally imposed liability regimes.⁴⁰ In recounting the history of corporate criminal liability, for example, there is scant discussion of the internal efforts of firms to manage the risks associated with employee deviance, and the corresponding strategies of employees to shield themselves from liability for acts encouraged by top management.⁴¹ Where available, the scope of such scholarship is generally limited to enterprise liability in tort law.⁴² To understand the history of corporate criminal law, however, one must consider the emergence of vicarious liability in the context of the contemporaneous rise of related civil law doctrines, parallel liability regimes, and certain forms of insurance. This history reveals both internal and external firm initiatives to manage risks.⁴³

prosecutorial decision making? Answers to these questions, it will be argued, must consider the compliance movement as one of the last phases in a series of phases marked by shifts of liability, risk, and loss.

40. In its place, commentators debate the relative efficiency of liability regimes. See Arlen & Kraakman, *supra* note 8.

41. An explanation of this posturing, albeit reductionist, is that firms are responding to nothing more than defensive law practice by corporate counsel. This view could be bolstered by tracking the evolution of corporate law departments following the advent of corporate criminal liability. See, e.g., Joseph R. Creighton, *Corporate Law Departments Adjust to Corporate Decentralization*, 16 BUS. LAW. 1004 (1961) (discussing the unique role of corporate counsel); Richard S. Gruner, *General Counsel in an Era of Compliance Programs and Corporate Self-Policing*, 46 EMORY L.J. 1113 (1997); Arthur Sears Henning, *What a Legal Department Does*, 16 L. STUDENT'S HELPER 4 (1908) (describing how advances in commerce have complicated the practice of law in corporations); Leon E. Hickman, *The Emerging Role of the Corporate Counsel*, 12 BUS. LAW. 216 (1957) (commenting on the evolution of corporate counsel); John M. Holcomb, *Preventive Maintenance: Using Business Strategies to Reduce Corporate Liability*, PREVENTIVE L. REP., Spring 1996 at 26; Robert Eli Rosen, *The Inside Counsel Movement: Professional Judgment and Organizational Representation*, 64 IND. L.J. 479 (1989); Sylvester C. Smith, Jr., *The Changing Status of Corporate Counsel*, 35 N.Y. ST. B.J. 9 (1963); Marc I. Steinberg, *The Role of Inside Counsel in the 1990s: A View from Outside*, 49 SMU L. REV. 483 (1996) (discussing the role of counsel in shaping corporate policy and strategy).

42. See generally Kraakman, *supra* note 8. The literature considering principal and agency risk certainly does not extend from the genesis of liability through the effects of the Guidelines. This is true, as well, of general treatises on corporate criminal liability. See, e.g., CELIA WELLS, *CORPORATIONS AND CRIMINAL RESPONSIBILITY* (1993).

43. Notably, there is insignificant literature on the external initiatives of firms through the lobbying of legislative bodies and law reform commissions to avoid the criminal law, either individually, by public interest organizations, or through representative trade associations. See, e.g., Peter M. Gillon & Steven L. Humphreys, *Corporate Officer Liability Under Clean Air Act May Create Disincentives*, INSIDE LITIG., May 1992, at 6 (discussing the lobbying by labor groups that contributed to the shifting of liability onto corporate managers for criminal violations of the Clean Air Act). According to the authors:

Internal efforts to manage liability risk within firms have been and are a function of corporate strategy constrained by legal doctrine.⁴⁴ Consider Professor Christopher Stone's rendering of enterprise liability in terms of the reciprocal risk shifting.⁴⁵ According to Stone, the firm and its agents are continually shifting the risk of legally imposed losses back and forth.⁴⁶ Agents rely on an employee's indemnity to recover losses on account of agency.⁴⁷ Conversely, the firm depends on employer's indemnity to recoup losses imposed on it

The shifting of liability to corporate managers reflects a victory for labor groups who lobbied hard to exempt hourly laborers and other union members from penalties for non-compliance under the Act, even if they are responsible for a violation [T]he amendments deliberately shift liability for criminal violations of the statute away from employees at the operational level or those merely 'following orders.'

Id. See generally Simeon M. Kriesberg, Note, *Decisionmaking Models and the Control of Corporate Crime*, 85 YALE L.J. 1091 (1976), for an extensive consideration of the role of the political process in shaping liability rules. Her focus on corporate criminal liability in relation to the aborted recodification of the Federal Criminal Code is instructive. For a discussion of changing regulatory enforcement policies, see Jed S. Rakoff, *Four Postulates of White-Collar Practice*, N.Y.L.J., Nov. 12, 1993, at 3 (discussing the growing reliance on civil remedies for white-collar and corporate crimes). Consider, for example, the move by the business lobby in the late 1980s and early 1990s to influence the Commission's early drafts of the Guidelines. See, e.g., Charles-Edward Anderson, *Business Bashes Sentencing Plans: Sentencing Commission and Justice Department Release Competing Proposals*, A.B.A. J., Jan. 1991, at 30 (describing response of trade associations to proposed guidelines includes their frustration that: "Neither proposal takes into account [the situation where] a corporation has done all it can to comply with the law and just has some aberrant, low-level employee, or people who simply don't understand all the complicated new laws being thrown at corporations today."). A persistent lobby publicly attacked the proposed fine levels, asked for the incorporation of a wide range of mitigating circumstances, argued implicitly in favor of proportionately higher fines for small businesses, and sought to maintain the status quo in sentencing law so that judges, rather than prosecutors, would retain full discretion to fashion corporate sanctions. See Amitai Etzioni, *A Vote for Peer Pressure*, N.Y. TIMES, May 5, 1991, at 13. As Amitai Etzioni concluded, the final draft of the Guidelines became remarkably lenient "mainly because the commission bent to heavy corporate lobbying." *Id.* For a critical look at how the Guidelines work against the interests of large businesses, see generally Parker, *supra* note 28. Interestingly, the Sentencing Guidelines accommodate in some significant ways for firm size. For example, firm size is considered in determining a culpability score. See U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(14) (background) (1998) ("[A]s 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."). Firm size also affects the evaluation of a compliance program's effectiveness. See, e.g., *id.* at § 8A1.2(7)(i):

The requisite degree of formality of a program to prevent and detect violations of law will vary with the size of the organization: the larger the organization, the more formal the program typically should be. A larger organization generally should have established written policies defining the standards and procedures to be followed by its employees and other agents.

44. See generally Kraakman, *supra* note 8.

45. See Stone, *supra* note 8, at 45-47. For a general discussion of the reciprocity of risks, see COLEMAN, *supra* note 8, at 254-69.

46. See Stone, *supra* note 8, at 46.

47. See *id.*

through vicarious liability.⁴⁸ This results in an indemnification equilibrium, an ideal state of balance of risks governed largely by doctrinal constraints. Professor Reinier Kraakman joins Stone in accounting for the pervasive risk shifting within firms. The most powerful risk shifting tool of senior management, according to Kraakman, is the delegation of risk bearing roles, responsibilities, and policies to subordinates.⁴⁹

From the work of Stone and Kraakman, it follows that the balance of principal-agent liability risk is not static; rather, it evolves over time in two distinct directions—liability toward and away from the firm. The lesson for understanding the rise of corporate criminal liability is that firms and their owners are strategic in shifting liability and its attendant losses through the direct and derivative litigation, compliance practices that assume the form of defensive risk management, reliance on proactive legal strategies of corporate counsel, and active lobbying of governmental bodies and commissions in defense of business interests. Reflecting their own strategic interests, agents have sought methods of protecting themselves from the liability and losses that belong to the firm, e.g., indemnification.⁵⁰

Stone's writing reflects a prevailing view that risk shifting has resulted in de facto unitary liability.⁵¹ He and Professor Kraakman observe a strong trend in the balance of risks toward enterprise liability with culpable agents most often escaping the attribution of criminal liability.⁵² While this might once have been true, and may be

48. See *id.*

49. See Kraakman, *supra* note 8, at 859. Kraakman observes, "[w]hen we allow such risk shifting, what enforcement function remains for individual liability? Alternatively, when we constrain individual risk shifting and compel corporate agents to bear 'absolute' personal liability for their delicts, what enforcement advantages do we gain or lose?" *Id.*

50. See generally James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404 (1987) (arguing that managers' perceptions of risk depart from the classical conception). For an excellent discussion of agency conflicts across the corporate hierarchy, including those between managers and employees, as well as shareholders and managers, see John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 19 (1986) ("The manager, however, has no real protection against firm-specific risk and thus will be risk averse."); Steven P. Croley, *Vicarious Liability in Tort: On the Sources and Limits of Employee Reasonableness*, 69 S. CAL. L. REV. 1705, 1715 (1996) ("Firms are plagued by principal-agent problems at the level of managers and employees as well. Just as owners' and managers' interests diverge, so do managers' and their subordinates'."). The idea of agent "shirking" in the absence of sufficient monitoring or bonding was advanced recently by Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 276-77 (1998).

51. See Stone, *supra* note 8, at 46.

52. As evidence, Stone notes an erosion of the employer's indemnity action; the expansion of defenses grounded in the right of corporate officers to rely on records, reports, and opinion of counsel; and the evolution of rules relating to "business judgment." *Id.* Kraakman concludes that:

true today of the "iron law of tort,"⁵³ it fails to reflect the recent evolution and present law of corporate criminal liability.⁵⁴

B. Strategic Phases

Contrary to Stone and Kraakman's claims of long-standing unitary liability and the conventional wisdom of the birth of a new draconian corporate criminal law, I argue that the recent evolution of corporate criminal law, fashioned by the strategic posturing of corporations, has increasingly immunized firms from the risk and costs of criminal liability.⁵⁵ Nowhere is this more evident than in large corporations. There is no longer a "natural division," to use Kraakman's words, of the entrepreneurial function into risk bearing and management.⁵⁶ Further, any discussion of the risk of corporate criminal liability or the loss from such liability must account for a history dating back to the mid-1800s of active strategic risk shifting.

Over the past century, corporations became indictable persons in the criminal law as their power and influence began to affect interstate commerce in ways that overwhelmed state and federal regulatory efforts (shifting liability toward the firm). For example, firms shared liability with their agents as railroad companies and large industrials grew to dominate interstate commerce (sharing liability with agents). Next, corporations protected against losses caused by the criminal acts of employees through the purchase of fidelity insurance (shifting losses away from the firm). Firms also

The corporation typically bears the brunt of tort damages or criminal penalties arising out of the activities of its agents or employees. Except in the most serious cases, culpable corporate agents are monitored and sanctioned internally: The firm may fire, demote, or otherwise discipline managers or employees whose actions create unacceptable legal risks.

Kraakman, *supra* note 8, at 859. The most incisive of all of Kraakman's observations is his desire to see absolute liability attach to those at the apex of the corporate hierarchy—those best equipped to deflect liability. *See id.*

53. Kraakman, *supra* note 8, at 858.

54. *See generally* Joseph G. Block & Nancy A. Voisin, *The Responsible Corporate Officer Doctrine—Can You Go to Jail for What You Don't Know?*, 22 ENVTL. L. 1347 (1992); Richard I. Werder, Jr., *A Critical Assessment of Intracorporate Loss Shifting After Prosecutions Based on Corporate Wrongdoing*, 18 DEL. J. CORP. L. 35, 36 (1993) ("[D]irectors, officers, and employees are often finding themselves named as defendants in subsequent civil actions brought by or on behalf of the corporation itself and not by the victim of the corporation's crime."); Paul F. Schaaff, Jr., Note, *Indirect Criminal Conduct of Corporate Officers—Law in Search of a Fair and Effective Standard of Liability*, 13 DEL. J. CORP. L. 137 (1988).

55. This is, no doubt, an empirical claim. Evidence of the infrequency of criminal indictments and convictions against large corporations is supportive. *See infra* note 199 and accompanying text.

56. Kraakman, *supra* note 8, at 862.

sought ways to recoup losses from director mismanagement and fraud through derivative actions (shifting loss to agents). They actively shifted liability to agents as the diligent "good faith" efforts of firms were first recognized as a defense in both federal and state law (shifting liability toward agents). Later, corporations inherited liability from the indemnification of directors and high managerial agents (shifting liability toward the firm). They shifted losses directly to directors, officers, and high managerial agents through innovative derivative actions (shifting liability toward agents). Most recently, firms regained a near immunity to the criminal law as resource-capable organizations institutionalize compliance for reasons of risk management, reaping the incentives generously offered by the "good citizen corporation" movement (shifting liability toward subordinate agents).⁵⁷

For nearly a century, during many shifts of liability risk, courts and legislatures have embraced enforcement strategies, both implicit and explicit, but only one liability rule: vicarious liability.⁵⁸ The steadfast observation of this rule during periods when liability was anything but vicarious suggests that it is far less important to deliberate over optimally efficient liability regimes than it is to consider how an invariant liability rule (vicarious liability) may be countered and undermined by the efforts of corporations to manage risks. Risk management avoids the harshness of the criminal law, let alone the discretionary enforcement strategies of regulators and prosecutors.⁵⁹

57. This is not to say that the phases in the evolution of liability are exclusive. See *infra* Par I.E.

58. The application of respondeat superior to corporate criminal liability creates, in theory, joint and several liability. This liability, according to Kraakman, "holds both the firm and the agent responsible for crimes committed within the scope of the agent's employment." Kraakman, *supra* note 8, at 859. To this day, courts have left this liability rule undisturbed. Those commentators who refer to the Guidelines as creating a "dual" liability regime do so in error. See Arlen & Kraakman, *supra* note 8, at 694. The duty-based regime that allegedly has joined vicarious liability to create a dual liability is no more than an enforcement strategy. No state or federal decision, including recent board of director liability cases, acknowledges a competing liability regime. See, e.g., *In re Caremark Int'l Inc.*, 698 A.2d 959 (Del. Ch. 1996).

59. See generally Steven Shavell, *The Optimal Level of Corporate Liability Given the Limited Ability of Corporations to Penalize Their Employees*, 17 INT'L REV. L. & ECON. 203 (1997). Arlen and Kraakman miss the more significant meaning of the Guidelines' effect on vicarious liability in their effort to craft a regime that maximizes social welfare. They claim that Chapter Eight of the Guidelines "replace[s] the traditional rule imposing strict vicarious liability on the firm for its agents' wrongdoing with a 'composite' regime in which the firm incurs a reduced penalty if it has discharged certain compliance-related duties." *Id.* at 690. On the contrary, the "duty-based" scheme suggested by the commentary of the Guidelines was not intended (or should not have been intended) as a liability rule. As shall be argued in Part III, using the culpability provisions of the Guidelines as a liability rule may undermine the

Scholars wedded to agency theory and transaction cost economics explain shifting risks of liability and loss quite simply.⁶⁰ This phenomenon is further evidence of the divergent interests of principals and agents. It cannot be doubted that owners have tried to minimize the costs of opportunism and other conflicts of interests that accompany agency relationships from the rise of corporate criminal liability.⁶¹ Meanwhile, directors and managers, as undiversified risk bearers, seek to deflect risk of liability and loss through a number of well-known and often discussed mechanisms, including company-sponsored indemnification and insurance.⁶² Despite this, a satisfactory discussion of corporate liability and compliance must explain why the risks of liability and loss have shifted back and forth during the past century between the firm and agent, recently moving further down the corporate hierarchy.⁶³ Indeed, there must be an accounting of those factors that have shifted liability risk and risk of loss in firms at the inception of corporate criminal liability in the early 1900s. It is with this accounting, I argue, that active risk management and risk control are able to best explain the transition from the ideal of theoretical risk sharing to a consistent and unequal risk shifting from principal to agent. To focus merely on cost

corporate criminal law, as well as the objectives of the Sentencing Reform Act of 1984 which gave rise to the Commission in the first place.

60. For a discussion of agency theory in relation to corporate criminal liability, see generally Barry D. Baysinger, *Organizational Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 341 (1991); Jensen & Meckling, *supra* note 11; Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315 (1991).

61. See generally Maria Moschandreas, *The Role of Opportunism in Transaction Cost Economics*, 31 J. ECON. ISSUES 39 (1997) (questioning the nature of opportunism and the efficiency of governance structures). Firms seek to align divergent interests and control the actions of agents through contract and the reward structure, e.g., aligning managerial incentives with the interests of the owner. See generally Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983). A combination of managerial incentives and monitoring is seen as the best way to increase firm control over top and middle management. See Edward J. Zajac & James D. Westphal, *The Costs and Benefits of Managerial Incentives and Monitoring in Large U.S. Corporations: When is More Not Better?*, 15 STRATEGIC MGMT. J. 121, 124 (Special Issue, Winter 1994); cf. Henry L. Tosi, et al., *Disaggregating the Agency Contract: The Effects of Monitoring, Incentive Alignment, and Term in Office on Agent Decision Making*, 40 ACAD. MGMT. J. 584 (1997) (finding that incentive alignment more so than monitoring prompted agents to act in the interests of owners).

62. See WILLIAM E. KNEPPER & DAN A. BAILEY, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* (5th ed. 1993); Dennis J. Block et al., *Indemnification and Insurance of Corporate Officials*, 13 SEC. REG. L.J. 239 (1985); Pamela H. Bucy, *Indemnification of Corporate Executives Who Have Been Convicted of Crimes: An Assessment and Proposal*, 24 IND. L. REV. 279 (1991); March & Shapira, *supra* note 50.

63. Recent critiques and extensions of agency theory may suggest some new and reasonable lines of argument. See Orts, *supra* note 50, at 298-326; Wiseman & Gomez-Mejia, *supra* note 16 (challenging the restrictive risk assumptions of agency theory).

internalization and the minimization of net social costs, as have most, is to miss the mark. Most organizations with sufficient resources seek cost-efficient risk management and "purchase" the amount of compliance necessary to insure against the risk of liability to the firm.⁶⁴

C. The Idea of Liability Risk Sharing

In a convincing but incomplete attack on the assignment of criminal blame to corporations, Jeffrey Parker notes that "corporate criminal liability in American law is nothing more than an historical artifact of a non-bureaucratic legal system reacting to an industrializing economy."⁶⁵ It is the rise of industry in the late 1800s, he says, that posed a strong challenge to courts and legislatures: criminal law was the only available institution of public law enforcement. In the absence of both regulatory agencies and a substantial system of public enforcement of civil and administrative law, the criminal law was the only available form of social control. The alternative to corporate criminal law was regulatory inaction.⁶⁶

The political, economic, and social climate at the turn of the twentieth century would have tolerated nothing short of an expansion of federal power and jurisdiction over interstate commerce.⁶⁷ During this time, the United States underwent a transportation revolution with the advent of automobiles and airplanes; the electrical industry moved across state lines allowing for the popularization of the telephone, telegraph, and radio; powerful railroad companies

64. Cf. Sally S. Simpson, *Corporate-Crime Deterrence and Corporate-Control Policies: Views from the Inside*, in WHITE COLLAR CRIME RECONSIDERED, *supra* note 7, at 289.

65. Parker, *supra* note 29, at 387.

66. See *id.* at 385-87. Parker underplays the legal conditions that eventually led to a corporate criminal law. These conditions include the inaction of Congress to effectively regulate interstate commerce; the unprecedented growth in corporations; the failure of states to combat monopolies; and the frightening power of corporations to expand across state borders. See *id.* For an excellent discussion of the failure of state initiatives to control corporate abuses, e.g., railroad commissions and antitrust acts, see H.L. Wilgus, *Need of a National Incorporation Law*, 2 MICH. L. REV. 358 (1904) (advocating a national incorporation law). The extent of the concern over issues of state sovereignty and unbridled corporate power is captured by William E. Church, *The Tramp Corporation*, 11 AM. LAW. 13 (1903). See also Carman F. Randolph, *Considerations on the State Corporation in Federal and Interstate Relations: The Northern Securities Cases*, 3 COLUM. L. REV. 168 (1903).

67. See Jeremy Atack, *Industrial Structure and the Emergence of the Modern Industrial Corporation*, in HISTORICAL PERSPECTIVES ON THE AMERICAN ECONOMY 428, 449 (Robert Whaples & Dianne C. Betts eds., 1995); JAMES OLIVER ROBERTSON, *AMERICA'S BUSINESS* 120-87 (1985) (discussing the rise of big business in relation to the evolution of national power); Gavin Wright, *The Origins of American Industrial Success, 1879-1940*, in HISTORICAL PERSPECTIVES ON THE AMERICAN ECONOMY, *supra*, at 455, 456.

emerged; large producer-goods industrials, such as U.S. Steel and Amalgamated Copper, secured vast power through horizontal growth; and there was a discernible concentration of economic power as mergers occurred and monopolies were formed.⁶⁸ Commentators obsessed over the destructive nature of these trusts and monopolies, expressing doubts about the power of state governments without a federal incorporation law to control the insatiable interests of corporations.⁶⁹

Parker's conclusion would be even more persuasive had he noted the powerful effects of vertical integration and the separation of ownership and control on the emergence of the modern multidivisional corporation.⁷⁰ By the culmination of the first merger wave, which ended in 1904, traditionally centralized functions in many large corporations had become increasingly decentralized.⁷¹ Departments, managerial oversight, as well as employee functions and roles, were highly specialized.⁷² With decentralization, specialization, and an increasing organizational complexity came concerns over loss of corporate control across the managerial hierarchy (often referred to as "authority leakage"). This variable has been used to explain organizational deviance and also to justify the

68. See MANSEL G. BLACKFORD & K. AUSTIN KERR, *BUSINESS ENTERPRISE IN AMERICAN HISTORY* 222 (1986) ("Enormous economic growth, the rise of the first giant, vertically integrated firms, and the spread of horizontal integration had appeared within the lifetimes of Americans who had matured in a simpler, earlier period when the interactions of thousands of small, independent firms governed the marketplace."); RICHARD L. WATSON, *THE DEVELOPMENT OF NATIONAL POWER: THE UNITED STATES, 1900-1919*, at 1-27 (1976); Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537, 1557 (1981). For a discussion of the rise of railroad regulation, and its effects, see generally Richard Selden Harvey, *The Influence of Railroad Decisions in Corporation Law*, 15 AM. LAW. 315 (1907) (claiming that early decisional law relating to railroad "controversies" afforded courts an opportunity to articulate general principles of corporation law); Colloquy, *The Railroad Problem: A Discussion of Current Railway Issues*, 86 ANNALS 1 (1919).

69. The desirability of a new federal incorporation law was discussed extensively during this period. See, e.g., Frederick H. Cooke, *State and Federal Control of Corporations*, 23 HARV. L. REV. 456 (1910) (discussing the relative benefits of state versus federal control); Max Thelen, *Federal Incorporation of Railroads*, 5 CAL. L. REV. 273 (1917) (arguing against existing plans and proposals for a federal incorporation law); George W. Wickersham, *Government Control of Corporations*, 18 COLUM. L. REV. 187 (1918) (noting the importance of both state and federal regulatory efforts).

70. See George David Smith & Davis Dyer, *The Rise and Transformation of the American Corporation*, in *THE AMERICAN CORPORATION TODAY* 28, 40-41 (Carl Kaysen ed., 1996). For an extensive treatment of the rise of the diversified firm, see NEIL FLIGSTEIN, *THE TRANSFORMATION OF CORPORATE CONTROL* 258-94 (1990).

71. See generally HAROLD C. LIVESAY, *ANDREW CARNEGIE AND THE RISE OF BIG BUSINESS* (1975).

72. See Atack, *supra* note 67, at 431-35.

imposition of vicarious liability.⁷³ Legislators and regulators debated which incentives or disincentives were essential to maximize law abidance, as well as to equitably distribute risk of liability, where the distance between a corporation's headquarters and a branch or subsidiary operation was growing ever more vast.⁷⁴ Of central concern was the increasing separation in status and role of shareholders and management. Managers with an insignificant ownership interest assumed prominent decision-making roles as shareholders forfeited active control over corporate operations.

Between 1850 and 1910, courts acceded to the realities of rising monopolistic powers and rapid market integration by expanding the fiction of corporate criminal liability.⁷⁵ Criminal

73. See MARSHALL B. CLINARD, U.S. DEP'T OF JUSTICE, *ILLEGAL CORPORATE BEHAVIOR* 7 (1979):

Decentralization is, almost by definition, accompanied by the establishment of elaborate hierarchies, based on authority position and functional duties. This allows the abdication of personal responsibility for almost every type of decision. . . . Under these conditions almost any type of corporate criminality, from production of faulty or dangerous products to bribery, bid-rigging and even theft is possible.

See also Gilbert Geis, *The Heavy Electrical Equipment Antitrust Cases of 1961*, in *WHITE-COLLAR CRIME: OFFENSES IN BUSINESS, POLITICS, AND THE PROFESSIONS* 117 (Gilbert Geis & Robert F. Meier eds., 1977); Diane Vaughan, *Toward Understanding Unlawful Organizational Behavior*, 80 *MICH. L. REV.* 1377, 1395 (1982) (discussing authority leakage, as well as the effects of tall hierarchies, organizational specialization and complexity on control functions and resulting deviance). Professor Brickey addresses the diffusion of responsibility that accompanies the decentralization of corporations (also known as the law of diminishing control). See Kathleen F. Brickey, *Rethinking Corporate Liability Under the Model Penal Code*, 19 *RUTGERS L.J.* 593, 625-26 (1988) ("These examples briefly demonstrate what management theorists and students of bureaucracies have known for some time: '[t]he larger any organization becomes, the weaker is the control over its actions exercised by those at the top.'") (quoting ANTHONY DOWNS, *INSIDE BUREAUCRACY* 143 (1967)); see also Victor H. Kramer, *Criminal Prosecutions for Violations of the Sherman Act: In Search of a Policy*, 48 *GEO. L.J.* 530, 540 (1960) (noting that is often impossible to fix corporate criminal responsibility in organizations in which responsibility is so diffused). An interesting parallel that may explain the timing of the most recent fascination with corporate criminal liability is found in the wave of corporate restructuring during the late 1980s and early 1990s. Useem observes that a central theme of this restructuring was the decentralization of corporate authority and accountability. Both authority and accountability are pushed downward into autonomous operating units, and to units within units. See Michael Useem, *Corporate Education and Training*, in *THE AMERICAN CORPORATION TODAY*, *supra* note 70, at 292, 297.

74. See, e.g., William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 *YALE L.J.* 193, 195-218 (1929) (discussing the strategic use of parent-subsidiary structure to avoid or at least minimize tort and contract liability).

75. For an early account of the importance of corporate criminal liability with particular attention to trusts as a violation of public policy and public welfare, see Cicero J. Lindley, *Criminal Acts of Corporations and Their Punishment*, 7 *AM. LAW.* 564, 566 (1899):

From the very nature of the organization of a corporation it is apparent that nearly every crime known to the law can be committed by it. It may, and frequently does, commit the crime of murder, and the crime of manslaughter is an every day occurrence upon the part of some of the incorporated companies of the land.

liability, as well as the rise of civil liability regimes, simply provided some needed relief from the risks associated with the rise of the modern corporation.⁷⁶ The emergence of multidivisional large-scale organizations, the move from horizontal to vertical integration, the separation of corporate ownership and control, and the rising prominence of railroad conglomerates in interstate commerce led Congress and then federal courts to implement the power of the criminal law as a regulatory weapon.⁷⁷ Courts first extended the criminal law to corporations for crimes of nonfeasance, and then for crimes of misfeasance in which no intent was required.⁷⁸ Finally,

For a discussion of these early cases, see KATHLEEN F. BRICKEY, *CORPORATE CRIMINAL LIABILITY: A TREATISE ON THE CRIMINAL LIABILITY OF CORPORATIONS, THEIR OFFICERS AND AGENTS* 1-37 (1984).

76. See Brent Fisse, *The Duality of Corporate and Individual Criminal Liability, in CORPORATIONS AS CRIMINALS* 69, 69-80 (Ellen Hochstedler ed., 1984) (describing the main reasons why both entity and individual liability exist); cf. KIP SCHLEGEL, *JUST DESERTS FOR CORPORATE CRIMINALS* 85-86 (1990) (discussing Fisse's justifications); see also RICHARD S. GRUNER, *CORPORATE CRIME AND SENTENCING* 76-77 (1994) (noting that "corporate criminal liability, like the corporation itself, is no more than a convenient legal fiction. Such liability is recognized because it serves public policy and for no other reason."); Albert W. Alschuler, *Ancient Law and the Punishment of Corporations: Of Frankpledge and Deodand*, 71 B.U. L. REV. 307, 313 (1991):

It is too late to reconsider the error that the Supreme Court made in 1909; corporate criminal responsibility is here to stay. Nevertheless, we should recognize the beast for what it is—not criminal punishment as we customarily understand punishment—but a form of instrumental regulation with which ordinary principles of culpability do not fit.

See also John C. Coffee, Jr., "No Soul to Damn: No Body to Kick": *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 448 (1981); William S. Laufer, *Culpability and the Sentencing of Corporations*, 71 NEB. L. REV. 1049 (1992) (arguing that the substantive corporate law has been outdone by principles of liability derived from the Sentencing Guidelines); Mueller, *supra* note 29, at 40 ("As a matter of convenience and expediency the law thinks of the corporation as the operating concern in terms of a man-like phenomenon.").

77. See, e.g., Smith & Dyer, *supra* note 70, at 40-41; Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1627-49 (1988) (discussing critical factors and forces responsible for the evolution of the modern corporation at the turn of the century).

78. For a pre-*Hudson* discussion of the emerging principles of corporate criminal liability, see Charles G. Little, *Punishment of a Corporation — The Standard Oil Case*, 3 U. ILL. L. REV. 446, 447 (1909). Early scholarship questioned the need for a corporate criminal law. See George F. Canfield, 14 COLUM. L. REV. 469, 481 (1914):

Our final conclusion, therefore, is that, notwithstanding this or similar statutory provisions, a corporation, according to sound theory and the general principles of the law of corporations, is not indictable for any crimes except those for which if committed on behalf of or under the general direction of an individual or partnership, such individual or a member of such partnership, although innocent, would be indictable.

See also Henry W. Edgerton, *Corporate Criminal Responsibility*, 36 YALE L.J. 827, 832-36 (1927) (considering the benefits and drawbacks of corporate criminal liability); Joseph F. Francis, *Criminal Responsibility of the Corporation*, 18 U. ILL. L. REV. 305, 323 (1924) (concluding that "[u]ntil and unless it is demonstrated that the social good demands that corporations be held

with the watershed case of *New York Central & Hudson River Railroad Co. v. United States* in 1909, the corporate criminal law was applied to crimes of intent.⁷⁹

This view that the extension of criminal liability was an artifact of a non-bureaucratic legal system responding to the rise of corporate power is strongly supported by *Hudson*.⁸⁰ The United States sought criminal penalties against the New York Central & Hudson River Railroad Company for the acts of an assistant traffic manager who illegally offered rebates to preferred customers. The briefs submitted to the Court by the Government make clear the practical importance of a vicarious liability for corporations.⁸¹ Prosecutors argued persuasively that agents are vested with corporate powers, and that where and when they act on behalf of the principal within their authority it is as though the corporation itself has acted.⁸²

The Court did not struggle with this agency argument, or with the notion that corporations must share in the risks of conducting business by internalizing the costs for the wrongdoing of their agents.⁸³ Given the prominence of corporations in interstate

responsible for crimes, there is no sound reason for so holding them."); Ervin Hacker, *The Penal Ability and Responsibility of the Corporate Bodies*, 14 J. AM. INST. OF CRIM. L. & CRIMINOLOGY 91, 96-101 (1923) (debating the virtues of corporate criminal liability); Frederic P. Lee, *Corporate Criminal Liability*, 28 COLUM. L. REV. 1, 16-24 (1928) (presenting one of the first critical examinations of corporate liability rules). The history of corporate criminal liability has been discussed at length elsewhere. See generally Kathleen F. Brickey, *Corporate Criminal Accountability: A Brief History and an Observation*, 60 WASH. U. L.Q. 393 (1982); V.S. Khanna, *Corporate Criminal Liability: What Purpose Does it Serve?*, 109 HARV. L. REV. 1477 (1996). A discussion of the historical antecedents of the expansion of corporate criminal liability is a high point in Khanna's otherwise dismissive discussion of the value of a corporate criminal law. See Khanna, *supra*, at 1479-88.

79. *New York Cent. & Hudson R.R. Co. v. United States*, 212 U.S. 481 (1909).

80. See *id.* at 494.

81. "If punishment for such payments when prohibited by law can be administered only on proving authorization from the president or directors no railway corporation can ever be legally punished for such payments. But, on the other hand, if a railroad corporation may be made criminally responsible for the acts of its officers or agents, to whom have been delegated power to control its corporate action *within the sphere represented by the transaction* then no case can more completely show ground for liability than the case at bar." Brief for the United States at 14-15, *Hudson* (No. 57).

82. This argument was made much earlier in state cases. See, e.g., *Commonwealth v. Pulaski County Agric. & Mechanical Ass'n*, 17 S.W. 442, 442 (Ky. 1891) ("With the growth of corporations came the necessity for this rule [corporate criminal liability], and its adaptability to changed circumstances is an excellence of the common law . . . The object should be to reach and punish the real power in the matter, and thus prevent a repetition of the offense.").

83. The Court reasoned that the doctrine of respondeat superior in tort law supplied the necessary ingredients for a vicarious criminal liability. As the Court stated:

Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of

commerce, their immense potential to do wrong, and the absence of other regulatory mechanisms, a powerful deterrent would have been lost by restricting criminal liability to agents.⁸⁴ Individuals and organizations, it seemed, had few incentives without the prospect of vicarious liability.⁸⁵ With joint and several liability, however, both the principal and its agents have a distinct risk of liability and, from this, a reciprocal incentive for law abidance.⁸⁶

The simple-minded public policy that emerged in *Hudson* seemed ideal in its shared allocation of risks to both principal and agent.⁸⁷ Corporate liability deters crime; it moves the risk of loss away from risk averse officers and directors toward the firm; it efficiently distributes liability risk between the firm and employees.⁸⁸ Without significant entity liability or even shared liability, some argued, incentives would be seen as too weak to ensure an organizational commitment to law abidance.⁸⁹ As one commentator

public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.

Hudson, 212 U.S. at 494. The issue of internalizing costs was disposed of as a matter of policy. See *id.* at 495 ("If [corporate criminal liability] were not so, many offenses might go unpunished and acts be committed in violation of law, where, as in the present case, the statute requires all persons, corporate or private, to refrain from certain practices forbidden in the interest of public policy.").

84. The Court went so far as to say that "[i]t would be a distinct step backward to hold that Congress cannot control those who are conducting this interstate commerce by holding them responsible for the intent and purposes of the agents to whom they have delegated the power to act in the premises." *Id.* at 496. See generally Brent Fisse & John Braithwaite, *The Allocation of Responsibility for Corporate Crime: Individualism, Collectivism and Accountability*, 11 SYDNEY L. REV. 468 (1988).

85. See Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 433 (1963) ("The case for corporate criminality rests presumably upon the inadequacy of the threat of personal conviction upon the individual actors."). For a recent case that refers to the importance of incentives in vicarious liability, see *United States v. Sun-Diamond Growers*, 138 F.3d 961, 971 (D.C. Cir. 1998).

86. See Kraakman, *supra* note 8, at 858-59.

87. The discussion of agency issues in relation to criminal liability assumes that both principal and agent are utility maximizers. All other contract assumptions apply as well, such as the importance of the equity contract, limited liability, and diversified investment portfolios as risk bearing devices for shareholders. See generally Jensen & Meckling, *supra* note 11 (discussing the importance of market and contract controls that are designed, at least in theory, to align the divergent interests of owners and managers).

88. See Arlen & Carney, *supra* note 8, at 700; Macey, *supra* note 60, at 319.

89. Courts find corporations criminally liable for the conduct of employees acting within the scope of employment, with an intent to benefit the corporation. The doctrine of respondeat superior, derived from tort law, views corporations as principals, and officers, directors, and employees as agents. Resort to vicarious liability is justified on at least two grounds. First, there is convenience and expediency. Second, there is an assumption that it allocates risks and economic losses efficiently. See H. Lowell Brown, *Vicarious Criminal Liability of Corporations for the Acts of Their Employees and Agents*, 41 LOY. L. REV. 279, 280-308 (1995). For a discussion of models of regulation that extend well beyond vicarious liability, see generally IAN

concluded, “[c]orporate criminal responsibility tends to prevent crime not only by influencing the corporation’s representatives of all degrees to abstain from conducting its business in unlawful ways, but also by influencing those of higher or more remote degree to restrain subordinates.”⁹⁰

In theory, vicarious liability should align organizational incentives (e.g., increases in payroll compensation, significant bonuses, and promotion to higher positions in the corporation) with corporate policies, codes, standards, and procedures. Top management must be put on notice that entity liability is likely where incentives are outdone by implicit messages to deviate from the law. Successful managers must institutionalize an adequate control system to identify deviance, exercise great care in the delegation of significant corporate responsibility, and clearly communicate the importance and relevance of policies, code provisions, standards, and procedures, while defining those acts that are within the scope of an agent’s authority.⁹¹

The scholarly response to *Hudson* was scarcely favorable. Unlike the application of vicarious tort liability, which seems to have been accepted uncritically, commentators, law reform commissions, and corporations all sensed the distinct limitations of a fictionally imputed fault in the criminal law.⁹² First, the rationale for extending

AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION* (1992); John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 MICH. L. REV. 1466 (1982).

90. See Edgerton, *supra* note 78, at 835. In Edgerton’s insightful comment he observes that vicarious liability

supplies the stockholder with a strong motive for seeing that its business is lawfully conducted. Similarly, directors, managers and superior agents are necessarily more inclined to encourage or ignore criminality on the part of their subordinates, when the subordinates alone are subject to punishment, than when their crimes involve a risk of injury to the corporation, and through it to the directors and managers themselves.

Id. To illustrate the proper use of a vicarious criminal liability, Lee pointed to the case of *Overland Cotton Mill Co. v. People*, 75 P. 924 (Colo. 1904). In *Overland* there was a joint criminal indictment of the company and an assistant supervisor. The latter had delegated authority to hire a new employee to a subordinate, who violated child labor laws. See *id.* at 925-26.

91. A corporation risks liability where its agent acts within the scope of her authority and for the benefit of the corporation. Where acts fall outside the boundary of the employee’s authority, or are solely for her personal benefit, liability remains exclusively with the agent. See, e.g., *Standard Oil Co. v. United States*, 307 F.2d 120, 128-29 (5th Cir. 1962) (reversing conviction of corporation where there was evidence that employees acts did not benefit their employers); cf. *Old Monastery Co. v. United States*, 147 F.2d 905, 908 (4th Cir. 1945) (“We do not accept benefit as a touchstone of corporate criminal liability; benefit, at best, is an evidential, not an operative, fact.”).

92. For a consideration of vicarious liability in tort law, see Gary T. Schwartz, *The Hidden and Fundamental Issue of Employer Vicarious Liability*, 69 S. CAL. L. REV. 1739, 1744-45 (1996):

principles of respondeat superior to corporate criminal liability appeared shallow and inadequate. As Professor G.O.W. Mueller has noted: "It is safe to say that, for the most part, the law has proceeded without rationale whatsoever—particularly in the area of regulatory and absolute liability offenses. It simply rests on an assumption that such liability is a necessary and useful thing."⁹³ Notably, it has been argued that the necessity for a fictional attribution of criminal liability diminished as the federal regulatory state emerged toward the middle of the twentieth century.⁹⁴ Corporations were increasingly regulated and frequently sanctioned, both administratively and with civil judgments.⁹⁵ Surely Mueller would not be alone in asking the obvious question: Is a corporate criminal law necessary?⁹⁶

In regard to cases in which an agent's actions are attenuated from the corporate policy or standards, organizations were subjected to an unnecessarily harsh form of strict liability.⁹⁷ Commentators reasoned that firms are less culpable when a rogue employee acts contrary to a company policy implemented in good faith.⁹⁸ Yet there

But despite all the debate and legislative action involved in tort reform, no attention has been paid to employer vicarious liability. No business group has suggested that the doctrine be reviewed and no legislature has considered its modification or repeal. Insofar as academic writings exert some influence on the legislative agenda, no scholars have written articles that have called into question the wisdom of vicarious liability in tort.

Id. at 1744-45. The general rule is that "the employer should be liable for those faults that may fairly be regarded as risks of his business, whether they are committed in furthering it or not." 5 FOWLER V. HARPER ET AL., LAW OF TORTS 40-41 (2d ed. 1986). Recently, the Supreme Court extolled the virtues of the doctrine of respondeat superior in holding that employers are liable for a hostile environment created by a supervisor with immediate authority over a victimized employee. See *Faragher v. City of Boca Raton*, ___ U.S. ___, 118 S. Ct. 2275 (1998).

93. Mueller, *supra* note 29, at 23. For a similar critique of corporate criminal liability by reporters for the American Law Institute's Model Penal Code, see MODEL PENAL CODE § 2.07 commentary at 146 (Tentative Draft No. 4, 1955) ("The modern development, however, has proceeded largely without reference to any intelligible body of principle and the field is characterized by the absence of articulate analysis of the objectives thought to be attainable by imposing criminal fines on corporate bodies.").

94. See Khanna, *supra* note 78, at 1487.

95. See, e.g., CLINARD, *supra* note 73 (detailing the civil, administrative, and criminal liability of 582 of the largest publicly owned corporations in the United States).

96. See generally Khanna, *supra* note 78.

97. See Note, *Indemnification of the Corporate Official for Fines and Expenses Resulting from Criminal Antitrust Litigation*, 50 GEO. L.J. 566, 567 (1962); see also Kraakman, *supra* note 8, at 859. It is of some interest that at least initially, the concern was with the unfair attribution of liability to the entity or the agent. Consider, for example, Lee's discussion of subordinate employees suffering exclusive liability for the crimes of superior officers. See Lee, *supra* note 78, at 21-22.

98. See, e.g., Note, *Criminal Liability of Corporations for Acts of Their Agents*, 60 HARV. L. REV. 283, 286 (1946) (arguing that corporate criminal liability risks loss of public good will because the stigma of a corporate conviction will have little meaning if there is evidence of a good faith effort of the organization to ensure law abidance). According to Coffee, a corporation

is the problem that, under a strict regime of vicarious liability, much of a firm's incentive to maintain the monitoring and self-policing of employees comes from a fear of entity liability notwithstanding the organization's compliance efforts.⁹⁹

The premise of a shared risk seems to have been more apparent than real. The notion of risk sharing is often eroded by strong incentives to quietly discipline or terminate wayward employees so that a strict imputation of liability might be avoided.¹⁰⁰ Detecting employee misconduct subjects the corporation to incrimination and, thus, to a tax.¹⁰¹ An awareness of this problem emerged immediately after *Hudson* as corporations considered the expenditure of their enforcement costs.¹⁰² Professor Arlen was the first to make the incisive observation that,

[i]f the expected cost to the corporation of the resulting increase in its expected criminal liability exceeds the expected benefit to the corporation of the reduction in the number of crimes, a corporation subject to strict vicarious liability will not respond by increasing its enforcement expenditures because additional enforcement would only increase the firm's expected criminal liability.¹⁰³

Predictably, some rational corporations chose to avoid the reach of vicarious liability by obscuring illegalities,¹⁰⁴ asking courts to

that has engaged in a diligent, albeit unsuccessful, effort to prevent law violations should receive sentencing considerations instead of an affirmative defense. See *Coffee*, *supra* note 76, at 445-46.

99. See *Laufer*, *Integrity*, *supra* note 7, at 176.

100. On the one hand, increased enforcement expenditures reduce the number of agents who commit crimes by increasing the probability of detection and thus each agent's expected cost of crime. On the other hand, these expenditures also increase the probability that the government will detect those crimes that are committed, thereby increasing the corporation's expected criminal liability for those crimes. . . . [A] corporation subject to vicarious liability may spend less on enforcement than it would absent vicarious liability.

Arlen, *supra* note 2, at 836

101. See *id.* at 834-36; David A. Dana, *The Perverse Incentives of Environmental Audit Immunity*, 81 IOWA L. REV. 969, 970 (1996) ("[C]ommentators stress that corporations may forego internal audits if they fear that they will be held liable for, and hence punished for, any violations that they might uncover.").

102. This appears to be a classic risk tradeoff. See generally RISK VERSUS RISK: TRADEOFFS IN PROTECTING HEALTH AND THE ENVIRONMENT (John D. Graham & Jonathan Baert Wiener eds., 1995).

103. Arlen, *supra* note 2, at 836.

104. See, e.g., C.Y. Cyrus Chu & Yingyi Qian, *Vicarious Liability Under A Negligence Rule*, 15 INT'L REV. L. & ECON. 305, 306 (1995) ("[T]he principal has an incentive to hide the evidence, or to collude with the agent, to avoid their joint and several liability.").

consider good faith efforts to prevent illegal activity,¹⁰⁵ exploiting the fact that liability is restricted to the illegal acts of more significant corporate actors¹⁰⁶ and, as shall be discussed below, shifting losses away from the firm.

D. The Emergence of Corporate Risk Shifting

1. Due Diligence and Good Faith

The first evidence of a disavowal of vicarious liability was marked by a judicial recognition of an organization's good faith efforts to abide by the law. Only four years after *Hudson* was decided, corporations were asking courts to consider the complexity of the corporate form, the critical importance of clearly stated firm policies prohibiting unethical and illegal acts, and the good faith efforts of firms to ensure compliance with the law.¹⁰⁷ To be sure, not all courts responded by ruling that corporations are absolved of liability or are due less blame when their agents engage in criminal acts against express instructions. In fact, a number of courts went so far as to hold entities liable when not a single employee was to blame.¹⁰⁸

Even so, in the series of cases that followed *Hudson*, the application of vicarious liability was limited where the rule as applied was harsh—where the rule, as one court observed, “would carry corporate responsibility beyond . . . the boundary to which we think

105. See *Developments in the Law*, *supra* note 23, at 1257 (“A new system of corporate liability based on the reasonableness of the corporation's practices and procedures to avert illegal conduct would better reflect the blameworthiness of the corporation as an entity.”).

106. Liability was restricted to high managerial agents for certain crimes under a regime proposed by the Model Penal Code. See generally Brickey, *supra* note 73.

107. See *John Gund Brewing Co. v. United States*, 204 F. 17 (8th Cir.), *modified*, 206 F. 386 (8th Cir. 1913). For a discussion of *Gund* and the advent of the due diligence defense, see Brown, *supra* note 89, at 309-12.

108. See, e.g., *AMA v. United States*, 130 F.2d 233 (D.C. Cir. 1942); *United States v. General Motors Corp.*, 121 F.2d 376 (7th Cir. 1941); *United States v. Austin-Bagley Corp.*, 31 F.2d 229 (2d Cir. 1929). Courts inconsistently ruled on matters of acting on express instructions or corporate policy. See *United States v. Cadillac Overall Supply Co.*, 568 F.2d 1078 (5th Cir. 1978); *United States v. Hilton Hotels Corp.*, 467 F.2d 1000 (9th Cir. 1972); *United States v. American Radiator & Standard Sanitary Corp.*, 433 F.2d 174 (3d Cir. 1970); *United States v. Armour & Co.*, 168 F.2d 342, 343-44 (3d Cir. 1948) (“The employer ‘does not rid himself of that duty because the extent of the business may preclude his personal supervision, and compel reliance on subordinates. He must then stand or fall with those whom he selects to act for him.’” (quoting *People v. Sheffield Farms—Slawson-Decker Co.*, 121 N.E. 474 (N.Y. 1918))); James V. Dolan & Richard S. Rebeck, Note, *Corporate Criminal Liability for Acts in Violation of Company Policy*, 50 GEO. L.J. 547 (1962). The drafters of the MPC discussed this issue extensively. See MODEL PENAL CODE § 2.07 commentary at 14 (Tentative Draft No. 4, 1955).

corporate criminal responsibility should be carried."¹⁰⁹ Some courts expressed a particular sympathy with the realities of corporate life. For example, in *United States ex rel. Porter v. Kroger Grocery & Baking Co.*, Circuit Judge Major acknowledged that, "[a]s the magnitude of a business increased, with its personal supervision further removed, we apprehend that the difficulties were correspondingly enhanced. Certainly 100% compliance could not be expected in any event; in fact, it would be impossible."¹¹⁰ Authors of popular treatises in the early 1900s noted a particular sympathy to a corporation's diligence as well.¹¹¹

Drafters of the Model Penal Code ("MPC") seemed to have been unconcerned that good faith compliance efforts might compromise the incentives derived from vicarious liability.¹¹² They concluded that if sanctions were designed to encourage the reasonable supervision of employees, then failing to reward genuinely diligent compliance efforts would be a distinct disincentive, undermining the deterrent value of any fine or period of probation.¹¹³ In 1962, the American Law Institute ("ALI") codified in the MPC a narrowly drafted due diligence defense for all state regulatory offenses designed to "encourage diligent supervision of corporate personnel by managerial employees in those cases in which the corporation is bound by the conduct of inferior personnel."¹¹⁴ In a host of states, corporate exculpation

109. *Holland Furnace Co. v. United States*, 158 F.2d 2, 8 (6th Cir. 1946); see also *United States v. Basic Constr. Co.*, 711 F.2d 570, 572 (4th Cir. 1983) ("[T]he existence of such instructions and policies, if any be shown, may be considered by you in determining whether the agents, in fact, were acting to benefit the corporation."); *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) ("[A] corporation may be liable for acts of its employees done contrary to express instructions and policies, but that the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation.") (second emphasis added); *Hilton Hotels*, 467 F.2d at 1007 (policy statements and specific instructions along with appropriate enforcement would give organization immunity from the criminal law).

110. *United States ex rel. Porter v. Kroger Grocery & Baking Co.*, 163 F.2d 168, 177 (7th Cir. 1947). It is notable that a due diligence defense was raised in the *Electrical Antitrust* cases. See *United States v. Westinghouse Elec. Corp.*, 1960 Trade Cas. (CCH) ¶ 69,699, at 76,759 (E.D. Pa. 1960). The Chairman of the Board of Directors of General Electric, Ralph Cordiner, was reported to have said that compliance with corporate directives for employees on antitrust legislation should provide a defense to corporate liability. See Dolan & Rebeck, *supra* note 108, at 548 n.5 (citing R. Smith, *The Incredible Electrical Conspiracy*, FORTUNE, May 1961, at 161, 164).

111. See, e.g., FLOYD R. MECHEM, *OUTLINES OF THE LAW OF AGENCY* § 562 (3d ed. 1923) ("The principal will not ordinarily be held criminally responsible for the crimes of his agent or servant, unless he has in some way directed, participated in, or approved the act."); SEYMOUR D. THOMPSON, *7 COMMENTARIES ON THE LAW OF CORPORATIONS* § 5645 (3d ed. 1927).

112. See generally Herbert Weschsler, *Codification of Criminal Law in the United States: The Model Penal Code*, 68 COLUM. L. REV. 1425 (1968).

113. See generally MODEL PENAL CODE § 2.07, *supra* note 93.

114. MODEL PENAL CODE § 2.07 commentary at 154, *supra* note 93. Due diligence is conceived of as an affirmative defense. See *id.* at § 2.07 commentary at 154. Notably, the

follows the showing of due diligence by the supervisor of the wayward agent.¹¹⁵ In cases that once met the standards of vicarious liability, courts following the MPC upheld the convictions of culpable agents with the caveat that: "[t]o impose criminal liability on the corporation . . . would amount to a strict criminal liability in the absence of proof of fault."¹¹⁶

The recognition of the importance of organizational due diligence should have raised serious questions about the risk of diminishing the incentives driving principles of vicarious fault.¹¹⁷ In cases where prosecutors and courts are hard-pressed to determine the effectiveness or authenticity of compliance efforts, a good faith defense would tend to absolve the entity, perhaps without justification.¹¹⁸ Further, a due diligence defense corrodes the principles of delegation and authority that are at the foundation of a consensual agency relationship.¹¹⁹ Organizations delegate authority to agents who act on their behalf as their representatives. The failure of an agent to perform as instructed is incidental to an organization's

National Commission on the Reform of the Federal Criminal Code, known as the Brown Commission, specifically rejected this defense. See STAFF MEMORANDA ON RESPONSIBILITY FOR CRIMES INVOLVING CORPORATIONS AND OTHER ARTIFICIAL ENTITIES 172 (1969) (on file with author). For a discussion of the treatment of corporate criminal liability by the Brown Commission, see Comment, *Corporate Criminal Liability*, 68 NW. U. L. REV. 870, 877-92 (1973).

115. In any prosecution of a corporation or an unincorporated association for the commission of an offense included within the terms of Subsection (1)(a) or Subsection (3)(a) of this Section, other than an offense for which absolute liability has been imposed, it shall be a defense if the defendant proves by a preponderance of evidence that the high managerial agent having supervisory responsibility over the subject matter of the offense employed due diligence to prevent its commission.

MODEL PENAL CODE § 2.07(5) (1962) For a detailed discussion of the adoption of this due diligence defense, see generally Brickey, *supra* note 73.

116. See *State v. Abboud, Inc.*, No. 68611, 1995 WL 680920, at *5 (Ohio Ct. App. 1995). Though there was no mention of the MPC's due diligence defense, the Supreme Court's decision last term in *Faragher v. City of Boca Raton* sought to avoid a strict form of vicarious employer liability in Title VII cases where victims are subjected to a hostile environment. Justice Souter articulated an affirmative defense having two elements: "(a) that the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (b) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to avoid harm otherwise." *Faragher v. City of Boca Raton*, 118 S. Ct. 2275, 2293 (1998).

117. See Laufer, *Integrity*, *supra* note 7, at 171-77.

118. See GRUNER, *supra* note 76, at 344-47.

119. The notion of delegated authority is critical. See, e.g., *C.I.T. Corp. v. United States*, 150 F.2d 85 (9th Cir. 1945) ("It is the function delegated to the corporate officer or agent which determines his power to engage the corporation in a criminal transaction."); see also RESTATEMENT (SECOND) OF AGENCY § 1(1) (1958) ("Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."). For an extension of the legal conception of agency theory, see Orts, *supra* note 50, at 273.

diligent efforts to prevent such failures.¹²⁰ Surely, some rational corporations will find less of an incentive to fashion effective compliance programs as their liability will be excused regardless of the success of compliance efforts.¹²¹

Although most prosecutors consider the diligent efforts of corporations in deciding whether to investigate, charge, and pursue an aggressive prosecution, those who do not raise reasonable concerns. According to the Chief of the Department of Justice's Antitrust Division, the concern in crediting failed programs is that "there would be less incentive for companies to make sure these programs work, to refine the programs, and to make them effective. The ultimate goal, after all, is a compliance program that prevents crimes, not one that excuses the corporation in the event that one occurs."¹²² For some state and federal prosecutors, no evidence of diligence on the part of a company can shield the principal from the acts of the wayward agent. Here liability is absolute, the miscreant agent simply acts and speaks for the principal in the commission of a crime.¹²³

Recognition of organizational due diligence as a defense allows organizations with ineffective, skeletal compliance initiatives to strategically shift blame to their agents and unjustifiably escape a

120. See Recent Case, *Corporations—Powers and Liabilities—Criminal Responsibility for Act of Agent*, 95 U. PA. L. REV. 557, 557-58 (1947) (arguing this point but conceding that, "[i]t is not, however, clearly settled whether a corporation may be indicted for a crime committed by its agents within the scope of his authority but without the knowledge of the corporation or against its instructions").

121. This is the position taken by the Antitrust Division of the United States Department of Justice. See, e.g., Robert E. Bloch, *Compliance Programs and Criminal Antitrust Litigation: A Prosecutor's Perspective*, 57 ANTITRUST L.J. 223 (1988).

122. Gary R. Spratling, *The Experience and Views of the Enforcement Community*, in PROCEEDINGS, *supra* note 1, at 317, 319. It is unclear how the Antitrust Division's Amnesty Program is consistent with Mr. Spratling's position. According to the most recent Division policy, amnesty from federal prosecution for antitrust violations is automatic "if a corporation comes forward before our investigation begins. . ." *Id.* at 321. See also "Front End" Benefits of Antitrust Compliance Program, *Self-Reporting Offer Best Hope of Avoiding Fine Floor*, Prevention of Corp. Liab. (BNA) 10 (Apr. 15, 1996).

123. For a discussion of this point in relation to vicarious liability, see Brickey, *supra* note 73, at 628-29 ("Under the *respondeat superior* rule, if the corporation has entrusted the miscreant agent with responsibility for the function he is performing, he is deemed to act and speak for the corporation when he unlawfully transacts its business."); GRUNER, *supra* note 76, at 346-47. A different argument was made in *Developments in the Law*:

Both the moral quality of the new system and its value as a deterrent depend largely on what courts require for a corporate due diligence defense.

If the defense is extremely difficult to meet, it becomes identical in practice to the system of *respondeat superior*, and its moral quality is diminished. If the defense is too easily satisfied, liability becomes easily evaded and its deterrent effectiveness is destroyed.

Developments in the Law, *supra* note 23, at 1257 n.72

strict imputation of fault.¹²⁴ Professor Coffee acknowledges this concern in cases where corporations are most interested in the cosmetic appearance of compliance.¹²⁵ This concern also extends to organizations that are indifferent to an effective compliance program and culture.¹²⁶ Survey research, for instance, suggests that in some (if not many) corporations, the role of compliance has more to do with maintaining the appearance of a compliant reputation than that of a meaningful culture of ethical awareness and law abidance.¹²⁷ Codes of conduct are often disregarded as "legalistic and one-sided."¹²⁸ Compliance also may be seen as a concession to regulators for some deference to the entity with a prospective or pending investigation, charging decision, or plea bargain.¹²⁹ In short, the strategic utility of

124. See Spratling in PROCEEDINGS, *supra* note 1, at 303. According to Spratling, to give weight to compliance efforts would: (a) serve to encourage and reward the creation of pro forma, prophylactic programs, (b) create a category of excuses and justifications that are not warranted, (c) undermine the deterrent ability of due diligence, (d) be inconsistent with principles of vicarious liability, and (e) add disparity to prosecutorial decision-making. See *id.*; see also James F. Rill, *The Importance of Deterring Antitrust Crime: Corporate Compliance Programs and Federal Antitrust Enforcement*, Remarks at the Symposium on Antitrust and Association Law, Bar Association of the District of Columbia, Washington, D.C. (Feb. 20, 1992); cf. *United States v. Basic Constr. Co.*, 711 F.2d 570, 572 (4th Cir. 1983) (discussing how compliance initiatives may determine whether agents were acting with an intent to benefit the corporation); *United States v. Greyhound Corp.*, 508 F.2d 529, 532 (7th Cir. 1974) ("[A]ctions showing a good faith effort to comply with the order will tend to negate willfulness . . .").

125. See Coffee, *supra* note 35, at 229 ("In fact, if corporate penalties were greatly reduced to reflect the adoption of corporate compliance plans or other monitoring systems, corporations would rationally develop an interest in cosmetic monitoring—so that they could both benefit from illegal behavior and also incur only modest penalties, if apprehended.").

126. See, e.g., Neil S. Cartusciello, *The Con Edison Case & Emerging Principles of Corporate Prosecution*, BUS. CRIMES BULL., May 1995, at 1 (discussing the revelations regarding corporate culture at Con Edison).

127. See, e.g., Richard S. Gruner, *Compliance Programs and Corporate Liability: A Look Into the Future*, in CORPORATE COMPLIANCE: CAREMARK AND THE GLOBALIZATION OF GOOD CORPORATE CONDUCT, *supra* note 3, at 199, 205 (footnote omitted):

Compliance programs that are treated by management as a sham tend to encourage cynicism by employees. Such cynicism, in turn, tends to cause employees to pay less attention to legal requirements and to be more willing to commit offenses. Hence, a poor law compliance program may actually increase levels of offenses, making it worse than doing nothing.

128. Pastin, *supra* note 25, at 175, 177-78 ("Codes of conduct viewed by employees as legalistic and one-sided, i.e., in favor of the company, increased the likelihood that employees would exhibit behavior that they identified as unethical or illegal. . . . Our summary reading of the results of this study is that many compliance measures being taken by companies have no effect of [sic] a negative effect on the compliance environment of the company."). See *infra* notes 235-46 and accompanying text

129. See F. Joseph Warin & Jason C. Schwartz, *Deferred Prosecution: The Need for Specialized Guidelines for Corporate Defendants*, 23 J. CORP. L. 121, 123-32 (1997) (discussing the initiation or declination of prosecution based on compliance efforts in four companies).

compliance standards may be far greater than any sort of organizational integrity.¹³⁰

2. High Managerial Agents

MPC drafters further shifted the risk of liability for non-regulatory crimes away from the entity by limiting corporate liability to actions taken by high managerial agents.¹³¹ The objective was to restrict entity liability to those situations in which members of the board of directors, corporate officers, or agents sufficiently high in the corporate hierarchy engaged in criminal acts. Such acts were seen as reflective of the character of the corporate body. The drafters acknowledged that this rule was a partial rejection of the general respondeat superior approach adopted by federal courts, preserving it for situations in which shareholders are well positioned to indirectly prevent corporate crime.¹³² This stands in sharp contrast to the federal law. Prevailing federal law, in its application of fault throughout the corporate hierarchy, suggests that liability does not arise out of any particular relation between the entity and the agent, but that it is found in the organization's duty toward the public.¹³³ Thus, under the MPC, corporations stand or fall by the choices of their agents.

130. See Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV., Mar.-Apr. 1994, at 106, 106:

Prompted by the prospect of leniency, many companies are rushing to implement compliance-based ethics programs. Designed by corporate counsel, the goal of these programs is to prevent, detect, and punish legal violations. But organizational ethics means more than avoiding illegal practice; and providing employees with a rule book will do little to address the problems underlying unlawful conduct.

131. See MODEL PENAL CODE § 2.07(1)(c) (1962) ("A corporation may be convicted of the commission of an offense if: the commission of the offense was authorized, requested, commanded, performed or recklessly tolerated by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment."); see also MODEL PENAL CODE § 2.07 commentary at 151 (Tentative Draft No. 4, 1955).

132. MODEL PENAL CODE, § 2.07 commentary at 151 (Tentative Draft No. 4 1955)

The general *respondeat superior* approach of paragraph a is rejected for these cases, and corporate liability is confined to situations in which the criminal conduct is performed or participated in by the board of directors or by corporate officers and agents sufficiently high in the hierarchy to make it reasonable to assume that their acts are in some substantial sense reflective of the policy of the corporate body.

133. The best illustration of this is where courts have found corporate criminal liability for a breach of a non-delegable duty. In such cases, corporations have been estopped from attributing a breach of statutory duty to subordinate employees or, for that matter, from claiming organizational diligence, because the duty cannot be delegated. See *United States v. Illinois Cent. R.R. Co.*, 303 U.S. 239, 244 (1938) (finding that a statutory duty to unload cattle was owed to public at large, and could not be avoided by delegation to subordinate employees); *United States v. Armour & Co.*, 168 F.2d 342, 343-44 (3d Cir. 1948) (deciding that good faith precautions did not overcome non-delegable duty); *United States v. E. Brooke Matlock, Inc.*, 149

The effect of this partial rejection by the MPC, however, did more than just renounce the harshness of vicarious liability. By limiting liability in cases where owners, officers, directors, and those responsible for the construction of corporate policies had no knowledge of the illegality, these new liability rules afforded organizations protection from criminal liability for acts of deliberate indifference by high managerial agents.¹³⁴ Of far greater concern, the MPC rules offered a marginal incentive to high managerial agents to delegate tasks and responsibilities to their subordinates in an indifferent, negligent, even reckless manner. As one commentator noted, senior management "can protect themselves from knowledge—and the corporation from liability—simply by delegating to subordinates full responsibility for those activities which might result in criminal violations."¹³⁵

By insulating senior officers and managers from liability, and encouraging the delegation of risk bearing activities, the risk of liability is shifted further down the corporate hierarchy. Kraakman noted this effect in observing that "managers and directors enjoy *de facto* insulation from liability—even apart from risk-shifting agreements—because of the organizational buffer between themselves and lower-level employees who implement their decisions."¹³⁶ This shift

F. Supp. 814, 820 (D. Md. 1957) (holding that corporations cannot avoid liability by claiming that a subordinate neglected his duty). Comments from reporters to the Brown Commission made explicit reference to this case in justifying the adoption of the Federal Rule, and rejecting the MPC liability rule; see also S. REP. NO. 96-553, at 79-83 (1980).

134. See *Developments in the Law*, *supra* note 23, at 1254 ("Consequently, liability can be evaded whenever illegal activity occurs without the authorization or reckless toleration of top officials. Since an executive cannot authorize or recklessly tolerate an offense unless he knows about it, a corporation can escape liability under this system as long as high officials remain ignorant of illegal activity.")

135. *Id.* (borrowing language from *United States v. Van Riper*, 154 F.2d 492, 493 (3d Cir. 1946)). Similarly, Dolan and Rebeck have reasoned

[I]f courts were to draw a distinction between the corporation's officers and its ordinary agents, imputing the criminal intent of only the former to the corporation, the corporation could then completely immunize itself from penal punishment for its crimes by simply delegating the officer's responsibility for those acts which might be performed in an illegal manner to agents below the officer level.

Dolan & Rebeck, *supra* note 108, at 552. Similar concerns were raised in *United States v. Twentieth Century Fox Film Corp.*, 882 F.2d 656, 661 (2d Cir. 1989) ("Were we to import 'reasonable diligence' into the law of criminal contempt, corporations could more easily distance themselves from the wayward acts of their agents—a prospect that threatens the very authority of the court that criminal contempt is designed to preserve.")

136. Kraakman, *supra* note 8, at 860 n.9 (emphasis added). From a pre-Sentencing Guidelines view, one commentator has reasoned:

When faced with a criminal investigation, corporate personnel tend to close ranks out of loyalty or through fear of dismissal. If they do, the result may be *de facto* immunity against individual criminal liability, at least for highly

has been profound in large multidivisional entities where decision making is both decentralized and delegated to empowered subordinate employees.¹³⁷

The consequences of this shift, as significant as they are, cannot be fully understood without considering the rise of intracorporate loss shifting mechanisms, such as director and officer indemnification, and employee fidelity insurance. As the debate over corporate criminal liability took shape in the late 1800s, principals and agents had conceived of ways to reduce their exposure to losses from the risks of a vicarious liability.

E. The Contemporaneous Rise of Intracorporate Liability and Loss Shifting

By the time the Supreme Court issued its opinion in *Hudson*, a well-articulated body of statutory and decisional law had developed on shifting risks of liability and loss between a corporation, its directors, and officers. While *Hudson* supported state and federal prosecutions of corporations, firms responded by purchasing fidelity bonds and insurance for lines arising from the crimes of their employees, as well as indemnifying corporate directors and officers from derivative actions by shareholders. These and other intracorporate loss shifting mechanisms emerged for reasons that are indistinguishable from those that prompted corporate criminal liability in the first place. Shareholders, top management, middle management, and subordinate employees sought ways to accommodate the conflicting incentives that emerged with the separation of ownership and control.¹³⁸

placed officers who can stay at a safe distance from criminal acts performed lower in the corporate hierarchy.

Fisse, *supra* note 76, at 70.

137. See *Developments in the Law*, *supra* note 23, at 1254-55.

138. It is difficult to imagine how the emergence of principles of corporate criminal law, particularly the effect of the MPC on state law doctrine, can be interpreted without reference to intracorporate loss shifting. See generally Frederick Dwight, *Liability of Corporate Directors*, 17 YALE L.J. 33 (1907) (bemoaning the inadequate performance of directors in modern corporations); M.C. Lynch, *Diligence of Directors in the Management of Corporations*, 3 CAL. L. REV. 21, 21 (1914) ("Modern business conditions during the years since 1896 have brought the question of the responsibility of directors for abuses of their powers, violations of their duties, and their liability for their conduct and acts either of omission or commission squarely before the public for serious attention."); C. Brewster Rhoads, *Personal Liability of Directors for Corporate Mismanagement*, 65 U. PA. L. REV. 128 (1916) (focusing on the leading American case for the mismanagement of directors, *Spring's Appeal*). This is not to suggest that indemnification emerged for reasons other than corporate self-interest. See generally Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573 (1996) (discussing the

1. Director and Officer Losses

In the 1800s, directors and officers were regarded as both trustee and agent.¹³⁹ Defining the boundaries of their fiduciary responsibility and civil liability, however, challenged the wisdom of the bench.¹⁴⁰ In *Spering's Appeal*, for example, Justice Sharswood of the Pennsylvania Supreme Court ruled that directors are personally liable to shareholders "for any losses resulting from fraud, embezzlement or willful misconduct or breach of trust for their own benefit and not for the benefit of stockholders, for gross inattention and negligence by which such fraud or misconduct has been perpetrated by agents, officers or co-directors"¹⁴¹ Directors are free from liability, Sharswood concluded, where they have made honest mistakes of judgment within the bounds of their powers and discretion.¹⁴²

In 1891, the United States Supreme Court considered director liability for the first time in *Briggs v. Spaulding*, holding that directors must be vigilant in their supervision, and exercise ordinary skill and diligence in the administration of their business affairs.¹⁴³ Further, the Court reasoned that directors are not absolved "from the duty of reasonable supervision, nor ought they to be permitted to be shielded from liability because of want of knowledge of wrong-doing, if that ignorance is the result of gross inattention."¹⁴⁴

Not that long after the recognition of director liability both in state and federal courts, directors sought indemnification for the costs

rise of director and officer indemnification as "a key ingredient to effective corporate management").

139. See, e.g., H.A. Cushing, *The Liability of the Inactive Corporate Director*, 8 COLUM. L. REV. 18 (1908).

140. See Lynch, *supra* note 138, at 22; see also Robert J. Keller, *Degree of Diligence a Director Must Exercise to Avoid Liability to the Corporation*, 7 MARQ. L. REV. 159 (1923); cf. *Briggs v. Spaulding*, 141 U.S. 132, 147 (1891):

[Directors] are not insurers of the fidelity of the agents whom they have appointed, who are not their agents but the agents of the corporation; and they cannot be held responsible for losses resulting from the wrongful acts or omissions of other directors or agents, unless the loss is a consequence of their own neglect of duty, either for failure to supervise the business with attention or in neglecting to use proper care in the appointment of agents.

Unfortunately, *Briggs* has not survived. See generally Atherton v. FDIC, 519 U.S. 213 (1997) (overturning *Briggs* by holding that there is no federal common law standard of care for officers and directors, but finding a gross negligence standard for directors or officers of federally insured savings institutions).

141. *Spering's Appeal*, 71 Pa. 11, 24 (1872).

142. See *id.*

143. *Briggs*, 141 U.S. at 165.

144. *Id.* at 165-66.

of defending against shareholder suits in federal securities cases.¹⁴⁵ Indemnification was justified given the inadequacy of compensation relative to liability risks. Further, indemnification was intended to free otherwise risk averse directors to engage in desirable risk bearing activities.¹⁴⁶ In 1941, the first state statute authorizing indemnification of directors and officers appeared in New York.¹⁴⁷ Most states followed New York after provisions on indemnification appeared in the Model Business Corporation Act.¹⁴⁸ In recent years, indemnification statutes have been amended to permit corporations to purchase director and officer liability insurance.¹⁴⁹ Such policies, first introduced with the passage of federal securities laws, include provisions for corporate reimbursement for indemnification payments made to directors and officers, as well as those that provide personal coverage for directors and officers for unindemnified payments.¹⁵⁰

Concerns with loss shifting appear reasonable given the changes to liability rules following the MPC, and the rise of indemnification and insurance.¹⁵¹ Such concerns were that much more reasonable when indemnification was extended to shareholder

145. See, e.g., *Solimine v. Hollander*, 19 A.2d 344 (N.J. Ch. 1941) (holding that directors and officers have a right to recover costs in successfully defending against a derivative action alleging double-dealing, negligence, fraud, diversion of funds, and mismanagement); *Jesse v. Four-Wheel Drive Auto Co.*, 189 N.W. 276 (Wis. 1922) (refusing to allow directors to use corporate funds to pay for their defense against personal charges); *Figge v. Bergenthal*, 109 N.W. 581 (Wis. 1906) (requiring the corporation to pay the attorneys fees for directors that were found innocent of fraud and mismanagement); George E. Bates & Eugene M. Zuckert, *Directors' Indemnity: Corporate Policy or Public Policy*, 20 HARV. BUS. REV. 244 (1942); Joseph W. Bishop, Jr., *Current Status of Corporate Directors' Right to Indemnification*, 69 HARV. L. REV. 1057 (1956); Ralph M. Carson, *Further Phases of Derivative Actions Against Directors*, 29 CORNELL L. Q. 431 (1944); *Distribution of Risk Imposed Upon Corporate Officials By Federal Securities Legislation*, 49 YALE L.J. 1423 (1940); George D. Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784 (1939); Orrin L. Helstad & Russell F. Williams, Note, *Corporations-Directors' Reimbursement for Litigation Expenses*, 1950 WIS. L. REV. 157; Note, *Defence of Directors by Corporation Against Suit Brought in Its Behalf*, 43 YALE L.J. 661 (1934); Harris W. Seed, Comment, *Corporate Responsibility for Litigation Expenses of Management*, 40 CAL. L. REV. 104 (1952); Recent Case, *Corporations-Officers-Right of Directors to Use Corporate Funds to Defend Suit Against Them As Individuals*, 16 MINN. L. REV. 102 (1931).

146. See Alfred F. Conrad, *A Behavioral Analysis of Directors' Liability For Negligence*, 1972 DUKE L.J. 895, 898-900.

147. See *Indemnification of Directors and Officers—An Annotation to the Model Business Corporation Act*, 13 BUS. LAW. 693 (1958); see also Joseph W. Bishop, *Indemnification of Corporate Directors, Officers and Employees*, 20 BUS. LAW. 833 (1965).

148. See *Indemnification of Directors and Officers*, *supra* note 147, at 694.

149. See *Liability Insurance for Corporate Executives*, 80 HARV. L. REV. 648 (1967) (questioning the public policy of director and officer insurance).

150. See Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989) (describing the problems with the directors and officers' insurance market in the 1980s).

151. See generally Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 BUS. LAW. 1993 (1978); Note, *supra* note 97.

claims for compensation from directors' involvement in criminal activities.

For example, in *Wilshire Oil Co. v. Riffe*, the Tenth Circuit recognized a cause of action by a corporation to recover losses attributed to the criminal and civil antitrust violations of its employees.¹⁵² The implicit objective of the corporate plaintiff was to "shift the losses that attend corporate criminality to fiduciaries whose actions on behalf of the corporation constituted, caused, or contributed to the criminal activity for which the corporation has been punished."¹⁵³ In finding for *Wilshire*, the court reasoned that the burden of the loss should fall upon the agent who committed the crime (or tolerated the commission of a crime), not to an innocent principal.¹⁵⁴ Employees owe a distinct duty to a corporation that, if breached, gives the latter a clear right to recover for any losses resulting from the breach.¹⁵⁵ The cause of action is analogous to a derivative suit by shareholders.¹⁵⁶

2. Employee Losses

Of course, long before *Wilshire* was decided, corporations were actively recovering losses due to the criminal acts of employees from third party insurers. From the time of *Hudson*, the incompatibility of intracorporate loss shifting and the doctrine of respondeat superior was most apparent with the purchase of fidelity bonds and fidelity insurance coverage.¹⁵⁷ Fidelity bonds and insurance policies compen-

152. *Wilshire Oil Co. v. Riffe*, 409 F.2d 1277 (10th Cir. 1969). *Wilshire* follows in a tradition of corporate indemnification for civil actions of gross negligence, fraud, and mismanagement. See, e.g., *Trustees of the Mut. Bldg. Fund & Dollar Sav. Bank v. Bosseix*, 3 F. 817 (E.D. Va. 1880) (holding that directors are liable separately and jointly for the losses to the company resulting from fraud and negligence); *Broderick v. Marcus*, 272 N.Y.S. 455 (Sup. Ct. 1934) (accepting a cause of action against the former directors of the Bank of United States to recover losses sustained by the bank as a result of their breaches); *Anthony v. Jeffress*, 90 S.E. 414 (N.C. 1916) (finding that the Central Mercantile Company may recover damages from directors for their negligence in the management of the affairs of the corporation).

153. *Werder*, *supra* note 54, at 37.

154. See *Wilshire*, 409 F.2d at 1283.

155. See *id.* at 1284 (The corporation is "merely attempting to redress an injury which was inflicted as a result of an effort on the part of certain of its employees to commit a public wrong.").

156. See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 182 A.2d 328 (Del. Ch. 1962), *aff'd*, 188 A.2d 125 (Del. Super. Ct. 1963); *Simon v. Socony-Vacuum Oil Co.*, 38 N.Y.S.2d 270 (Sup. Ct. 1942) *aff'd mem.*, 47 N.Y.S.2d 589 (App. Div. 1944).

157. See *First Nat'l Bank v. National Sur. Co.*, 130 F. 401 (6th Cir. 1904); *Florida Cent. & R.R. Co. v. American Sur. Co.*, 99 F. 674 (2d Cir. 1900); *Supreme Council Catholic Knights of America v. Fidelity & Cas. Co.*, 63 F. 48 (6th Cir. 1894); *Lombard Inv. Co. v. American Sur. Co.*, 65 F. 476 (C.C.W.D. Mo. 1895); *Mayor of Brunswick v. Harvey*, 40 S.E. 754 (Ga. 1902); *John Church Co. v. Aetna Indem. Co.*, 80 S.E. 1093 (Ga. Ct. App. 1913); *Grant County Bldg., Loan &*

sate firms for losses attributable to a wide range of employee infidelities committed within the course of employment, from crimes to breaches of trust and dishonesty.¹⁵⁸ Commercial coverage for employee infidelity predates *Hudson* in separate policies, as part of larger insurance policies, and in the 1920s with blanket indemnity bonds.¹⁵⁹ Significant litigation challenging provisions of fidelity instruments and their interpretation, may be seen as early as the middle 1800s.¹⁶⁰

Fidelity claims undercut the incentives and disincentives of an imputed fault. As corporations were subjected to vicarious liability for the malfeasance or nonfeasance of their agents immediately after *Hudson*, they were at liberty to purchase a hedge against the costs of sanctions.¹⁶¹ Banks recovered losses due to the fraudulent actions of employees, ranging from the president, secretary, and treasurer, to cashiers;¹⁶² real estate companies were reimbursed for the embezzlement of rent collectors;¹⁶³ an agricultural company recovered losses from employee embezzlement;¹⁶⁴ a grain company recouped losses from fraudulent misrepresentations of a warehouse superintendent;¹⁶⁵

Sav. Ass'n v. Lemmon, 78 S.W. 874 (Ky. 1904); American Bonding & Trust Co. v. Milwaukee Harvester Co., 48 A. 72 (Md. 1900); Lexington & W. Cambridge R.R. Co. v. Elwell, 90 Mass. (8 Allen) 371 (1864); First Nat'l Bank v. United States Fidelity & Guar. Co., 75 S.W. 1076 (Tenn. 1903).

158. For a consideration of fidelity bonds in relation to the proposed Restatement (Third) of Suretyship, see generally Hugh E. Reynolds, Jr. & James Dimos, *Fidelity Bonds and the Restatement*, 34 WM. & MARY L. REV. 1249 (1993).

159. See, e.g., United States Fidelity & Guar. Co. v. Barber, 70 F.2d 220 (6th Cir. 1934) (discussing a fidelity schedule bond issued to a bank). In addition to commercial fidelity coverage and fidelity bonds, governments may purchase public official bonds, and banks may purchase financial institution bonds.

160. See, e.g., Note, *Fidelity Bonds—Does It Pay to Renew Them?* 27 MICH. L. REV. 442 (1929); Francis T. Goheen, Recent Decisions, *Principal and Surety—Fidelity Bonds—Effect of Failure to Make Disclosures Regarding Bonded Employees*, 35 MICH. L. REV. 345 (1936); Recent Decisions, *Insurance—Corporations—Illegal Act of Directors As Constituting Act of the Corporation—Liability of Insurer on Fidelity Policy*, 33 COLUM. L. REV. 365 (1933). For a discussion of the concerns with firm liability policies, see generally Charles F. Krone, *Employers' Liability Policies*, 44 AM. L. REV. 513 (1910). The rise of insurance law is considered by W.R. Vance, *The Early History of Insurance Law*, 8 COLUM. L. REV. 1 (1908).

161. See Recent Case, *Corporations—Liability of Employees—Corporations May Seek Indemnity for Civil or Criminal Liability Incurred By Employee's Violation of Antitrust Law Without Corporation's Knowledge or Consent—Wilshire Oil Co. v. Riffe*, 409 F.2d 1277 (10th Cir. 1969), 83 HARV. L. REV. 943 (1970).

162. See *Centerville State Bank v. National Sur. Co.*, 27 F.2d 552 (D. Kan. 1928) (president); *Forest City Bldg. & Loan Ass'n v. Davis*, 133 S.E. 530 (N.C. 1926) (secretary-treasurer); *Morrellville Deposit Bank v. Royal Indem. Co.*, 144 A. 424 (Pa. 1928) (cashier).

163. See *Curran & Treadaway, Inc. v. American Bonding Co.*, 192 So. 335 (La. 1939).

164. See *American Bonding & Trust Co. v. Milwaukee Harvester Co.*, 48 A. 72 (Md. 1900).

165. See *Kendrick-Roan Grain & Elevator Co. v. Weaver*, 163 S.W. 814 (Tenn. 1913).

and a finance company recovered misappropriated funds from its fidelity insurer for acts of an employee who committed fraud.¹⁶⁶

3. Loss Shifting and the New Gospel

The recovery of losses caused by employee deviance through fidelity instruments and the indemnification of directors and officers accused of fraud and mismanagement serve as a disincentive for owners—particularly those in small firms—to encourage or promote the active monitoring of employees by management.¹⁶⁷ With some recent loss shifting decisions, moreover, it is simply unclear whether the risk sharing incentives of vicarious liability still have meaning.

In *In re Caremark International, Inc.*, shareholders sought recovery from directors for fines paid following the criminal conviction of their company for employee violations of laws regulating health care providers.¹⁶⁸ Caremark pleaded guilty to mail fraud, and paid significant civil and criminal fines.¹⁶⁹ In a creative marriage of the business judgment rule, the American Law Institute's Principles of Corporate Governance, and the Sentencing Guidelines for Organizations, the fiduciary duties of corporate directors were extended to matters of organizational compliance.¹⁷⁰

The Delaware Chancery Court ruled that the duty of a director includes the assurance of compliance procedures and reporting

166. See *White & Bollard, Inc. v. Standard Accident Ins. Co.*, 27 P.2d 123 (Wash. 1933).

167. See Recent Case, *supra* note 161, at 945. In this note, the author argues that allowing indemnity will deter employees, but denying indemnity will encourage shareholders to increase surveillance and monitoring of employees, no matter how distant they are from the day-to-day operations of the firm. Denying indemnity also will assist prosecutors in gaining access to internal corporate information necessary for prosecuting antitrust violations. See *id.*

168. *In re Caremark Int'l Inc.*, 698 A.2d 959 (Del. Ch. 1996).

169. See Richard S. Grnner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond*, in CORPORATE COMPLIANCE: AFTER CAREMARK, *supra* note 3, at 57.

170. See Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355 (1993); Joseph F. Savage, Jr., *Caremark: Director's Fiduciary Duty in a Sentencing Guidelines World*, BUS. CRIMES BULL., Jan. 1997, at 4. For an interesting pre-Caremark discussion of director liability, see generally Melvin A. Eisenberg, *The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); James L. Griffith, Jr., *Director Oversight Liability: Twenty-First Century Standards and Legislative Controls on Liability*, 20 DEL. J. CORP. L. 653 (1995). "One aspect of the board's general duty of care obligation in the oversight and inquiry areas is an affirmative obligation of directors to be reasonably concerned with the existence and effectiveness of procedures, programs, and other techniques . . . to assist the board in overseeing the corporation's business." ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 comment to § 4.01(a)(1)-(a)(2), cmt. c (1994)

systems reasonably capable of preventing law violations.¹⁷¹ Accordingly, a "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."¹⁷² In the aftermath of the decision, corporate counsel preached the new "post-Caremark" gospel by admonishing boards to assume a proactive role in allocating sufficient resources to ensure the active monitoring of agents throughout the corporate hierarchy.¹⁷³

The wisdom of this gospel was tested in a recent settlement of Securities and Exchange Commission ("SEC") charges against senior officers and directors of W.R. Grace & Co. for their failure to make required disclosures to shareholders.¹⁷⁴ Following an investigation by the staff of the Division of Enforcement in 1996, the SEC charged the chairman of the board, the chief executive officer, as well as various directors and officers with a failure to disclose details of a retirement package, as well as certain negotiations to sell a subsidiary to the ex-chairman's son.¹⁷⁵ The SEC concluded that the absence of disclosures violated securities laws, and the likely culprit was top management's acceptance of the corporate culture at W.R. Grace.¹⁷⁶ Although SEC Chairman Arthur Levitt has urged corporate counsel not to interpret *W. R. Grace* as an extension of a board's responsibility, commentators have seen the investigation and subsequent SEC ruling as a complement to the decision in *Caremark*.¹⁷⁷ Together, these cases suggest that the duty of corporate directors to protect shareholder interests includes an obligation to use compliance systems to monitor both management and subordinate employees.

171. Notably, the *Caremark* decision fails to specify the boundaries of a director's duties, the meaning of "good faith" efforts by directors, and the extent of a director's duty to supervise and monitor compliance efforts. See *Caremark*, 698 A.2d 959.

172. *Id.* at 970.

173. According to Harvey Pitt and his colleagues, directors must ensure that managers demonstrate a respect and allegiance to the law, update codes, ensure that the corporation provides sufficient compliance-related training and education, provide an anonymous means of communicating unethical or illegal acts when observed by employees, maintain an awareness of relevant legal issues, and reasonably delegate the supervisory oversight of corporate internal controls. See Harvey L. Pitt et al., *Director Duties to Uncover and Respond to Management Misconduct*, INSIGHTS, June 1997, at 5, 8.

174. See *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Concerning the Conduct of Certain Former Officers and Directors of W.R. Grace & Co.*, 65 SEC DOCKET 1240 (1997).

175. See *id.*

176. See *id.* at 1243-44.

177. See SEC 'Should Be More Outspoken' On Directors' Duty to Monitor Management, 30 Sec. Reg. & L. Rep. (BNA) 398 (Mar. 13, 1998); see also Susan Kavanaugh, *Corporations Discuss Ethics Challenges and Opportunities*, FED. ETHICS REP., June 1998, at 1.

III. THE GOOD CITIZEN CORPORATION AND CORPORATE COMPLIANCE

Though we cannot doubt the impact of a due diligence defense that insulates the corporate entity, the passage of MPC provisions that shift liability downward, the many *ex ante* and *ex post* mechanisms that serve the function of intracorporate loss shifting, and a new vision of the board's duty of care, each of these pales in comparison to the Guidelines' effect on the risk equilibrium of principals and their agents. This causes no surprise. Following passage of the Guidelines, maximum corporate sentences in federal courts were increased significantly while the range of permissible judicial departures was narrowed.¹⁷⁸ Yet both surprising and counter-intuitive is the effect that the Guidelines have had on the actual risk of liability in firms.

*A. Risk Shifting and the Emergence of the
Good Citizen Corporation*

The Guidelines reflect a "carrot and stick" approach. They acknowledge that management can engage in a proactive compliance that will reduce the likelihood of criminal activity, that Guidelines tied to "good citizen" actions will create incentives for law abidance, and that the failure to engage in such actions will result in significant fines. These objectives are explained in provisions that allow for sentence mitigation and aggravation. The commentary accompanying these provisions reveals prescriptive steps for due diligence that, in combination, afford firms insulation against criminal investigation, indictment, conviction, and significant fines.¹⁷⁹ The Guidelines'

178. See Laufer, *supra* note 76, at 1082-84.

179. According to the Guidelines, "culpability generally will be determined by the steps taken by the organization prior to the offense to prevent and detect criminal conduct, the level and extent of involvement in or tolerance of the offense by certain personnel, and the organization's actions after an offense has been committed." U.S. SENTENCING GUIDELINES MANUAL, *supra* note 43, at introductory commentary to ch. 8. Thus, while the Commissioners acknowledged that organizations act through agents, they also adopted the view that organizations operate, act, and have culpability. Consider, for example, the Commission's conceptualization of due diligence. Under the Guidelines, an effective program that prevents and detects crimes is underwritten by an organization's due diligence. Six of the seven factors considered by courts as evidence of organizational due diligence explicitly acknowledge the actions of the corporate entity:

(1) The organization must have established compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct. (2) Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures. (3) The organization must have used due care not to delegate substantial discretionary authority to individuals whom the organization knew,

mitigation provisions dramatically changed organizational strategy. Corporations no longer needed to plead with courts to recognize their diligent efforts. With the strong downward shift of liability, the importance to firms of the many loss shifting mechanisms had diminished. Indeed, the fate of vicarious liability was all but sealed. The liability rule that had been attacked and undermined since its recognition in *Hudson* would now be ignored by prosecutors wielding unbridled discretion to investigate, indict, settle, or proceed to trial.

1. A New Phase of Corporate Law Enforcement

Within the past decade, organizations have seized upon these prescriptive steps in the Guidelines' commentary, marking a new phase of corporate criminal law enforcement.¹⁸⁰ In this phase of "post-Guidelines" cases, corporate compliance for large, decentralized multinationals is bought and sold as cost-effective risk management in a marketplace of experts from "business integrity" consulting, insurance, and accounting firms.¹⁸¹ Evidence of organizational due diligence may forestall an investigation, minimize the chance of a criminal indictment, and possibly lead to a grant of governmental amnesty.¹⁸² In fact, in many jurisdictions, prosecutors are likely to

or should have known through the exercise of due diligence, had a propensity to engage in illegal activities. (4) The organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents, e.g., by requiring participation in training programs or by disseminating publications that explain in a practical manner what is required. (5) The organization must have taken reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution. (6) The standards must have been consistently enforced through appropriate disciplinary mechanisms, including, as appropriate, discipline of individuals responsible for the failure to detect an offense. Adequate discipline of individuals responsible for an offense is a necessary component of enforcement; however, the form of discipline that will be appropriate will be case specific. (7) After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately to the offense and to prevent further similar offenses—including any necessary modifications to its program to prevent and detect violations of law.

Id. at § 8A1.2(3)(k)(1)-(7) commentary at 389-90.

180. See generally Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559 (1990). For a reasonable view of Chapter Eight prescriptions, see Jeffrey M. Kaplan & George F. Meierhofer, Jr., *Compliance Programs on Trial*, PREVENTIVE L. REP., Spring 1997, at 27 (discussing compliance initiatives in the securities industry).

181. See, e.g., John H. Baker, *Who Wants to Buy Preventive Law?*, PREVENTIVE L. REP., Fall 1995, at 21 (noting how compliance may be marketed as a product).

182. As Neil Cartusciello has noted:

decline cases involving organizations with compliance programs modeled after the Guidelines' prescriptive steps. This is especially true in complex white-collar and corporate crime cases (e.g., antitrust and securities fraud), which require significant investigative and prosecutorial resources.¹⁸³ Declinations reward firms for their proactive and reactive efforts, focus scarce resources on the most abusive firms, and identify organizations that will not benefit from the Guidelines' mitigation credit.¹⁸⁴

The effect of the Guidelines on the balance of risks between agents and principals is predictable. Culpability scores, as well as judgments, as to the effectiveness of compliance efforts turn on the role of high-level personnel and those with substantial organizational authority.¹⁸⁵ Corporations face increasing fines where high-level

[A] corporation that fully cooperates and provides the government with information, access to witnesses and perhaps even access to otherwise privileged information, has a far better chance of avoiding indictment than one that does not. So, too, the corporation that disciplines or even terminates the wrongdoer employees, and installs management systems designed to detect and prevent such violations from recurring before charges are filed, can avoid an indictment.

Cartusciello, *supra* note 126, at 3.

183. See John Hagan et al., *The Social Organization of White-Collar Sanctions: A Study of Prosecution and Punishment in the Federal Courts*, in *WHITE-COLLAR AND ECONOMIC CRIME* 259 (Peter Wickman & Timothy Dailey eds., 1982); Susan P. Shapiro, *The Road Not Taken: The Elusive Path to Criminal Prosecution for White-Collar Offenders*, 19 *LAW & SOC'Y. REV.* 179 (1985).

184. See Richard S. Gruner, *Reducing Corporate Criminal Liability Through Post-Offense Responses*, in *ALI-ABA*, *supra* note 5, at 161, 168; Laufer, *Integrity*, *supra* note 7, at 164-65. As one prosecutor observed: "In general, if a company promptly discloses wrongdoing, makes full restitution to the government, and takes swift disciplinary action against the employees engaged in the misconduct, a prosecutor may conclude that the federal interest in prosecuting the corporation under these circumstances is significantly lessened." Robert S. Litt, *The Experience and Views of the Enforcement Community*, in *PROCEEDINGS*, *supra* note 1, at 303, 306.

185. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 43, at ch. 8:

'High-level personnel of the organization' means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest.

Id. at § 8A1.2 cmt. 3(b). "Substantial authority personnel' means individuals who, within the scope of their authority, exercise a substantial measure of discretion in acting on behalf of an organization. The term includes high-level personnel, individuals who exercise substantial supervisory authority (e.g., a plant manager, a sales manager), and any other individuals who, although not a part of an organization's management, nevertheless exercise substantial discretion when acting within the scope of their authority (e.g., an individual with authority in an organization to negotiate or set price levels or an individual authorized to negotiate or approve significant contracts.)" *Id.* at § 8A1.2 cmt. 3(c).

personnel participate in, condone, or deliberately ignore illegal acts.¹⁸⁶ Higher culpability scores are assessed on organizations when personnel of substantial authority tolerate pervasive violations.¹⁸⁷ Where employees with substantial authority participate in an offense, the Guidelines mandate a rebuttable presumption that extant compliance programs are ineffective.¹⁸⁸

The substantial connection between top management's involvement in the commission of an offense and the Guidelines' determination of corporate culpability provides a powerful incentive for organizations to push liability risk down the hierarchy, and away from the firm.¹⁸⁹ Corporate counsel are the first to say that their objective is to recast violations by employees across the organization as those that were committed by wayward employees—agents who failed to comply with a prescribed set of reactive and proactive corporate principles.¹⁹⁰

Corporate legal departments are in the unenviable position of assisting prosecutors in developing criminal cases against wayward employees, a phenomenon known as "flipping," in an attempt to minimize the allocation of liability to the entity.¹⁹¹ Many corporate

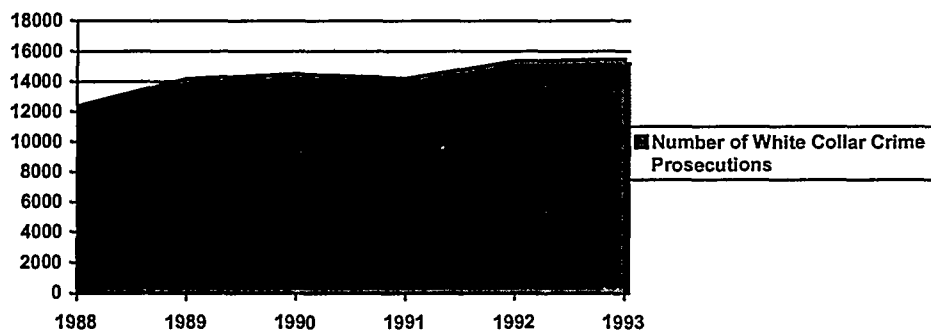
186. *See id.* at § 8C2.5(b).

187. *See id.*

188. *See id.* at § 8C2.5(f).

189. For a discussion as to how firms respond to this incentive, see *infra* Part III.B.

190. Data on the number of defendants prosecuted in federal courts for white-collar crimes following the Guidelines support this trend. The figure below illustrates the number of prosecutions in U.S. district courts between 1988 and 1993, for embezzlement, fraud (excluding tax), forgery, and counterfeiting.



BUREAU OF JUSTICE STATISTICS, U.S. DEP'T. OF JUSTICE, FEDERAL CRIMINAL CASE PROCESSING, 1982-1993, WITH PRELIMINARY DATA FOR 1994 2 (1996).

191. In discussing corporate compliance failures, Joseph E. Murphy noted that one of the central goals of compliance is to deter prosecution. "If you want any credit," according to Murphy, "your company must roll over and flip the culprits to the prosecutors." Joseph E. Murphy, *Handling the Risks: How to Respond to Compliance Failures*, in ALI-ABA, *supra* note 3, at 281, 299; *see also* John F. Savarese & Carol Miller, *Employee Issues in Internal*

policies now require an affirmative disclosure of criminal violations by employees directly to regulators and prosecutors.¹⁹² In the absence of such policies, there is still a strong incentive to flip given the negotiating leverage gained by defendants in pleading guilty, especially in complex corporate crime cases.¹⁹³ Where the entity is threatened with indictment, and evidence of individual misconduct is not disclosed, prosecutors need only resort to the threat of parallel civil proceedings to force the corporate hand.¹⁹⁴

2. Corporate and Prosecutorial Behavior Under the Guidelines

The Guidelines may be credited for the renewed interest of the business community in ethics and legal compliance. Further, the work of the Commission has brought concerns with corporate responsibility and organizational deviance to the forefront of a

Investigations, in CORPORATE COMPLIANCE: AFTER CAREMARK, *supra* note 3, at 1043; Gregory J. Wallace & Jay W. Waks, *Internal Investigation of Suspected Wrongdoing by Corporate Employees*, 11 CORP. COUNSEL'S Q. 77 (1995); Dean Starkman, *Pollution Case Highlights Trend to Let Employees Take the Rap*, WALL ST. J., Oct. 9, 1997, at B10 ("What happened in the [Darling International] case is being repeated across the country. Corporations under government investigation are increasingly turning on their employees to win leniency for themselves."). For a discussion of this practice in terms of leverage, see BRENT FISSE & JOHN BRAITHWAITE, CORPORATIONS, CRIME AND ACCOUNTABILITY 159 (1993) ("Using collective liability as a lever for bringing internal accountability out in the open. . .").

192. See Kirk S. Jordan & Joseph E. Murphy, *Compliance Programs: What the Government Really Wants*, in CORPORATE COMPLIANCE: HOW TO BE A GOOD CITIZEN CORPORATION THROUGH SELF-POLICING, *supra* note 3, at 121, 127. Commission data of corporations convicted over the past three years reveal an absence of organizations that self-report violations. In 1994, 1.8% of all corporations sentenced self-reported; 3.7% in 1995; and 0.0% in 1996. See U.S. SENTENCING COMM'N, 1994 ANNUAL REPORT 130 (1995); U.S. SENTENCING COMM'N, 1995 ANNUAL REPORT 127 (1996); U.S. SENTENCING COMM'N, 1996 ANNUAL REPORT 38 (1997). Prosecutors openly discuss the role of self-reporting. See Litt, *supra* note 184, at 306 ("In general, if a company promptly discloses wrongdoing, makes full restitution to the government, and takes swift disciplinary action against the employees engaged in the misconduct, a prosecutor may conclude that the federal interest in prosecuting the corporation under these circumstances is significantly lessened.").

193. See Celesta A. Albonetti, *Direct and Indirect Effects of Case Complexity, Guilty Pleas, and Offender Characteristics on Sentencing for Offenders Convicted of a White-Collar Offense Prior to Sentencing Guidelines*, 14 J. QUANTITATIVE CRIMINOLOGY 353 (1998) (discussing the incentives associated with guilty pleas and the shifting negotiating power of defendants in complex white-collar crime cases). See generally KENNETH MANN, DEFENDING WHITE-COLLAR CRIME: A PORTRAIT OF ATTORNEYS AT WORK (1985).

194. For a recent examination of prosecutorial strategy in relation to civil versus criminal proceedings, see Khanna, *supra* note 78, at 1525 (arguing that the pursuit of parallel proceedings by prosecutors place organizations in a poor strategic position, because it forces the disclosure of their litigation strategies, while encouraging the loss of civil claims so as to encourage prosecutorial leniency). See generally Coffee, *supra* note 35; John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875 (1992); *Modern Pressures*, *supra* note 21; Savage & Martz, *supra* note 20.

critically important debate over corporate compliance. The effect of the Guidelines on corporate and prosecutorial behavior, however, raises serious concerns about the real meaning of good corporate citizenship, and the apparent weakness of corporate self-regulation.¹⁹⁵ Most of these concerns reflect the insignificance of vicarious liability in the enforcement of corporate crime.¹⁹⁶

In contrast to the moderate but steady rise in individual liability over the past decade, there are simply fewer post-Guidelines corporate cases that proceed beyond a plea agreement or civil settlement. There are so few cases that the idea of "going to trial" is now discussed as if it is a thing of the past.¹⁹⁷ Deferred prosecution and pretrial diversion have emerged as the preferred tools of prosecutors.¹⁹⁸ Even though the Commission recently reported that 220 corporations were sentenced in federal courts under Chapter Eight of the Guidelines in 1997, a forty percent increase over the prior year and nearly twice as many as in 1994, this still represents significantly fewer annual convictions than in most years before the Guidelines were passed.¹⁹⁹

195. The idea of a good citizen corporation was discussed at some length nearly thirty years ago in Phillip I. Blumberg, *Corporate Responsibility and the Social Crisis*, 50 B.U. L. REV. 157, 163-64 (1970). Good corporate citizenship is different from organizational citizenship behavior. See generally Linn Van Dyne et al., *Organizational Citizenship Behavior: Construct Redefinition, Measurement, and Validation*, 37 ACAD. MGMT. J. 765 (1994).

196. See Savage & Martz, *supra* note 20, at 13.

197. See *Is the Corporate Defense a Relic of the Past or a Glimmer of the Future?*, Prevention of Corp. Liab. (BNA) 12 (July 20, 1998) (recognizing the antiquated federal law "on corporate criminal liability," and the paucity of corporations going to trial).

198. See generally Warin & Schwartz, *supra* note 129 (discussing the externalities associated with the prosecution of large, publicly traded entities).

199. See, e.g., U.S. SENTENCING COMM'N, 1997 ANNUAL REPORT 40 (1998). The Commission is required by statute to collect information concerning all organizational defendants that are sentenced in federal courts across all districts. Unfortunately, data collection efforts have been less than optimal. Commission data are compromised by the fact that: (a) not all cases have been reported to the Commission by the United States Probation Office, resulting in Commission efforts to supplement data files with cases gleaned from media reports; (b) only those federal criminal cases that terminate at the sentencing phase are reported, neglecting an ever increasing trend toward plea agreements and prosecutorial preference for civil proceedings; and (c) data sets for the first two years following the passage of the Guidelines are incomplete and, thus, too unreliable for any meaningful analysis. Even with these limitations, the data do not clearly demonstrate the number of convictions seen in pre-Guidelines prosecution or an overall significant increase in fines. See U.S. SENTENCING COMM'N, 1993 ANNUAL REPORT 45-47 (1994); U.S. SENTENCING COMM'N, 1994 ANNUAL REPORT 29-31 (1995); U.S. SENTENCING COMM'N, 1995 ANNUAL REPORT 33-35 (1996); U.S. SENTENCING COMM'N, 1996 ANNUAL REPORT 31-32 (1997); U.S. SENTENCING COMM'N, 1997 ANNUAL REPORT 33-34 (1998). For an excellent discussion of the increase in fines during 1984-87 and 1989-90, see generally Mark A. Cohen, *Corporate Crime and Punishment: A Study of Social Harm and Sentencing Practice in the Federal Courts, 1984-1987*, 26 AM. CRIM. L. REV. 605 (1989); Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-1990*, 71 B.U. L. REV. 247 (1991).

Why should the relative decline in convictions with a corresponding increase in pretrial diversion raise concerns? First, the trend suggests a discretionary use of the corporate criminal law by prosecutors that circumvents the overriding justification for sentencing guidelines—reducing discretion and the risk of disparity.²⁰⁰ Second, given the absence of “effective” compliance initiatives in many of the corporations that were spared continued prosecution, one must question the allegiance of prosecutors to the widely touted “carrot and stick” philosophy of the Guidelines. Third, any comparison of the kinds of cases that move forward to trial and conviction, against those that are diverted, reveals a difference in size and ownership structure.

The trend toward convictions of small, privately held organizations continues to be strong. Over the past five years, an average of ninety-six percent of all organizations sentenced in federal courts have been privately held, with fewer than fifty employees.²⁰¹ In addition, there remains a significant awareness of and involvement in the illegalities by senior management of these small firms. In a majority of cases, owners and top management are prosecuted as individuals and convicted along with the corporation.²⁰²

200. See William W. Wilkins, Jr. & John R. Steer, *The Role of Sentencing Guideline Amendments in Reducing Unwarranted Sentencing Disparity*, 50 WASH. & LEE L. REV. 63, 64 (1993) (“Congress was motivated by several primary objectives in enacting sentencing reform legislation, but none was more important than increasing fairness and uniformity in sentencing.”).

201. See William S. Laufer, *A Study of Small Business Compliance Practices*, in PROCEEDINGS, *supra* note 1, at 135; John Scalia, Jr., *Cases Sentenced Under the Guidelines*, in PROCEEDINGS, *supra* note 1, at 243, 244 (“Consistent with what Bill Laufer found in his study, the organizations sentenced under the guidelines typically employ fewer than 50 people. . . . [T]he overwhelming majority, 56%, employed fewer than 20 persons, and another 23 percent employed between 20 and 100 people. A very small percentage employed fewer [sic] than 500. Under the Small Business Administration criteria, those organizations employing fewer than 50 people would be classified as extremely small organizations.”); Joe Davidson, *Corporate Sentencing Guidelines Have Snagged Mostly Small Firms*, WALL ST. J., Aug. 28, 1995, at B3; Laufer & Darnell, *supra* note 1. See also Macey, *supra* note 60, at 323. Only 2.9% of the organizations sentenced in the calendar year 1997 employed more than 1,000 individuals; 33.6% employed less than 10 individuals; and 42.1% employed between 10 and 100 individuals. Of the 220 organizations convicted in federal courts, only four were publicly traded companies. U.S. SENTENCING COMM’N, 1997 ANNUAL REPORT 40 (1998).

202. According to Scalia in his piece *Cases Sentenced Under the Guidelines*, PROCEEDINGS, *supra* note 1, at 243, 244, more than 96% of the post-Guidelines cases, as of 1995, involved closely held organizations. This, in part, accounts for the fact that owners or top management are aware of illegalities and are often named as co-defendants with the organization. In 1995, Scalia observed that: “Of the 264 closely held organizations sentenced thus far, an owner or top executive was convicted in approximately 51 percent, or 134, of these cases; 189 owners or top executives were convicted in all.” *Id.* Most recent data support Scalia’s observation: 344 individuals were convicted in individual prosecutions for the same offense conduct that led to 162 corporate convictions; 104 were owners, and 39 were officers. See U.S. SENTENCING COMM’N, 1997 ANNUAL REPORT 41 (1998).

Cases reported to the Commission following the passage of the Guidelines also point to the power of compliance programs—no matter how effective or ineffective—as preventive law.²⁰³ Only one of the corporations convicted in federal courts in 1997 had what was determined by a court to be an “effective” compliance program.²⁰⁴ Annual Commission data also reveal that mitigation credit for having a compliance program—effective or not—is rarely offered to the few corporations that go to trial and are convicted.²⁰⁵

The absence of effective compliance programs and the failure of corporations to obtain even nontrivial mitigation credit may be interpreted in several ways. First, reasonably constructed compliance initiatives effectively shift prosecutorial attention to alternate civil remedies, consent decrees, and plea agreements, as well as the criminal investigation of individual agents.²⁰⁶ A more interesting and important question, however, is whether ineffective compliance initiatives also inhibit the criminal process. As the Deputy Assistant Attorney General in the Criminal Division of the Department of Justice observed, prosecutors often require corporations to contractually promise to establish a compliance program or strengthen an existing ineffective initiative as part of an agreement

203. See, e.g., Michael M. Baylson, *Getting the Demons Into Heaven: A Good Corporate Compliance Program*, 2 CORP. CONDUCT Q. 33, 34 (1992):

But with a compliance program, you might be able to show that high corporate officials were not aware of it or did not in any way encourage it; you might be able to show that individuals did not believe they were committing a crime and as soon as criminal liability was suggested, they stopped whatever they were doing.

204. U.S. SENTENCING COMM’N, 1997 ANNUAL REPORT 41 (1998). Federal courts are consistent in ruling that organizations fail to satisfy all of the requirements of § 8A1.2 (1997). In both 1994 and 1995, three companies offered evidence of compliance procedures, albeit inadequate, according to reviewing courts. See U.S. SENTENCING COMM’N, 1994 ANNUAL REPORT 125 (1995); U.S. SENTENCING COMM’N, 1995 ANNUAL REPORT 124-25 (1996).

205. See *Scalia Cases Sentenced Under the Guidelines*, in PROCEEDINGS, *supra* note 1, at 243, 245.

206. See Baylson, *supra* note 203, at 33-35 (“You must recognize the role of prosecutorial discretion in the bringing of charges. This is the other fundamental reason why a compliance program is essential. . . . Having an effective compliance program to pull out of your portfolio and lay on the prosecutor’s desk is a very key weapon. . . . You cannot get to first base with a prosecutor without having a compliance program, and having one may land you a home run.”); cf. MICHAEL L. BENSON & FRANCIS T. CULLEN, *COMBATING CORPORATE CRIME: LOCAL PROSECUTORS AT WORK* (1998). Unfortunately, Benson and Cullen’s survey of district attorneys and state prosecutors fails to inquire about the role of corporate compliance initiatives, even though anecdotal evidence of a comparable effect in state prosecutions has been noted. See William K. Perry et al., *State Attorneys General Encourage Voluntary Corporate Compliance Programs*, 2 CORP. CONDUCT Q. 49 (1993); NEW JERSEY ENVTL. PROSECUTOR’S OFFICE, *FACTORS IN THE EXERCISE OF DISCRETION ON CRIMINAL PROSECUTIONS FOR ENVIRONMENTAL VIOLATIONS IN THE CONTEXT OF EFFECTIVELY OPERATION VOLUNTARY COMPLIANCE/AUDIT PROGRAMS* (1992) (on file with author).

not to prosecute. "In other words, even if you don't have a compliance program at the time you come into the prosecutor's office, you ought to think about setting up an effective one and offering this up as part of a plea bargain or an agreement not to prosecute the corporation."²⁰⁷

This concession, that firms may strengthen an ineffective program, or even create one if none is present, is made because of the difficulty both prosecutors and courts have had in determining what "effective" compliance means, particularly in large and complex corporate bureaucracies. What combination of ombudsmen, review boards, hotlines, disciplinary mechanisms, internal audits, training programs, and code complexity must be present to make such a determination? How should prosecutors assess the commitment of top management?

Prosecutors admit comfort with identifying the easy cases where there is a "nice compliance program with a little gold seal at the bottom and a frame around it, and the company's officers and employees go out and violate the law anyway because the program is not an effective one."²⁰⁸ These easy cases may still exist within small, privately-held firms, poorly counseled in preventive law. The real challenge, if the corporate criminal law still has meaning, is the comfort level of prosecutors and courts in evaluating compliance effectiveness with those corporations that rarely if ever go to trial—the large, diversified, publicly held corporation. Here, there simply does not exist an accepted metric used to assess program design, operation, and outcome.

Some commentators point to a growing consensus of what constitutes an "effective" compliance program. This consensus is reflected in the conditions and requirements of the court-imposed criminal plea agreements and civil consent decrees against such firms as National Medical Enterprises, Conrail, Con Edison, Caremark, Grumman Corporation, and Prudential Securities.²⁰⁹ Trying to distill a set of objective, no less subjective, metrics from these cases requires more creativity than is currently available. Moreover, these are a very select few of the hundreds, if not thousands, of federal investigations of organizations each year that never result in a

207. Litt, *supra* note 184, at 305.

208. *Id.* at 304.

209. See generally Kirk S. Jordan & Joseph E. Murphy, *Compliance Programs: What the Government Really Wants*, in CORPORATE COMPLIANCE: HOW TO BE A GOOD CITIZEN CORPORATION THROUGH SELF-POLICING, *supra* note 3, at 121 (discussing common elements of compliance programs in civil antitrust cases, civil and criminal settlements in environmental cases, health care fraud cases, defense contracting fraud cases, and an assortment of other settled civil allegations).

criminal indictment or trial. One must question whether the importance of their treatment by prosecutors stems from significant name recognition or the generalizability of regulatory treatment and oversight.

Substituting intuitive determinations of compliance effectiveness from regulators or courts risks significant error. Without an internally consistent set of objective criteria, courts are as stymied as business ethicists and compliance experts in providing anything but limited anecdotal evidence of compliance effectiveness.²¹⁰ Prosecutorial discretion is neither guided nor constrained by reasonable proxies of effectiveness. This would be less of a problem but for the fact that the reach of the criminal and civil law is now determined by the subjective discretion of prosecutors, who balance matters of compliance effectiveness with concerns over the available resources of their office.²¹¹

A final effect of the risk shifting brought on by the passage of the Guidelines is that the long-standing tradition of top management indemnification has been undermined by incentives to discipline agents across the corporate hierarchy, as well as distinct disincentives if organizations choose otherwise. As one corporate counsel surmised, there are multiple risks posed by indemnification, including: (1) an increased perception of corporate irresponsibility, (2) the suggestion of an organizational conspiracy, (3) a decreased mitigation score under the Guidelines for failing to fully cooperate with prosecutors and regulators, and (4) an increased likelihood of shareholder derivative

210. The difficulty with obtaining objective indicia of compliance effectiveness haunts business ethics research on compliance. Evidence of increased reliance on compliance procedures, such as a rise in the number of calls to an ethics office or an ethics hot line, may be indicative of effectiveness (i.e., the existence of procedures reasonably capable of preventing law violations), ineffectiveness (i.e., an increase in the extent of deviance within the firm), or both. Courts are capable of assessing adherence to the prescriptive steps in the Guidelines, but establishing adherence is quite different from assessing effectiveness. According to the National Center for Preventive Law, "[w]hile some rudimentary tests are contained in the Sentencing Guidelines and other legal standards, these tests provide little concrete direction on how to create effective programs." NCPL, CORPORATE COMPLIANCE PRINCIPLES III (1997) (on file with author).

211. Perhaps the Advisory Group on Environmental Sanctions to the United States Sentencing Commission proposed the most reasonable set of criteria to date. On December 6, 1993, this group reported a draft proposal of sanctions for organizations convicted of environmental offenses. In evaluating the extent of a firm's environmental compliance, the Working Group proposed that courts should consider: line management attention to compliance; integration of environmental policies, standards, and procedures; auditing, monitoring, reporting and tracking systems; regulatory expertise, training and evaluation; incentives for compliance; disciplinary procedures; continuing evaluation and improvement; and other innovative approaches. U.S. SENTENCING COMM'N, REPORT FROM ADVISORY GROUP ON ENVIRONMENTAL SANCTIONS § 9D1.1(a) 1-8 (1993).

actions.²¹² Loss shifting practices that interfere with the prospect of liability risk shifting are the latest casualty of the Guidelines.

3. Prosecutorial Strategy

Prosecutors are forthright about their discretionary strategy to avoid vicarious liability. Guided by the spirit of formal Department of Justice policies and a strong interest in minimizing the externalities associated with corporate sanctions, United States Attorneys prize active cooperation by the target company, proactive structural and managerial changes designed to remedy organizational deficiencies, a willingness to enter into consent civil judgments, and the payment of significant civil and administrative fines.²¹³

Resorting to civil remedies reflects a prosecutorial deference to large corporations. There is a sense that it is imprudent to be unnecessarily harsh when the social costs of a criminal indictment against an organization with multiple stakeholders may be great.²¹⁴ With the active cooperation of large organizations, prosecutorial strategy also reflects a propensity for the criminal prosecution of

212. See generally *Modern Pressures to Cooperate with Prosecutors Almost Make 'Defending a Corporation' Oxymoronic*, *supra* note 21.

213. See Cartusciello, *supra* note 126, at 3; Savage & Martz, *supra* note 20, at 13. For a discussion of these policies, see generally Warin & Schwartz, *supra* note 129. Individual governmental agencies have promulgated enforcement policies that guide regulatory and prosecutorial activities. See Publication of the OIG Compliance Program Guidance for Hospitals, 63 Fed. Reg. 8987 (1998); Interim Policy on Compliance Incentives for Small Businesses, 61 Fed. Reg. 27,984 (1996):

EPA will refrain from initiating an enforcement action seeking civil penalties, or will mitigate civil penalties, whenever a small business makes a good faith effort to comply with environmental requirements by receiving on-site compliance assistance or promptly disclosing the findings of a voluntarily conducted environmental audit, subject to certain conditions.

See also Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 60 Fed. Reg. 66,706 (1995) ("[W]here violations are found through voluntary environmental audits or efforts that reflect a regulated entity's due diligence, and are promptly disclosed and expeditiously corrected, EPA will not seek gravity-based (i.e., non-economic benefit) penalties and will generally not recommend criminal prosecution against the regulated entity."). For a general outline of these regulations, see Paula J. Desio, *The Regulatory Environment and the Organizational Sentencing Guidelines*, Ass'n for Practical and Prof'l Ethics, Feb. 26, 1999 (on file with author).

214. See generally Wallace N. Davidson, III & Dan L. Worrell, *The Impact of Announcements of Corporate Illegalities on Shareholder Returns*, 31 ACAD. MGMT. J. 195 (1988); Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear From Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993) (discussing the reputational cost of fraud); Alan K. Reichert et al., *The Impact of Illegal Business Practice on Shareholder Returns*, 31 FIN. REV. 67 (1996). For an example of an organization and its agents facing civil and criminal liability for the same acts, see *United States v. Andrews*, 136 F.3d 933 (D.C. Cir. 1998) (upholding the indictment of the CEO and president of a corporation that had already been fined \$500,000 for securities fraud).

middle management, supervisory personnel, and subordinate employees. Most important, the perceived power and authority of the Guidelines' incentives, as well as the transparency and signaling of strategy, support a view that compliance is risk management. Firms use compliance to their significant advantage, as a means of avoiding the imputation of criminal liability.²¹⁵ That this is no mere speculation, observe how the firm's cost of pure risk has been minimized through management's control and discipline of its agents.

In fact, in tracing the evolution of corporate criminal liability in the context of the many other risk shifting mechanisms used to transfer tort or contract liability, one concludes that considerations of strategic risk management account for a large number of the historical shifts. This is not to say that the rise and fall of vicarious liability, the recognition of common law corporate governance principles, or the consideration of various defenses to both criminal and civil liability may be traced to a systematic risk management process.²¹⁶ Rather, organizations must be credited with actively managing and controlling risks of liability and loss.

B. The Meaning of Compliance

Scholars considering a corporate due diligence defense have asked the rhetorical question: Can a corporation save its soul?²¹⁷ Standing alone, this question makes sense to those who believe that some, if not many corporations, genuinely seek compliance as a function of good corporate citizenship. Corporations adopt integrity-based management initiatives through strong and courageous leadership. Compliance is an empowered accountability that is driven down the corporate hierarchy through the firm's structure, processes, and decisions. Compliance should be institutionalized to shape "an organization's guiding values, to create an environment that supports ethically sound behavior, and to instill a sense of shared accountability among employees."²¹⁸

215. For a general treatment of risk management, see generally NEIL A. DOHERTY, *CORPORATE RISK MANAGEMENT: A FINANCIAL EXPOSITION* (1985); JAMES S. TRIESCHMANN & SANDRA G. GUSTAVSON, *RISK MANAGEMENT AND INSURANCE* (10th ed. 1998).

216. A systematic risk management process is an ongoing, systematic identification and evaluation of risks, followed by the selection and implementation of risk management techniques. For a discussion of risk analysis, more generally, see *infra* Part II.D.

217. See, e.g., Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 47 *RUTGERS L. REV.* 605 (1995). Notably, there was no attribution to Lord Thurlow.

218. Paine, *supra* note 130, at 111.

This question of corporate salvation appears naïve to those who see more strategic utility in corporate compliance than morality.²¹⁹ Those who think it naïve would argue, as I have here, that the Guidelines must be seen within the larger context of the positioning of firms relative to the strategic management of risks. The Commission responded to the business lobby by giving those firms with the necessary resources and counsel a definitive risk shifting mechanism backed by the legitimate pretext of employee compliance to law. This pretext allows for the integration of compliance into an overall corporate strategy, while encouraging a convergence of agency interests. Organizations can hold themselves out as having integrity, diligence, and a commitment to law without excessive monitoring expenditures. Agents can minimize bonding costs by effortlessly endorsing business conduct principles, codes of ethics, and compliance standards that are consistent with their values and beliefs, and at the same time reflect firm policy.

Finally, there is an even more critical view of the “good corporate citizenship” movement. Corporate compliance is perhaps best conceptualized as an effort on the part of firms to extend the management of liability risks to the point of insurance or self-insurance. Whether compliance is driven by the preventive law strategies of corporate counsel or integrated seamlessly into the audit and control functions of the firm, “good corporate citizenship” is an elaborate and well-dressed variation of fidelity insurance or fidelity bonding—with a clever risk shifting twist.

All three views, and any combination of these views, are found in the conceptual continuum that represents the explicit or implicit rationale for corporate compliance practices.²²⁰ As we shall see below and later in Part IV, problems arise when there are limited incentives to do more than see compliance as risk-driven strategy, when a firm’s message of compliance stands in contrast to incentive and reward systems that reinforce a very different culture, and when the dogma of leadership is inconsistent with prevailing business practices.²²¹

219. Though not necessarily intended, this question implies that compliance can affect corporate, if not moral, salvation. See generally Greg Baldwin & John Campbell, *Sentencing Rules Point Way to Organizational Salvation*, MONEY LAUNDERING ALERT, Jan. 1995, at 8.

220. See Laufer, *A Study of Small Business Compliance Practices*, *supra* note 1, at 147.

221. See generally Erik Jansen & Mary Ann Von Ghinow, *Ethical Ambivalence and Organizational Reward Systems*, 10 ACAD. MGMT. REV. 814 (1985).

C. Compliance as Integrity

Several years ago, Professor Paine divided corporate strategies for ethics management into two categories: compliance and integrity.²²² Compliance seeks conformity with laws and regulations. It is designed to prevent corporate and white-collar crime. It is championed by legal counsel. It is controlled by audits and strict penalties. It assumes that all employees are driven by material self-interest.²²³ Yet integrity is guided by ethical values and commitments that are clearly communicated by corporate leaders with a strong personal commitment to an ethical culture. These values and commitments are integrated into the normal channels of management decision-making. They are reinforced by organizational systems and structures. With integrity management, top and middle managers are empowered to make ethically sound decisions.²²⁴

Elsewhere I have argued that the virtue of corporate integrity may be captured in law by the Guidelines' conception of organizational due diligence, at least in theory.²²⁵ Due diligence can be an organizing virtue that imposes both ethical and legal obligations on corporations and their agents.²²⁶ First, it requires the articulation of ethical standards of conduct.²²⁷ Second, due diligence must satisfy

222. See generally Paine, *supra* note 130. Paine's integrity strategy compares favorably with the "compliance" strategy found in the Guidelines, as well as the interactive corporate compliance strategy articulated in JAY A. SIGLER & JOSEPH E. MURPHY, *INTERACTIVE CORPORATE COMPLIANCE: AN ALTERNATIVE TO REGULATORY COMPULSION* (1988). Notably, Sigler and Murphy focus on management commitment, education and awareness, and implementation and control. See also Alan R. Yuspeh & Rebecca E. Goodell, *Terms Such as 'Compliance Program,' 'Ethics Program' Aren't Synonymous*, *Prevention of Corp. Liab.* (BNA) 8 (Nov. 1995); *Are Compliance and Ethics Related?*, *BENCHMARKS*, Mar. 1994, at 3. See generally Winthrop M. Swenson, *An Effective Program to Prevent and Detect Violations of Law*, in KAPLAN, *supra* note 3, at § 4, § 4.07.75.

223. See Paine, *supra* note 130, at 113.

224. See *id.* at 112.

225. See Peter A. French, *Integrity, Intentions, and Corporations*, 34 *AM. BUS. L.J.* 141, 152-53 (1996):

Hence, it should make sense to say that corporations may act in ways that are consistent with the virtue of integrity. What that means, as I understand it, is that corporations can adopt policies that require them to continually pursue the truth of their corporate commitments and that regularly expose their convictions and corporate policies and procedures to moral scrutiny.

See also William S. Laufer, *Integrity*, *supra* note 7 (responding to French's commentary on integrity); ROBERT C. SOLOMON, *ETHICS AND EXCELLENCE: COOPERATION AND INTEGRITY IN BUSINESS* 168-74 (1992).

226. See generally *CORPORATE COMPLIANCE: HOW TO BE A GOOD CITIZEN CORPORATION THROUGH SELF-POLICING*, *supra* note 3.

227. See U.S. SENTENCING GUIDELINES MANUAL, *supra* note 43, at § 8A1.2 commentary at 3(k)(1)-(7).

an intentionality requirement by demanding action in accordance with these self-selected and self-imposed values.²²⁸ Third, it compels the acceptance of responsibility, and the affirmative obligation to disclose practices that violate the law.²²⁹ And finally, due diligence imposes responsible proactive and reactive behavior on firms consistent with prescribed standards of conduct.²³⁰

That due diligence actually reflects organizational integrity is, in the last, a matter of faith. Even scholars with allegiance to integrity-based strategies can point to only a select number of organizations that meet or exceed expectations.²³¹ When examples are offered, they are most often part of the membership of a business ethics association, e.g. the Ethics Officers Association. For the vast majority of organizations, however, it seems fair to conclude that the consideration of "ethics are tangential and warrant consideration only as an optic in response to a short-term crisis."²³² Research on the institutionalization of ethics compliance initiatives is also less than encouraging.²³³ Perhaps most significant, the real function of due diligence and the rhetoric of the "good citizen" corporation movement must be seen in light of the historical evolution of liability risk shifting. Within this context, one tends to discount some—if not much—of the inspiration from the rallying cry of its leaders. What does it mean when the Chairman of the United States Sentencing Commission inaugurates a conference designed for corporate legal departments by proclaiming the importance of good citizenship and

228. French notes that "the person of integrity is required to have a specific set of intentions . . . to pursue the proper moral principles and the truth of one's convictions." French, *supra* note 225, at 146; *see also* RICHARD T. DE GEORGE, *COMPETING WITH INTEGRITY IN INTERNATIONAL BUSINESS* 39 (1993).

229. *See* French, *supra* note 225, at 153 ("What that means, as I understand it, is that corporations can adopt policies that require them to continually pursue the truth of their corporate commitments and that regularly expose their convictions and corporate policies and procedures to moral scrutiny.").

230. As French has argued, corporate integrity is more than mere desires or beliefs. Integrity involves corporate planning and action, consistent with corporate policies. In law, due diligence is conceived of by degree and extent. *See generally* French, *supra* note 225.

231. *See* Robert H. Frank, *Can Socially Responsible Firms Survive in a Competitive Environment?*, in *CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS* (David M. Messick & Ann E. Tenbrunsel eds., 1996).

232. JOHN DALLA COSTA, *THE ETHICAL IMPERATIVE: WHY MORAL LEADERSHIP IS GOOD BUSINESS* 97 (1998). For scholarly research on the role of leadership and ethics, more generally, *see, e.g.*, Georges Enderle, *Some Perspectives of Managerial Ethical Leadership*, 6 *J. BUS. ETHICS* 657 (1987); Patrick E. Murphy & Georges Enderle, *Managerial Ethical Leadership: Examples Do Matter*, 5 *BUS. ETHICS Q.* 117 (1995) (discussing the role of ethical leadership in four companies).

233. *See infra* Part III.A.

the need to embrace those values that promote law abidance?²³⁴ These remarks are placed in proper context by the evolution in the meaning of corporate compliance over the last decade.

D. Compliance as Risk Management

The history of corporate compliance following the deliberations of the Sentencing Commission is marked by the immediate transformation of guidelines designed for use by federal judges in fashioning sentences, to principles that serve a complementary preventive law and internal control function.²³⁵ In the life of an organization, these principles are used in functions most appropriately and accurately described as risk management.²³⁶

234. See Richard P. Conaboy, *Welcome and Conference Overview*, in PROCEEDINGS, *supra* note 1, at 3, 5 (“[T]hose of you here today from the business community are in a position to do more than the bare minimum in taking a stand against crime. You must take on the obligation to lead this effort, to be in the forefront, not only by working to ensure that your companies’ employees follow the law but by embracing and placing at the very top of your companies’ priorities the basic good citizenship values that make law abidance possible.”). For a lay discussion of the potential for exploitation of the compliance movement, see Sandra Torry, *Tougher Penalties on Corporate Crime Raise Rich Opportunities*, WASH. POST, Mar. 2, 1992, at F5 (“The federal government’s new guidelines to toughen penalties for corporations that break the law have set off a booming business for lawyers, who are rushing to teach their clients how to stay out of trouble or soften the blow when they don’t.”).

235. See Laurence A. Urgenson, *Voluntary Disclosure: Opportunities and Issues for the Mid-1990’s*, in CORPORATE COMPLIANCE: AFTER CAREMARK, *supra* note 3, at 785, 788 (“The principle goal of compliance, however, is not to mitigate sentences, but to avoid indictment in the first place.”); see also Dana H. Freyer, *Corporate Compliance Programs for FDA-Regulated Companies: Incentives for Their Development and the Impact of the Federal Sentencing Guidelines for Organizations*, 51 FOOD DRUG L.J. 225, 229-30 (1996) (“An organization that, as a result of its compliance program, has detected unlawful activities and reported such acts to the appropriate regulatory agency has a powerful argument against indictment for such conduct.”). Similar to the organization of post-Guidelines’ risk management systems, the seven prescribed elements of the Guidelines are divided into three categories: Establishing Compliance Program (establishing compliance standards and procedures reasonably capable of reducing the prospect of criminal conduct); Structure and Control (assignment of high-level employees to oversee compliance efforts; using due care not to delegate significant discretionary authority; taking reasonable steps to communicate standards effectively); and Response to Violations and Incidents (taking reasonable steps to achieve compliance; consistent enforcement of standards; taking reasonable steps upon the discovery of an offense, as well as preventing further similar offenses). See *id.* at 235-39.

236. See generally JAMES S. TRIESCHMANN & SANDRA G. GUSTAVSON, RISK MANAGEMENT AND INSURANCE (1998); Dana H. Freyer & Benjamin B. Klubes, *A Practical Approach to Implementing a Corporate Compliance Program for Smaller Companies*, PREVENTIVE L. REP., Winter 1994, at 33.

Table 1: Models of Compliance as Risk Management

Compliance as Preventive Law	
National Center for Preventive Law: Twenty Principles of Corporate Compliance	
Establishing Compliance Program	
1.	Organizations should pursue compliance through the creation and maintenance of an effective compliance program.
2.	An effective compliance program is designed to prevent, detect and respond to legal risks and to promote compliance with law.
3.	An effective compliance program is a dynamic process that is designed to be flexible and modified, when appropriate, to reflect changing conditions
4.	An effective compliance program states that it is the organization's policy to comply with all applicable laws.
5.	The highest governing authority within the organization endorses the compliance program
6.	An effective compliance program establishes accountability for compliance throughout the organization.
7.	An effective compliance program is designed to operate fairly and equitably.
Structure and Control	
8.	Specific high-level personnel in an organization are responsible for the administration and oversight of the compliance program.
9.	A compliance program has the support of senior management of the organization. Each officer, manager and employee is responsible for supporting and complying with the compliance program's standards and procedures.
10.	The organization exercises due diligence to determine whether persons to whom substantial discretionary authority is delegated have a propensity to engage in illegal activities and to prevent such delegation to those persons.
Response to Violations and Incidents	
11.	The organization takes reasonable steps to achieve compliance with its standards and the law.
12.	An effective compliance program is proactive in its approach to dealing with incidents of noncompliance.
13.	An effective compliance program possesses or has access to investigatory, evaluative and reporting resources.
14.	An effective compliance program addresses the occasions for external reporting of violations of law.
15.	An effective compliance program utilizes incidents of noncompliance to evaluate its own effectiveness, to correct deficiencies and to effect improvements.
Training Programs—Making the System Effective	
16.	The organization's compliance program has a communications component, the objectives of which are to make employees and other agents aware of applicable standards of conduct and to promote compliance.
17.	An effective communications program is designed to reach the intended audience.
18.	An effective compliance program communicates appropriate information to the organization's employees and other agents.
19.	All levels of management are responsible for the operation of the organization's communications program concerning compliance.
20.	Incentives and disincentives are significant tools in promoting compliance.

Compliance as Internal Control	
Committee of Sponsoring Organizations (COSO): Internal Control System Evaluation	
Control Environment:	
1.	Does management adequately convey the message that integrity cannot be compromised? Does a positive control environment exist, whereby there is an attitude of control consciousness throughout the organization, and a positive "tone at the top"? Is the competence of the entity's people commensurate with their responsibilities? Is management's operating style, the way it assigns authority and responsibility and organizes and develops its people, appropriate? Does the board provide the right level of attention?
Risk Assessment	
2.	Are entity-wide objectives and supporting activity-level objectives established and linked? Are the internal and external risks that influence the success or failure of the achievement of the objectives identified and assessed? Are mechanisms in place to identify changes affecting the entity's ability to achieve its objectives? Are policies and procedures modified as needed?
Control Activities:	
3.	Are control activities in place to ensure adherence to established policy and the carrying out of actions to address the related risks? Are there appropriate control activities for each of the entity's activities?
Information and Communication	
4.	Are information systems in place to identify and capture pertinent information—financial and non-financial, relating to external and internal events—and bring it to personnel in a form that enables them to carry out their responsibilities? Does communication of relevant information take place? Is it clear with respect to expectations and responsibilities of individuals and groups, and reporting of results? And does communication occur down, across and upward in the entity, as well as between the entity and other parties?
Monitoring	
5.	Are appropriate procedures in place to monitor on an ongoing basis, or to periodically evaluate the functioning of the other components of internal control? Are deficiencies reported to the right people? Are policies and procedures modified as needed?

As Table 1 suggests, a common set of risk management principles were gleaned from the Guidelines' notion of due diligence by the National Center for Preventive Law ("NCPL"), as well as by the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission.²³⁷ The Guidelines and principles require the articulation of standards of conduct, delegation of compliance management to responsible personnel, appropriate monitoring in light of risks, and

237. See NCPL, *CORPORATE COMPLIANCE PRINCIPLES* (1997) (on file with author); NCPL's *TWENTY PRINCIPLES OF CORPORATE COMPLIANCE* (1998) (on file with author); COSO, *INTERNAL CONTROL—INTEGRATED FRAMEWORK* (1994) (on file with author). The principles in COSO were first published in a four-volume report in 1992. For a discussion of the first publication and its etiology, see generally Committee on Law and Accounting, "Management" Reports On Internal Control: A Legal Perspective, 49 *BUS. LAW.* 889 (1994). The history leading to the COSO Principles is also detailed in the text COSO, *INTERNAL CONTROL—INTEGRATED FRAMEWORK 93-98* (1994).

reasonable responses to the discovery of corporate illegalities.²³⁸ The NCPL's Principles of Corporate Compliance and the Internal Control Framework of COSO, however, extend the somewhat elementary notion of due diligence found in the Guidelines.²³⁹

NCPL principles represent the strategic use of due diligence as legal risk management and as "principles of legal risk reduction."²⁴⁰ NCPL Working Groups provide a blueprint for corporate counsel in the design and implementation of compliance programs that are cost-effective, that maximize legal value, and that minimize the risks associated with employee deviance.²⁴¹ The Working Group Draft on Establishing Compliance Programs, for example, guides counsel on the preservation of a firm's legal rights and privileges while structuring the incentives guiding compliance initiatives, the need to continually examine incentives that promote deviance, and the identification and explanation of the reasons for liability-causing conduct.²⁴²

By contrast, COSO incorporates principles of due diligence into a larger paradigm of internal control, which offers a concept of integrated risk management. Integrated approaches conceive of risk management as a process. They require an effective control structure. They articulate a common risk language.²⁴³ The five interrelated

238. See Paul E. Fiorelli & Cynthia J. Rooney, *COSO and the Federal Sentencing Guidelines*, INTERNAL AUDITOR, Apr. 1997, at 57 (comparing the Guidelines and COSO in relation to the control environment, risk assessment, control activities, information and communication, and monitoring); K. Raghunandan & D.V. Rama, *Management Reports After COSO*, INTERNAL AUDITOR, Aug. 1994, at 54 (discussing the extent to which reports of internal control are relied on by the Fortune 100 companies).

239. See, e.g., Catherine Collins McCoy & John A. Galotto, *The COSO Report on Internal Control: Implications for Public Companies and Executives*, INSIGHTS, Aug. 1993, at 29.

240. NCPL, CORPORATE COMPLIANCE PRINCIPLES, *supra* note 237, at i; see also Edward A. Dauer, *Preventive Law Dictates Going to Root Causes to Prevent Claims from Arising*, PREVENTIVE L. REP., Sept. 1988, at 12; Lynn E. Pollan, *Training Managers: Problem Prevention By In-House Counsel*, ACCA DOCKET, Fall 1994, at 76, 76 ("Corporate legal policies are designed to achieve compliance with laws and minimize unnecessary risks and losses.").

241. NCPL Principles 2 prescribes that: "An effective compliance program is designed to prevent, detect and respond to legal risks and to promote compliance with the law." NCPL, CORPORATE COMPLIANCE PRINCIPLES, *supra* note 237, at 6. The factors to be considered include:

- (1) identifying liability-causing conduct based on industry or organizational experience, as well as the occasions for such conduct;
- (2) identifying non-obvious and incipient misconduct that tends to promote illegal actions; and
- (3) structuring compliance practices to be effective, while still enhancing an organization's business, assets and goodwill and preserving its legal privileges and rights.

Id. at 7.

242. See NCPL, WORKING GROUP DRAFT: ESTABLISHING COMPLIANCE PROGRAMS: PRINCIPLE 2 (1998) (on file with author).

243. See Dave Lenckus, *Concentric Risk Programs Mean Big Business*, BUS. INS., Apr. 14, 1997, at 98 (discussing the value of an integrated (concentric) program designed for Fidelity

components of internal control work as a process to ensure operational effectiveness and efficiency, reliable financial reporting, and legal and regulatory compliance.²⁴⁴

The value of COSO is found in its integration of primary risk management functions. The environment, activities, and processes of an organization interact in meaningful ways across the five components of control. The control environment serves as a foundation for the assessment of compliance risks by management. Control activities ensure that the compliance message of management is conveyed through established channels of communication. Finally, the entire internal control process is actively monitored. The singular objective is to provide *reasonable assurance* of achieving compliance objectives.

The rhetoric of the “good citizen” corporation movement seems transparent when compliance is conceived of as the integrated management of legal risks with either NCPL or COSO principles. Organizational culture, ethos, values, and the notion of compliance effectiveness assume a distinct operational and instrumental meaning. “Compliance programming,” according to one compliance officer, “is just like any other risk management activity. What organization would go light today on insurance just because it has never been sued for property damage or personal injury?”²⁴⁵

The analogy to insurance is instructive. When compliance initiatives become an integral and instrumental part of a firm’s management of risks, or even a lesser part of an audit function, consider how similar the compliance rationale is to that which supports corporate insurance and self-insurance.²⁴⁶ After all, we are told that both are “required” risk shifting and risk retaining mechanisms.

Investments); Todd L. Williams, *An Integrated Approach to Risk Management*, RISK MGMT., July 1996, at 22 (discussing an integrated perspective as one requiring a focus on pure and speculative risk).

244. See generally Eisenberg, *supra* note 170 (discussing COSO and internal control in the context of a board’s responsibilities).

245. Herbert I. Zinn, *Boxing With Pandora—An Analysis of Management’s Role in Sustaining the Effectiveness of a Compliance Program*, in ORGANIZING FOR CORPORATE COMPLIANCE: TOWARD STANDARDS 133, 141 (1995).

246. Management may talk of mutual trust when unveiling a compliance plan, but employees often receive the message as a warning from on high. Indeed, the more skeptical among them may view compliance programs as nothing more than liability insurance for senior management. This is not an unreasonable conclusion, considering that compliance programs rarely address the root causes of misconduct.

Paine, *supra* note 130, at 111.

E. Compliance as Insurance and Self-Insurance

Traditional insurance products are made available to organizations for a host of compliance-related risks, from losses caused by the fraudulent acts of rogue traders, to the costs of violating environmental statutes.²⁴⁷ The range of fidelity policies available to firms, with coverage for virtually every crime and tort, is remarkable.²⁴⁸ With each policy or coverage, the insured (organization) pays a price that effectively transfers the risk of loss associated with law violations to a third-party insurer (insurance company). To the extent that organizations spend considerable resources in the name of risk management to internalize the costs of compliance failures, how similar is this to the risk retention and risk funding rationale that has driven many large corporations to self-insure?²⁴⁹ How similar are the reasons for traditional insurance with the rationale of firms that purchase compliance in order to shift risk of liability away from the entity?

The short answer to both of these questions is that there are a surprising number of similarities even though the purchase of compliance fails to meet most, if not all, of the legal requirements and non-legal assumptions of insurance and other risk financing alternatives. Instead of maintaining a fund to pay claims for covered employees, as is the case in traditional forms of self-insurance, firms purchase compliance to ensure against the inevitability of compliance failures. This "fidelity" insurance is as much self-insurance (not to mention self-protection) as the purchase of a fire extinguisher by a concerned homeowner.²⁵⁰

The primary justification for the purchase of compliance, however, is to insure that employee infidelity will be viewed as an indi-

247. See PAUL K. FREEMAN & HOWARD KUNREUTHER, *MANAGING ENVIRONMENTAL RISK THROUGH INSURANCE* (1997); Edwin Unsworth, *Lloyd's Offers Cover for Rogue Trading*, *BUS. INS.*, Oct. 13, 1997, at 25; Edwin Unsworth, *'Rogue Trader' Risks Covered By New Policy*, *BUS. INS.*, Feb. 16, 1998, at 55.

248. See, e.g., Thomas K. Bourke, *Their Own Worst Enemies*, *BUS. INS.*, June 29, 1992, at 56; R. Mark Keenan & Pablo Quinones, *Unraveling the Mystery of Insurance Coverage for Criminal Losses*, *HUM. RESOURCES PROF.*, July-Aug. 1998, at 28.

249. For an outline of the common motivations for self-insurance, see HERBERT S. DENENBERG ET AL., *RISK AND INSURANCE* 126-27 (2d ed. 1974). For a discussion of insurance in relation to tort and environmental law, see generally Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 *COLUM. L. REV.* 942 (1988); Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 *CORNELL L. REV.* 313, 316-17 (1990).

250. See Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 *CORNELL L. REV.* 129, 146 n.72 (1990) ("Fire extinguishers constitute a form of self-insurance; they are 'consumed' to reduce the expected cost of an accident.").

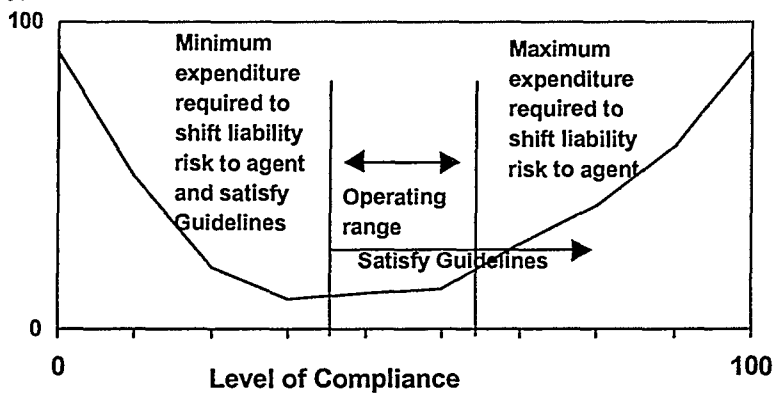
vidual, rather than a corporate act. Compliance, like insurance, is a method of greatly reducing a known risk. Consistent with the view that organizations are utility maximizers, and with the pretext of "good corporate citizenship," organizations simply select compliance purchases at the minimum level of expenditure necessary to shift liability to the agent.²⁵¹ Any expenditure beyond this level may be seen as inefficient. The costs to the firm are highest where there is little-to-no compliance (costs rise due to significant employee deviance that is imputed to the firm), and overcompliance (employee deviance is not imputed to the entity, but costs rise due to compliance expenditures). Firms maintain a level of compliance within an operating range that minimizes costs while at the same time shifting liability.²⁵²

Even with these similarities, no one would suggest that the purchase of compliance satisfies many of the nonlegal and the legal requirements of insurance or, for that matter, self-insurance. Courts have carefully drawn definitions challenging the deductibility of premiums as business expenses, requiring for proof of insurance a

251. Compliance and risk management experts are asked to institutionalize programs and initiatives that satisfy the "requirements" of the Guidelines. The orientation of the compliance industry is cost-effective risk reduction. Compliance products are marketed and sold as commercial insurance is brokered. See Dana Freyer & Joseph Murphy, *Obvious Legal Risks—Hidden Business Rewards*, 3 CORP. CONDUCT Q. 28 (1994) (discussing how to sell compliance as a business advantage: compliance reduces insurance costs and increases employee morale); Peg A. Schoenfelder, *Preventive Law "Marketing Tips" for Corporate Counsel*, PREVENTIVE L. REP., Fall 1995, at 19 (reviewing the business benefits of implementing minimal compliance programs); Lisa A. Whitney, *Marketing to the Corporate Client*, ACCA DOCKET, May-June 1995, at 40 (discussing how to "keep an eye" on the bottom line in marketing programs and services). "Carefully planned and implemented compliance programs," corporate counsel are told, "can reduce these risks by preventing illegal conduct and mitigating or eliminating punishment and liabilities for those offenses which still occur." NCPL, CORPORATE COMPLIANCE PRINCIPLES, *supra* note 237, at i.

252. A depiction of this, as an ideal function, appears below.

Hypothetical cost



clear showing of risk shifting and risk distribution.²⁵³ Risk shifting is narrowly defined by courts as the transfer of the risk of loss from one entity to another. Risk distribution requires a showing that losses will be spread across entities. Self-insurance, on the contrary, requires some risk-retention in addition to funding, and encompasses a wide range of risk-financing alternatives to traditional insurance.²⁵⁴

Notwithstanding these critical differences and generous violations of assumptions, the underlying rationales for underwriting compliance (shifting risk of loss to agents and minimizing costs due to compliance failures) are remarkably similar to those which support a more broad interpretation of insurance and self-insurance.²⁵⁵ Consider the central role of risk transference and risk control in both the purchase of insurance as well as compliance. Consider, in addition, that self-insurance may be conceptualized broadly as "any plan of risk retention in which a program or procedure has been established to meet the adverse results of a financial loss."²⁵⁶ Such an interpretation supports risk retention and risk funding plans that fail the legal requirements of pooling and inviolate reserves, but are nevertheless conceived of as self-insurance in many businesses.²⁵⁷

If it is true that firms purchase compliance as risk management to the point of insurance and generally minimize costs by spending only that amount necessary to effectively shift liability, it is critically important to consider how this might affect incentives and disincentives to institutionalize law abidance in firms. Such a consideration must address the adverse consequences, if any, of firms purchasing compliance in a manner similar to the purchase of insurance.²⁵⁸

253. See *Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941) ("Historically and commonly insurance involves risk-shifting and risk-distributing.").

254. See, e.g., James M. Fischer, *The Presence of Insurance and the Legal Allocation of Risk*, 2 CONN. INS. L.J. 1 (1996).

255. See, e.g., Jill B. Berkeley, *Recent Developments in Self-Insurance Law*, 33 TORT & INS. L.J. 693, 693-94 (1998) ("Self-insurance is a broad and relatively amorphous term that has been inconsistently used to describe any entity that lacks commercial insurance, either altogether or that otherwise retains ascertainable portions of its own risk.").

256. DENENBERG, *supra* note 249, at 125.

257. See *id.*

258. This question raises, more generally, the problem of moral hazard. See Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 326 n.65 (1993) ("Moral hazard is an adverse consequence of having insurance. It is defined as the increased probability of an insurable loss that arises solely because a person has insurance.").

IV. MORAL HAZARD AND THE FUTURE OF COMPLIANCE

For many years the problem of moral hazard, and its accompanying inefficiencies, was discussed in relation to insurance contracts.²⁵⁹ Scholars debated the detrimental effect that insurance has on an insured's incentives to avoid losses associated with a host of avoidable and unavoidable events, e.g., an automobile accident or house fire. Insurers concluded that a combination of the character of the insured and the incentives (or disincentives) from the purchase of insurance prompted a distinct risk of loss. Where an insured is of poor moral character, the purchase of insurance results in a temptation to engage in risk bearing behaviors.²⁶⁰ Short of taking optimal precautions, which is uncharacteristic of the morally weak, empirical research supported the experience and intuitions of a growing insurance industry. An insurance contract may compromise incentives, affecting an individual's care and activity levels, as well as the likelihood of loss.²⁶¹ In short, "insurance inevitably increases the occurrence, magnitude, or cost of that which is insured against."²⁶²

Kenneth Arrow first discussed the economics of moral hazard in the context of health insurance in 1963.²⁶³ Over the next three decades, the notion of moral hazard was extended to all forms of insurance. Scholars stretched its impact past traditional insurance to any situation where one party's action may affect the risk of loss assumed by another.²⁶⁴ Neoclassical economists found moral hazard problems in strict product liability regimes, cases of contributory

259. See, e.g., Ralph A. Winter, *Moral Hazard and Insurance Contracts*, in CONTRIBUTIONS TO INSURANCE ECONOMICS 61 (Georges Dionne ed., 1992) (considering the optimal insurance under moral hazard).

260. For a discussion of the origins of moral hazard, generally, see Baker, *supra* note 27 (tracing the origins of moral hazard to the nineteenth century fire insurance trade and, before that, to marine insurance).

261. An individual's care and activity level have distinct meanings. See generally Steven Shavell, *On Moral Hazard and Insurance*, 93 Q.J. ECON. 541 (1979).

262. Baker, *supra* note 27, at 241.

263. Arrow's article sparked an invaluable debate over the incentives and disincentives created by government-sponsored health insurance. See Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963); see also Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531 (1968); Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537 (1968).

264. See, e.g., Hanson & Logue, *supra* note 250; Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 507 (1994); Mancur Olson, *A Less Ideological Way of Deciding How Much Should Be Given to the Poor*, DAEDALUS, Fall 1983, at 217; George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297 (1981).

negligence, worker's compensation benefits, and virtually all agency relations.²⁶⁵

In recent years, the notion of moral hazard has been used to explain the perverse consequences of such good-intentioned and socially-minded initiatives as welfare programs for the poor, product liability coverage for the injured, and health insurance for the sick. As some commentators have observed, albeit with much suspicion, the lesson of neoclassical moral hazard theory is that the more one tries to safeguard against the consequences of poverty, accidents, and uncompensated illness, the greater the likelihood of poverty, injuries, and illness.²⁶⁶ Attempts to minimize the consequences of certain risk bearing behaviors through compensation (which approximates insurance) will do nothing more than encourage additional risk taking and loss.

The problem of moral hazard would be inapplicable to corporate compliance if such initiatives aligned principal/agent incentives, if compliance programs prompted meaningful ethical change in organizations, if compliance was more than a guise for strategic risk management, and if the rationale for purchasing compliance did not resemble the objectives of insurance and self-insurance. It is more than likely that *ex ante* moral hazards pose a problem, however, given that expenditures for compliance are bounded by risk shifting and risk management rationales. The likelihood increases significantly when one adds the inability of prosecutors and courts to objectively judge the effectiveness of compliance efforts together with research revealing that organizations resist meaningful cultural change. The prospects of moral hazards are as much confirmed after viewing the evidence that corporate deviance is often tolerated, if not tacitly encouraged, by an implicit agenda of top management—where compliance initiatives originate.²⁶⁷

265. See Winter, *supra* note 259, at 63 ("The importance of moral hazard extends beyond the context of insurance to the entire paradigm of agency theory.")

266. Baker does a wonderful job in undermining the logic of this "conventional lesson." He maintains that key assumptions supporting the economics of moral hazard are violated. See Baker, *supra* note 27, at 276.

267. After paying that minimum expenditure toward compliance necessary to shift liability downward, firms have reduced incentives to ensure against deviance. Organizations at the lower operating range of compliance are, for obvious reasons, most at risk. Here the cost is minimal, a primary objective of compliance is achieved, and, with an often less than genuine commitment of top management, deviance or pressures leading to deviance may be encouraged with little to no risk to the firm.

A. Cosmetic Compliance and Institutional Inertia

It is difficult to find practitioners who are critical of corporate compliance initiatives.²⁶⁸ In-house counsel are taught to see compliance efforts as preventive law; ethics consultants are frequently lured by a blind devotion to the ideal of promoting "good corporate citizenship," not to mention the generous compensation offered for their consultation; and regulators and prosecutors delight in the ease with which they may obtain inculpatory evidence through voluntary disclosure programs and other shrewd incentives.²⁶⁹ Even though critics are hard to find, the scholarly literature in management and business ethics is rife with evidence of the impotence of business conduct principles and ethics codes, and the resistance of corporate culture to an institutionalization of ethics. Though not all

268. Initiatives include codes of conduct, ethics training programs, procedures for reporting violations, disciplinary mechanisms, and disclosure procedures. *See generally* Laufer, *A Study of Small Business Compliance Practices*, *supra* note 1. In a remarkable exception, Senator Edward Kennedy cautioned the attendees of the Commission-sponsored Second Symposium On Crime and Punishment in the United States, in *PROCEEDINGS*, *supra* note 1, at 115, 119:

Members of the business community and those who counsel corporate clients must recognize that there will always be skepticism about a policy that gives any break to corporations that have committed crimes, as the guidelines will sometimes do when a corporation demonstrates a solid compliance program. That skepticism will grow if the public comes to believe that companies are approaching the guidelines with a 'window dressing' compliance effort and a clever law firm waiting in the wings at the first sign of trouble.

See also Richard Rocchini & Mark S. Olinsky, *Is Your Legal Compliance Program Merely a Paper Tiger?*, *CORP. LEGAL TIMES*, June 1994, at 29 (reviewing the inadequacy of compliance efforts).

269. *See* Laurence A. Urgenson, *supra* note 235, at 225; *Corporate Self-Policing Programs*, 1 *CORP. CONDUCT Q.* 11 (1991); Perry, *supra* note 206. Evidence was not always so easy to come by. *See, e.g.*, John Braithwaite & Gilbert Geis, *On Theory and Action for Corporate Crime Control*, 28 *CRIME & DELINQUENCY* 292, 298 (1982) (arguing that the prosecution often loses in corporate crime cases because firms can exploit the complexity of the corporate form and "corporate reality"). As John Shenefield has observed, the Antitrust Division of the Department of Justice has taken a cautious approach to compliance programs:

Nothing will quite so clearly demonstrate empty formalism or lack of conviction than a program that includes irrelevancies adopted untested and unscreened from the program of other companies with quite different problems. . . . Employees at lower levels in any organization surely take their cue from top management. If the head of the company doesn't take the program seriously, neither will anyone else.

John H. Shenefield, *Compliance Programs as Viewed from the Antitrust Division*, 48 *ANTITRUST L.J.* 73, 74-75 (1979). Voluntary disclosure of inculpatory evidence raises significant liability issues that remain unresolved. *See generally* Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 *VAND. L. REV.* 1 (1997); John Calvin Conway, Note, *Self-Evaluative Privilege and Corporate Compliance Audits*, 68 *S. CAL. L. REV.* 621 (1995).

are so pessimistic, it is easy to reach a conclusion that "ethical reform from within the system is largely cosmetic."²⁷⁰

A consistent stream of research over the past fifteen years has revealed that ethics codes do not relieve organizational pressures to be unethical or convince senior management to become more socially responsible.²⁷¹ A consensus of opinion has formed that generic ethics codes are often adopted for the appearance of legitimacy and legal protection.²⁷² There is also equivocal evidence of the utility of firm-and-industry specific codes.²⁷³ Such codes are not perceived to be effective in changing employee attitudes or behavior. In fact, they are often viewed as serving the company's interests over its employees.²⁷⁴ Survey research also reveals that a majority of employees see ethics

270. COSTA, *supra* note 232, at 97.

271. See Donald R. Cressy & Charles A. Moore, *Managerial Values and Corporate Codes of Ethics*, CAL. MGMT. REV., Summer 1983, at 53 (discussing their survey of 119 corporations).

272. See Susan J. Harrington, *The Effect of Codes of Ethics and Personal Denial of Responsibility on Computer Abuse Judgments and Intentions*, 20 M.I.S. Q. 257, 260 (1996) ("Another potential problem with generic codes is that much of what is in typical codes is only intended as a public relations gimmick or a means of protecting the corporation from legal liability."); Bruce N. Kaye, *Codes of Ethics in Australian Business Corporations*, 11 J. BUS. ETHICS 857, 858 (1992) (discussing the results of the Opinion Research Corporation's survey of American corporations for the Ethics Resource Center where 78% of the respondents indicated that the principal benefits of ethics codes are legal protection); Patrick E. Murphy, *Corporate Ethics Statements: Current Status and Future Prospects*, 14 J. BUS. ETHICS 727, 731 (1995) ("Some companies, unfortunately, believed that the public relations value was the most important aspect of their codes of ethics."); see also OPINION RESEARCH CORP., IMPLEMENTATION AND ENFORCEMENT OF CODES OF ETHICS IN CORPORATIONS AND ASSOCIATIONS (1980).

273. See, e.g., Terence R. Mitchell et al., *Perceived Correlates of Illegal Behavior in Organizations*, 15 J. BUS. ETHICS 439, 443 (1996) ("While the research seems to indicate that about 90% of the major corporations in America have or are planning to have such codes the data about their usefulness is less clear."); Gary R. Weaver, *Corporate Codes of Ethics: Purpose, Process and Content Issues*, BUS. & SOC'Y, Spring 1993, at 44, 51 ("Measuring the effectiveness of ethics codes, programs and structures—intended as regulatory tools—is problematic, and empirical study has provided at best mixed results."); Gary R. Weaver, *Does Ethics Code Design Matter? Effects of Ethics Code Rationales and Sanctions on Recipients' Justice Perceptions and Content Recall*, 14 J. BUS. ETHICS 367 (1995) ("Although codes of ethics figure prominently in organizations' efforts to reduce unethical behavior on the part [sic] their members, evidence on the actual impact of codes is at best mixed."); William A. Weeks & Jacques Nantel, *Corporate Codes of Ethics and Sales Force Behavior: A Case Study*, 11 J. BUS. ETHICS 753 (1992).

274. See M. Neil Browne et al., *The Seductive Danger of Craft Ethics for Business Organizations*, REV. BUS., Winter 1995-1996, at 23, 27 ("Citicorp's principles make it clear they are concerned about protecting themselves from the behavior of their own employees."); Betsy Stevens, *An Analysis of Corporate Ethical Code Studies: "Where Do We Go From Here?"* 13 J. BUS. ETHICS 63, 67 (1994):

Firms seem primarily concerned with employee misconduct which might damage the firm. . . . [T]he codes seem preoccupied with following laws. While ethical codes should promote law-abiding behavior, it appears that they are preoccupied with law enforcement and self-defense and often do not rise above this plateau to successfully articulate the values, beliefs, and precepts of a desirable corporate culture.

codes as an exercise in public relations.²⁷⁵ Most companies with codes have not institutionalized a mechanism or series of procedures to respond to violations.²⁷⁶ Finally, commentators have noted that ethics codes are often poorly integrated into firm culture.²⁷⁷

Studies pointing to the inadequacy of ethics codes are supported by the results of a series of national surveys of ethical corporate culture. For example, in a recent Benchmark Survey of 1,694 large and medium-sized firms in the United States, 27% of the respondents indicated that their organization knowingly broke the law "at least sometimes"; 17% acknowledged that where profit motive and ethics conflict, the former governs; 41% of the respondents acknowledged being aware of legal or ethical problems in their organization; only 37% of employees reported feeling comfortable reporting such misconduct; and 45% of all employees admitted feeling pressured to "cut corners."²⁷⁸ Finally, employees viewed senior management with suspicion: only 46% of all employees thought that management took responsibility for its actions; 45% of managers were viewed as acting fairly; and 40% were characterized as keeping their promises.²⁷⁹

The results of the 1997 Society for Human Resource Management/Ethics Resource Center Survey mirror the Benchmark Survey.²⁸⁰ In this study of 747 human resource professionals, 61% reported that their firms did not provide ethics training; 47% of the respondents reported feeling at least some pressure to compromise their organization's code of ethics to achieve business objectives—for

275. See generally Kaye, *supra* note 272, at 858.

276. See, e.g., R. Murray Lindsay et al., *Instilling Ethical Behavior in Organizations: A Survey of Canadian Companies*, 15 J. BUS. ETHICS 393, 401 (1996) ("The fact that 88 percent of the 84 companies attempting to instill ethical behavior did not have an ethics focused reward system raises important questions regarding the motivation that organizations are providing their employees to behave ethically."); Murphy, *supra* note 272, at 731 ("Anywhere from 10 to 30% of companies who have codes of ethics do not have systems in place for dealing with violations.").

277. See Isaac D. Montoya & Alan J. Richard, *A Comparative Study of Codes of Ethics in Health Care Facilities and Energy Companies*, 13 J. BUS. ETHICS 713, 717 (1994):

Despite relatively recent media attention focused on codes of ethics, our study indicates that the adoption of such codes is rarely accompanied by either a thorough development process or a system for assuring that the codes are known and used. As is indicated by existing literature, the absence of clear evaluation standards reflects a situation within which neither management nor employees know what to expect from a code of ethics.

278. See WALKER INFORMATION, A NATIONAL BENCHMARK STUDY ON BUSINESS ETHICS (1998) (on file with author).

279. See *id.* at 2.

280. See SOCIETY FOR HUMAN RESOURCE MANAGEMENT/ETHICS RESOURCE CTR., BUSINESS ETHICS SURVEY REPORT (1998) (on file with author).

reasons of meeting financial or business objectives (50%), scheduling demands (38%), and ensuring organizational survival (30%).²⁸¹

Evidence of the failure of ethics codes to affect corporate culture and structure is supported by organizational theories that suggest that there is a strong resistance to significant change on the part of many companies in stable environments.²⁸² Inertial constraints arise from both internal and external factors. Internally, there is the nontransferability of fixed expenses and investment, the limited access to and availability of information, the acceptance of custom and internal norms, and internal politics.²⁸³ External pressures that create inertia include legal and financial barriers, the availability of information, and legitimacy constraints.²⁸⁴ In many cases, both internal and external inertia pressures cause inertia, which in turn results in organizations pursuing "a very narrow repertoire of strategies."²⁸⁵ Stability and common routines move firms to maintain the status quo and resist change, until and unless significant problems arise.²⁸⁶ The results of these surveys are concerning given the value placed by prosecutors on the existence of effective compliance initiatives, and the absence of objective measures of effectiveness. This concern is magnified by the often complicit role of top management.

B. Corporate Deviance and the "Winking" of Top Management

Of all internal factors accounting for corporate crime, not one comes close in importance to the role of top management in tolerating,

281. *See id.* at 4.

282. For a discussion of organizational "imprinting," see WILLIAM C. FREDERICK, VALUES, NATURE, AND CULTURE IN THE AMERICAN CORPORATION 297 (1995) (discussing compliance initiatives as organizational innovations, and concluding that they "must lean against the powerful inertial forces of nature and of sociocultural habit long ingrained in the business institution. Even when sincerely adopted and skillfully launched, they cannot be expected to yield revolutionary results."); Arthur L. Stinchcombe, *Social Structure and Organizations*, in HANDBOOK OF ORGANIZATIONS 142-91 (James G. March ed., 1965); Deborah Vidaver Cohen, *Creating and Maintaining Ethical Work Climates: Anomie in the Workplace and Implications for Managing Change*, 3 BUS. ETHICS Q. 343, 353 (1993) ("[S]ignificant organizational resistance occurs quite predictably whenever intensive transformations in institutional culture are considered."); cf. Linda Klebe Trevino, *A Cultural Perspective on Changing and Developing Organizational Ethics*, in 4 RESEARCH IN ORGANIZATIONAL CHANGE AND DEVELOPMENT 195 (William A. Pasmore & Richard W. Woodman eds., 1990).

283. *See* MICHAEL T. HANNAN & JOHN FREEMAN, ORGANIZATIONAL ECOLOGY 66-90 (1989) (arguing that structural inertia in organizations may be explained as an outcome of an ecological-evolutionary process).

284. *See generally* Danny Miller et al., *The Evolution of Strategic Simplicity: Exploring Two Models of Organizational Adaptation*, 22 J. MGMT. 863 (1996).

285. *Id.* at 865-66.

286. *See generally* Danny Miller, *The Architecture of Simplicity*, 18 ACAD. MGMT. REV. 116 (1993).

even shaping, a corporate culture that allows for deviance.²⁸⁷ Senior management, in some firms, is well known for sending conflicting signals to middle management about short-term expectations, mandatory objectives, as well as contingent incentives and reward systems. This signaling risks encouraging deviant norms, while promoting a coercive organizational culture.²⁸⁸ The consensus view emerging among corporate crime scholars is that "corporate wrongdoing is more often the result of actions or inactions, deliberate or inadvertent, by the top managers of the organization."²⁸⁹

The line distinguishing the advertence or inadvertence of managerial actions, however, is often difficult to draw. For example, it has been argued that it is not uncommon for top management to lose control and direct supervision over subunits as well as subordinate employees, once an organization reaches a certain size, level of complexity, and specialization.²⁹⁰ This loss of supervisory

287. For a review of corporate crime causation theory, see Sally S. Simpson, *Strategy, Structure, and Corporate Crime: The Historical Context of Anticompetitive Behavior*, in 4 ADVANCES IN CRIMINOLOGICAL THEORY: NEW DIRECTIONS IN CRIMINOLOGICAL THEORY 71 (Freda Adler & William S. Laufer eds., 1993). See also Melissa S. Baucus & Janet P. Near, *Can Illegal Corporate Behavior Be Predicted? An Event History Analysis*, 34 ACAD. MGMT. J. 9 (1991); Charles W.L. Hill et al., *An Empirical Examination of the Causes of Corporate Wrongdoing in the United States*, 45 HUM. REL. 1055 (1992); Jon M. Joyce, *Effect of Firm Organizational Structure on Incentives to Engage in Price Fixing*, CONTEMP. POL'Y ISSUES, Oct. 1989, at 19; Eugene Sz wajkowski, *Organizational Illegality: Theoretical Integration and Illustrative Application*, 10 ACAD. MGMT. REV. 558 (1985).

288. See, e.g., Vaughan, *supra* note 73 (discussing the crime in relation to the role of top management in establishing the norms and reward systems that shape the ethical conduct of subordinates); Kriesberg, *supra* note 43 (noting the situations in which top management may direct, enable, or acquiesce to illegal activity). For an extensive discussion of the role of top management in corporate crime, see MARSHALL B. CLINARD, CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT 71 (1983) ("In our survey, middle management was clearly of the opinion that the very nature of top management's position and its actual behavior is largely responsible for unethical or illegal corporate behavior.").

289. Anthony J. Daboub et al., *Top Management Team Characteristics and Corporate Illegal Activity*, 20 ACAD. MGMT. REV. 138, 138-39 (1995) (describing the consensus view that corporate crime is most often the result of the inactions of top management). This was the conclusion of the much heralded survey of 582 of the largest corporations by Clinard and his colleagues in 1979:

The delegation of responsibility and unwritten orders often serve to isolate top management from the legal consequences of their policy decisions. The complex structural relationships of large corporations make it difficult, if not impossible, to disentangle delegated authority, managerial discretion, and ultimate responsibility. By tending to fix blame on middle-managers, criminal codes reflect an individualistic bias that obscures the organizational nature of corporate violations. Upper-level management may be left unscathed for actions to which they are at least contributing, if not causative, elements.

CLINARD, *supra* note 73, at 206.

290. See CORPORATE AND GOVERNMENTAL DEVIANCE: PROBLEMS OF ORGANIZATIONAL BEHAVIOR IN CONTEMPORARY SOCIETY 7-9 (M. David Ermann & Richard J. Lundman eds., 5th

control by top management, or authority leakage, allows for corporate deviance by lower-level employees often without any evidence of the knowledge or approval of top management.²⁹¹ Where there is evidence of knowledge or tacit approval, top management can be quite successful in displaying a deliberate indifference to or ignorance of middle management or subordinate employee deviance.²⁹² Typical are the remarks of Senator Kefauver who, after extensive hearings on the Electrical Equipment Antitrust cases in the early 1960s, concluded:

[I]t has been found many times, top corporation executives 'wink' at criminal antitrust violations going on right under their noses. Rather than assure that the antitrust laws were being obeyed by their subordinates, such executives take great pains to make certain that they have no 'knowledge' of any illegal activities.²⁹³

ed. 1996). See generally Vaughan, *supra* note 73. Courts recognize the problem of control in their consideration of corporate liability. See *Commonwealth v. Beneficial Fin. Co.*, 275 N.E.2d 33, 83 (Mass. 1971):

In a large corporation, with many numerous and distinct departments, a high ranking corporate officer or agent may have no authority or involvement in a particular sphere of corporate activity, whereas a lower ranking corporate executive might have much broader power in dealing with a matter peculiarly within the scope of his authority.

291. See CLINARD, *supra* note 288, at 71 (reporting how respondents to his survey emphasized the role of top management in selecting personnel to "fit their patterns of doing business."); Brickey, *supra* note 73, at 628 ("It bears observing that if corporate directors may rely upon their subordinates until something untoward reaches their attention, they will remain ignorant of facts crucial to effective corporate governance."). According to one commentary, evidentiary issues accompany investigations of large corporations. See *Developments in the Law*, *supra* note 23, at 1255 ("Moreover, in a large corporation, the existence of several tiers of middle-level supervisors makes it more difficult for the prosecutor to prove that a command or authorization originated with an upper echelon policymaking official.").

292. See JOHN E. CONKLIN, "ILLEGAL BUT NOT CRIMINAL": BUSINESS CRIME IN AMERICA 65 (1977) ("The delegation of responsibility and unwritten orders keep those at the top of the corporate structure remote from the consequences of their decisions and orders, much as the heads of organized crime families remain 'untouchable' by the law."); Coffee, *supra* note 76, at 398 ("[Decentralization] permits the central headquarters to insulate itself from responsibility for operational decisions while simultaneously pressuring for quick solutions to often intractable problems.").

293. Comment, *Increasing Community Control Over Corporate Crime—A Problem in the Law of Sanctions*, 71 YALE L.J. 280, 303 n.71 (1961) (alteration in original) (quoting Press Release from Senator Kefauver's Office, (July 13, 1961)); see also CLARENCE C. WALTON & FREDERICK W. CLEVELAND, JR., CORPORATIONS ON TRIAL: THE ELECTRIC CASES 82 (1964) (quoting Judge Ganey):

'I am convinced that in the great number of these defendants' cases, they were torn between conscience and an approved corporate policy, with the rewarding objectives of promotion, comfortable security and large salaries—in short, the organization or the company man, the conformist, who goes along with his superiors and finds balm for his conscience in the additional comforts and the security of his place in the corporate set-up.'

The subtleties of the top management perspective were captured as early as 1955 by drafters of the Model Penal Code, who commented that organizational crime may be “produced by pressures on the subordinates created by corporate managerial officials even though the latter may not have intended or desired the criminal behavior and even though the pressures can only be sensed rather than demonstrated.”²⁹⁴ Given the role of top management in charting the course of legal and ethical compliance in corporations, it is difficult to underestimate the importance of subtle pressures to walk the fine line between law abidance and law deviation. Few underestimate the less-than-subtle pressures to maximize profits, reduce costs, and meet sales goals or quotas.²⁹⁵

The range of pressures felt by middle managers and subordinate employees must be considered in light of the perception by employees that top management is often aware of legal and ethical violations—that they are “winking.”²⁹⁶ The phenomenon of winking is further complicated by the tendency of subordinate employees and middle management not to question the policies, judgments, and decisions of senior management.²⁹⁷ The corresponding tendency of senior management to foist blame on unwary agents when a line is crossed,²⁹⁸ and ease at which violations of both the corporate policy

See also Kadish, *supra* note 85, at 431-32 (“[T]he high policy makers of General Electric and other companies involved escaped personal accountability for a criminal conspiracy of lesser officials that extended over several years to the profit of the corporations, despite the belief of the trial judge and most observers that these higher officials either knew of and condoned these activities or were willfully ignorant of them.”).

294. MODEL PENAL CODE § 2.07 commentary at 149 (Tentative Draft No. 4 1955).

295. According to one of Clinard’s respondents, “You get the pressure so strong from top management that you will make judgmental efforts to make things come out right even if you use unethical practices such as lying about production or marketing progress. Pressures can result in cutting corners, e.g., on quality; a corporation has got to be a going concern.” CLINARD, *supra* note 288, at 142.

296. *See id.* at 140 (“Middle management executives tended to feel that corporate pressures at their level were extensive and serious. Undue pressures from top management, they maintained, may result in unethical or illegal behavior.”). The concept of “winking” may be traced back to *Standard Oil Co. v. United States*, 307 F.2d 120, 125 (5th Cir. 1962) (“Since the record is absolutely barren of even the most remote whisper of suspicion that this was the case of corporations winking at dereliction by energetic, zealous employees, the Government stresses, for both a legal and psychological purpose, the contention that the two corporations received some benefit.”). *See also* *Steere Tank Lines, Inc. v. United States*, 330 F.2d 719 (5th Cir. 1963).

297. *See generally* John M. Darley, *How Organizations Socialize Individuals Into Evildoing*, in CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS, *supra* note 231, at 13 (discussing the costs of disobeying orders from superiors to engage in unethical or illegal actions).

298. The effects of both winking and scapegoating are seen most clearly in organizations where there is significant diffusion and fragmentation of information and responsibility. *See generally id.*

and the law all may be hidden in the complexity of the corporate form.²⁹⁹ As one commentator noted, "Big corporations implicitly encourage scapegoating by their complete lack of any tracking system to trace responsibility."³⁰⁰

Empirical research in the banking industry suggests that top management winking is linked to two features of the corporate form.³⁰¹ The first is a segmentation of moral views by rank, status, or hierarchy within the organization. As one commentator notes, "Corporations implicitly house a division of moral labour according to which managers at different ranks are inclined to perceive dilemmas from differing moral angles."³⁰² The importance of this segmentation is evident when top management expresses an allegiance to corporate values and policies, while implicitly supporting if not encouraging unethical or illegal actions.³⁰³ In such situations, there is often an untenable conflict between top management's perception of a business need, the primacy of business goals, and what appears to be a restrictive corporate policy.³⁰⁴

299. See, e.g., James William Coleman, *The Theory of White-Collar Crime: From Sutherland to the 1990s*, in WHITE COLLAR CRIME RECONSIDERED, *supra* note 7, at 53, 69 ("Numerous social scientists have commented on the way large corporations encourage a narrow pragmatic approach to organizational responsibilities among their employees, which strongly discourages independent ethical judgments."). For an excellent discussion of the pressures placed on middle managers by superiors, see ROBERT JACKALL, MORAL MAZES: THE WORLD OF CORPORATE MANAGERS (1988); see also Myron W. Watkins, *Electrical Equipment Antitrust Cases—Their Implications for Government and for Business*, 29 U. CHI. L. REV. 97, 107 (1961) (discussing the difficulty of affixing blame "in the bewildering complexity and intricate ramifications of the administrative set-up in the modern 'big business' corporation, the spheres of delegated authority and of managerial discretion are virtually impossible to disentangle").

300. JACKALL, *supra* note 299, at 87. In Professor Clinard's survey of middle managers, for example, 92.2% of the respondents credited top management with setting the "ethical tone for compliance with government laws and regulations." CLINARD, *supra* note 288, at 71. Seventy-one percent of the respondents surveyed indicated that top management had positive knowledge of illegalities. According to the survey, "respondents felt that, in general, top management was most likely to know of any anti-trust violations, pricefixing infractions, possible serious plant or consumer (design) safety violations, large kickbacks, illegal foreign payoffs, and about such broad areas as violations in production quality, labor, the EPA, and tax matters." *Id.* at 74-79.

301. See generally Peter Cleary Yeager, *Management, Morality, and Law: Organizational Forms and Ethical Deliberations*, in CORPORATE CRIME: CONTEMPORARY DEBATES 147 (Frank Pearce & Laureen Snider eds., 1995).

302. *Id.* at 154.

303. Professor Yeager observes that "these guiding values, policies, and goals appear to be both internally consistent and rationally related to the companies' legitimate purposes. But under the complex requirements of management in large organizations, managers often experience them as dictating contradictory choices, and ones often ethically (if not always legally) suspect." *Id.*

304. Yeager notes that "business hierarchies impart a characteristic moral stance to their managers, which typically minimizes many private moral concerns in the service of organizational ends." See *id.* at 150.

The critical role of top management, along with the perception of their winking, has led courts to caution that "to conceal the nefarious acts of their underlings by using the shield of corporate armor to deflect corporate responsibility, and to separate the subordinate from the executive, would be to permit 'endocratic' corporations to inflict widespread public harm without hope of redress."³⁰⁵ This caution, however, is without meaning for firms in certain industries and markets where pressures are, at times, too much for middle managers, supervisory personnel, and subordinates to bear.³⁰⁶

C. The Paradox of Compliance and Its Resolution

Much has been made of the paradox of moral hazard—less loss from loss means more loss.³⁰⁷ The paradox of cosmetic compliance as a form of risk management reflects the same basic economics and logic. The purchase of compliance sufficient to shift the risk of liability and loss, in certain firms, has the effect of decreasing levels of care. Decreased levels of care with a top management that winks fosters an environment of tacit acceptance of illegalities. This acceptance, coupled with the constant pressure on middle management to produce results, has led to increased deviance throughout the corporate hierarchy.³⁰⁸ The purchase of compliance for purposes of liability shifting and cost internalization results in a redefinition of this deviance. Acts that were once held to be those of the firm, now remain those of individual employees.³⁰⁹ The evisceration of vicarious

305. *Commonwealth v. Beneficial Fin. Co.*, 275 N.E.2d 33, 83-84 (Mass. 1971).

306. It is far from oversimplification to say that the choice for a strained and burdened middle management is an attribution of incompetence—with the possibility of demotion or dismissal—or the taking of shortcuts that risk violations of law. For an extensive consideration of the problems and pressures of middle managers, see Coffee, *supra* note 76, at 396-400.

307. See Baker, *supra* note 27, at 269-72.

308. This is so in spite of any increase in offense rates that would be expected with greater monitoring activity. Of course, increased enforcement activity naturally results in higher rates of offending. See *Sentencing Commissioner Predicts Compliance Efforts Will Only Become More Crucial to Success in Business*, *Prevention of Corp. Liab.* (BNA) 8 (June 1996) (discussing the results of research that found that common compliance practices actually "may contribute to a poor compliance environment").

309. The effect of moral hazards on organizations that have invested in compliance as insurance may be seen as a function of compliance expenditures and top management tolerance of illegality (winking). Deviance is most significant where corporations fail to invest in compliance—no matter how defined—and, at the same time, tolerate illegalities (Model I). The compromising effect of moral hazards may be seen in Model II where the combination of significant compliance expenditures and winking result in moderate deviance. Finally, in Models III and IV, deviance is limited by an absence of moral hazards, regardless of compliance expenditures.

liability along with unbridled prosecutorial discretion in the intuitive evaluation of compliance effectiveness may be used to explain the steady increase in white-collar prosecution. Moral hazard theory reveals that certain compliance orientations have the counterintuitive effect of increasing white-collar deviance.

Short of a significant reform of the corporate criminal law which directly addresses the gaming problem caused by reactions to vicarious liability, the paradox of compliance may be resolved only by limiting the incentives that lead firms to purchase those programs and initiatives that successfully shift liability and loss. In theory, this might be accomplished in two ways. The first requires substantial changes in discretionary prosecutorial policies: Prosecutors must resist undermining principles of vicarious liability by rewarding due diligence. This becomes increasingly important given the absence of consensus on the meaning of effective compliance. The consideration of corporate compliance in relation to corporate liability is a task appropriately reserved in law for sentencing judges. Judicial determinations of compliance effectiveness along with verifiable measurements of the same will undercut incentives to diminish care and reduce monitoring levels.³¹⁰ Alternatively, regulators and prosecutors might agree on specific criteria for effectiveness. It seems too much to ask organizations to move beyond the rhetoric of "effective" compli-

<p style="text-align: center;">I</p> <p style="text-align: center;">LOW COMPLIANCE EXPENDITURES/ HIGH IMPLICIT TOLERANCE</p>	<p style="text-align: center;">II</p> <p style="text-align: center;">HIGH COMPLIANCE EXPENDITURES/ HIGH IMPLICIT TOLERANCE</p>
<p style="text-align: center;">III</p> <p style="text-align: center;">LOW COMPLIANCE EXPENDITURES/ LOW IMPLICIT TOLERANCE</p>	<p style="text-align: center;">IV</p> <p style="text-align: center;">HIGH COMPLIANCE EXPENDITURES/ LOW IMPLICIT TOLERANCE</p>

310. See David Yellen, *Compliance Programs and Coordination of Corp. Sanctions*, BUS. CRIMES BULL., Oct. 1995, at 6, 9 (noting with some frustration that federal prosecutors have failed to send a clear message and should "appreciate that a consistent approach to the effect of compliance programs would enable the government to sharpen its enforcement message. It would also give companies a clearer picture of what constitutes an effective compliance program and an indication of the potential benefits of implementing such a program.").

ance before prosecutors have been able to meaningfully assess the difference.³¹¹

1. Changes in Discretionary Policies

The debate over the proper role and efficiency of prosecutorial agencies continues.³¹² At the center of this debate is a body of scholarship that considers the ideal relation between regulators and corporations.³¹³ Braithwaite's Enforced Self-Regulation Model, and Fisse and Braithwaite's Accountability Model, for example, suggest the importance of corporate standards of conduct and disciplinary mechanisms as a form of reciprocal constraint.³¹⁴ Organizations self-regulate to the deference of regulators. Practical considerations like the grant of prosecutorial amnesty or the receipt of mitigation credit from the Guidelines lends support to the importance of these idealized models. The extent of a corporation's self-regulation will determine active criminal investigation versus prosecutorial declination, enforcement or non-enforcement, formal versus informal measures, monetary or non-monetary sanctions, and civil proceedings or criminal indictment.

Left all but unattended in both theory and practice, however, is the capacity of regulators, prosecutors, and courts to evaluate the effectiveness or authenticity of corporate self-regulation. Pretend for a moment that there is no history of risk shifting by corporations, and that there is no evidence of internal or external initiatives on the part of organizations to minimize entity liability by pushing blame down the organizational hierarchy. Disregard the fairness of allowing

311. This is unfortunate because organizational integrity, corporate ethics, and good corporate citizenship, after all, are said to impair moral hazards. See AMITAI ETZIONI, *THE MORAL DIMENSION: TOWARD A NEW ECONOMICS* 69 (1988) ("[T]he stronger the moral underwriting of implicit contracts, the lower the transaction costs, resulting in less of a need to buy hedge protection. . . .").

312. See generally EUGENE BARDACH & ROBERT A. KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982); Ann P. Bartel & Lacy Glenn Thomas, *Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact*, 28 J.L. & ECON. 1 (1985); Frank H. Easterbrook, *Criminal Procedure as a Market System*, 12 J. LEGAL STUD. 289 (1983); Stephen J. Schulhofer, *Criminal Justice Discretion as a Regulatory System*, 17 J. LEGAL STUD. 43 (1988); James Vorenberg, *Decent Restraint of Prosecutorial Power*, 94 HARV. L. REV. 1521 (1981).

313. See generally IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992); BENSON & CULLEN, *supra* note 206; JOHN BRAITHWAITE, *CORPORATE CRIME IN THE PHARMACEUTICAL INDUSTRY* (1984); JOHN BRAITHWAITE, *TO PUNISH OR PERSUADE: ENFORCEMENT OF COAL MINE SAFETY* (1985); Robert A. Kagan & John T. Scholz, *The "Criminology of the Corporation" and Regulatory Enforcement Strategies*, in *ENFORCING REGULATION* 67 (Keith Hawkins & John M. Thomas eds., 1984); John T. Scholz, *Voluntary Compliance and Regulatory Enforcement*, 6 L. & POL'Y 385 (1984).

314. See generally FISSE & BRAITHWAITE, *supra* note 191; Braithwaite, *supra* note 89.

prosecutors to craft new liability rules for corporate crimes all in the name of discretion. Put aside concerns that this undercuts the full force of vicarious liability, and results in diminished levels of care and incentives to police due to moral hazards. Forget that businesses with significant resources will be advantaged; and small, privately held businesses, often without access to legal counsel, will remain the disadvantaged targets of criminal prosecution. Even if one pretends, disregards, and forgets, it remains that there is little wisdom in the birth of new standards of corporate self-regulation without an agreed-upon method of assessing compliance with those standards.

That no such method exists is made far worse by the fact that corporations are all too aware of this fact. It is worth asking how organizations assess the value of their compliance expenditures, no less the effectiveness of internal standards and procedures.³¹⁵ It is critically important to ask how the inability of regulators, prosecutors, and courts to assess effectiveness influences corporate compliance expenditures and programs.³¹⁶ Even conservative answers to these two questions favor limited prosecutorial consideration of corporate compliance programs. If one should add to this the problem of incentives and moral hazards, then the case for restructuring prosecutorial discretion becomes compelling.

315. For a discussion of the analogous issue in tort law, see generally John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984) (discussing the common problem of uncertainty about legal standards, and the resulting problem of overcompliance or undercompliance).

316. This problem of assessing effective compliance is not limited to cases of corporate crime. Consider how the absence of clear standards by which to judge effective compliance with Title VII complicates an affirmative defense to liability for employers in a hostile work environment case. Last term, in *Faragher v. City of Boca Raton*, 118 S. Ct. 2275 (1998), Justice Souter crafted a due diligence defense requiring that: (1) employers exercise reasonable care "to prevent and correct" any sexual harassment, and (2) employees take reasonable advantage of such due care. *Id.* at 2293. Souter then added the caveat that while an employer may offer proof of a corporate anti-harassment policy with appropriate complaint procedures, such proof is not necessary as a matter of law. According to Souter, "the need for a stated policy suitable to the employment circumstances may appropriately be addressed in any case when litigating the first element of the defense." *Id.* In giving recognition to the due diligence of employers, Souter has complimented enforcement efforts and, at the same time, acknowledged the spirit of *Meritor Savings Bank, FSB v. Vinson*, 477 U.S. 57 (1986). In fact, we are told that "a theory of vicarious liability . . . would be at odds with the statutory policy if it failed to provide employers with some such incentive." *Faragher*, 118 S. Ct. at 2292. Yet, if the history and the lessons of corporate compliance apply, one might wonder how long it will be before most organizations have a compliance "prescription" against Title VII liability. Soon thereafter, it will be interesting to see how administrative agencies and then courts assess the effectiveness of an employer's due diligence.

2. Moving Beyond the Rhetoric of "Effective" Compliance

The idea that compliance must be effective is deceptively simple. It is naïve to say that compliance consultants preach a strict adherence to the seven prescriptive steps found in the Guidelines, and that ethics consultants see the integrity approach as the integration of ethical values into corporate culture. What makes the notion of effective compliance difficult, and somewhat deceptive, is that vastly different compliance initiatives will share the same outcome criterion (effectiveness) but will define it quite differently.

Consider that an organization may invest in compliance for a host of reasons, some genuine, others used to justify expenses. These reasons include satisfying the perceived requirements of the Guidelines, shifting liability down the corporate hierarchy, reducing unethical or illegal behavior, increasing the reporting of unethical or illegal behavior, promoting an ethical culture, and effecting corporate strategy.³¹⁷

Determinations of effectiveness also vary by compliance orientation, based in law, ethics, integrity, or a hybrid of all three.³¹⁸ The formality of the compliance orientation (undocumented versus written), as well as the rationale supporting its implementation (voluntary versus court ordered), affect assessments of effectiveness. So, too, do the budgeted expenditures for compliance (effectiveness determined by a cost/benefit analysis), the degree of regulatory risk in a given industry or market (effectiveness determined by the extent of regulatory oversight), and the methods used to assess effectiveness (objective versus subjective).

Most important, moving beyond the rhetoric of "effective" compliance requires consistency between organizational assessments of effectiveness and those of regulators, prosecutors, and courts. Until this challenge is met, lest a dramatic reform of the general principles of corporate criminal liability, the law offers few ways to address the moral hazards of compliance.

317. See Freyer & Murphy, *supra* note 251.

318. See generally Paine, *supra* note 130.

V. CONCLUSION

When the Commission finally completed its work in 1991, the Guidelines reflected a trend toward conceptualizing corporate liability and blameworthiness in the context of organizational theory.³¹⁹ The objective was to fashion a genuine corporate fault so that organizational sanctions would have meaning. The problem, however, was that the Guidelines did a far better job than the substantive criminal law in accounting for organizational structures, systems, and processes. In fact, the Guidelines made the simplistic liability regime of vicarious liability look wholly inadequate.

Several years later, scholars proposed a number of models of corporate culpability that would have complemented the steps taken by the Commission to develop a body of law reflecting the uniqueness of the corporate person. These theoretical models included proactive and reactive corporate fault, corporate policy, corporate ethos, and constructive corporate fault.³²⁰ Unfortunately, courts and legislatures did not rise to the challenge in the ensuing years. Instead, informal prosecutorial guidelines and regulatory policy statements have accommodated for the absence of statutory changes in liability rules prompted by either scholarly or judicial conceptions of corporate culpability. Problems of conflicting incentives and moral hazards reflect the inadequacy of vicarious liability, a liability rule that has been undermined by strategic interests from the time of *Hudson*. The predictable evolution of risk shifting from the turn of the century, the unwise vesting of unbridled prosecutorial discretion, and the cosmetic nature of corporate compliance efforts together issue a loud and powerful call for the reform of the substantive corporate criminal law.

319. See Laufer, *supra* note 76, at 1083.

320. See generally Brent Fisse, *The Attribution of Criminal Liability to Corporations: A Statutory Model*, 13 SYDNEY L. REV. 277 (1991) (proactive and reactive fault); Brent Fisse, *Corporate Criminal Responsibility*, 15 CRIM. L.J. 166 (1991) (same). For an early discussion of proactive and reactive fault based models, see Brent Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions*, 56 S. CAL. L. REV. 1141, 1200 (1983) ("Reactive and proactive corporate *mens rea* provide alternative bases of corporate blameworthiness, with proactive fault being relevant until the commission of the *actus reus* of an offense, and reactive fault being relevant thereafter."); see also PETER A. FRENCH, *COLLECTIVE AND CORPORATE RESPONSIBILITY* (1984) (corporate policy); Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095 (1991) (corporate ethos); Ann Foerschler, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287 (1990) (corporate ethos); Laufer, *Corporate Bodies and Guilty Minds*, *supra* note 7 (constructive corporate fault); Moore, *supra* note 18 (corporate culture and ethos).