Trial Balloon
Rethinking Corporate Criminal Liability

by Gregory L. Diskant

As a glance at the newspapers vividly demonstrates, public corporations have become favorite targets for federal prosecutors, right up there with drug dealers and the mob. Due in part to reasons of their own making, many corporations are now viewed as somewhat less-than-model citizens, and a corporate indictment almost inevitably leads to big headlines.

Meanwhile, unlike drug dealers or the mob, corporations rarely put prosecutors to the obligation of actually proving to a jury that a crime was committed. Only a corporation with nothing to lose, like Arthur Andersen, can afford to contest the charges in court. And so, with familiar predictability, a corporate indictment leads to a guilty plea, which leads to a large fine, which leads to more headlines.

There is, nonetheless, a growing sense that the government has overplayed its hand and that the time may be right to rethink the rules of corporate criminal liability. Last summer, in a widely watched ruling, U.S. District Court Judge Lewis A. Kaplan dismissed criminal charges against 13 former KPMG International employees, finding that the government had violated their Sixth Amendment right to counsel. *See United States v. Stein*, 495 F. Supp. 2d 390, 427-28 (S.D.N.Y. 2007). The KPMG 13 had expected to have their defense costs paid by the company, the normal rule in corporate America for employees who find themselves in the middle of a criminal investigation of their employer. But to avoid its own indictment, KPMG promised the government that it would not pay those counsel fees, supposedly to demonstrate its "cooperation" with the government.

KPMG's decision to abandon its employees—after it had expressly promised the opposite in a company-wide message from its CEO the day the investigation began—was in response to the government's aggressive enforcement of the now-infamous "Thompson Memorandum." The memorandum, issued by then-Deputy Attorney General Larry D. Thompson, set forth federal principles for prosecution of corporations. Among other things, the Thompson Memorandum promised companies under investigation "credit" for their cooperation if they took such counterintuitive actions as refusing to fund the defense of their employees, who were presumed innocent except in the government's eyes.

Judge Kaplan found that the government had coerced KPMG to abandon its employees' defense, thereby violating the defendants' Sixth Amendment rights. The decision drew attention once again to the enormous power wielded by the government in prosecuting corporations, and to its potential for abuse.

Prosecutors hold all the cards in negotiating with potential corporate defendants. If they choose to indict, they almost always win because, under current law, a corporation has no defense to a criminal charge if a single employee has committed a crime that was intended even in part to benefit the corporation—even if that employee is low-ranking and acted contrary to company directives and procedures.

KPMG, faced with the threat that even its indictment for a crime could literally put it out of business—as happened to its former competitor Arthur Andersen—had no choice but to do whatever the prosecutors wanted to stave off indictment—even cutting off its employees who were simply attempting to defend their work for KPMG.

The government has appealed Judge Kaplan's decision, and the Court of Appeals for the Second Circuit will decide whether it was correct. But whatever the outcome, Judge Kaplan's decision brings attention to a real and pressing problem. With respect to the prosecution of corporations, our system is broken. What is supposed to be an adversarial system, in which the threat of an eventual day in court acts as a brake on prosecutorial overreaching, is not anything remotely like that for corporations.

Because they often—indeed, usually—have no option but to plead guilty, corporations have little bargaining power against an overzealous prosecutor. There is no court available to provide a check on prosecutorial excess. Knowing that, prosecutors make demands that in some cases

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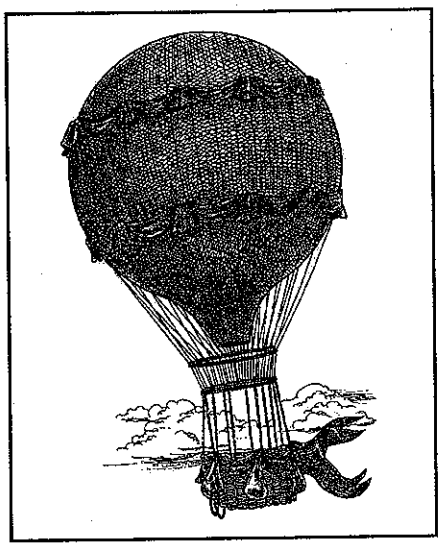


are excessive or unrelated to any legitimate law enforcement activity. In one case, a prosecutor demanded a company fund an endowed chair at his alma mater. Interview of Mary Jo White, *Corp. Crime Rep.*, Dec. 12, 2005, at 14-15. In another, the prosecutor demanded the company create new jobs in his jurisdiction. Interview of David Pitofsky, *Corp. Crime Rep.*, Nov. 28, 2005, at 14-15. In yet another, the prosecutor announced a plea agreement yet stated that he did not believe he could prove a crime had occurred. Kurt Eichenwald & Riva D. Atlas, "2 Banks Settle Accusations They Aided in Enron Fraud," *N.Y. Times*, July 29, 2003, at A1.

This imbalance in our criminal justice system is not healthy. Much debate has focused on the Thompson Memorandum, which was replaced by the only slightly improved McNulty Memorandum, a revision by then-Deputy Attorney General Paul J. McNulty. The McNulty Memorandum continues to encourage corporations to demonstrate their "cooperation" by declining to reimburse the defense costs of their employees or by abandoning the exercise of other lawful rights such as asserting the attorney-client privilege or entering into joint defense agreements. Offensive though these demands are, coming from a government agency whose traditional tools to investigate and prosecute crime have not generally been viewed as deficient, the tactics are simply examples of the government's aggressively utilizing the tools that the courts have given it to fight crime.

The root cause of the problem is that, as a practical matter, the government always wins when it chooses to charge a corporation with a crime. Because of its enormous power over potential corporate defendants, it can, and too often does, make unreasonable demands on those under investigation. Real reform requires reconsideration of the scope of the toolkit the courts have handed to the government. It requires a thoughtful answer to the fundamental question: What constitutes a crime by a corporation?

As Judge Kaplan observed in a speech earlier this year, a corporation is "a 'person' only in a metaphorical sense," and a criminal prosecution of such a "person" does not self-evidently serve any of the ordinary goals of criminal law. Hon. Lewis A. Kaplan, Address to the Commercial and Federal Litigation Section, New York State Bar Ass'n (Jan. 24, 2007), http://nysbar.com/blogs/comfed. Indeed, the "criminal conviction of a corporation does not punish the wrongdoers. It punishes the stockholders. . . ." As a result, Judge Kaplan suggested, it is "time for an objective consideration of whether any change is warranted in present circumstances."

The path to a solution begins with an understanding of the problem. The primary weapon that the courts have given to prosecutors to fight corporate crime is the doctrine of respondeat superior, the law in every circuit. Based on respondeat superior, a company is guilty of a crime if a crime was committed by any employee—no matter how lowly—acting within the scope of his or her employment and with at least a partial motive to benefit the corporation. This rule effectively denies a defense to any corporation saddled with a wrongdoing employee.

The rule of respondeat superior makes complete sense in the civil context. When a company employee injures a third party while on the job, it is a fair allocation of risk in our society for the corporation to be responsible for making that injured party whole.

But does the same analysis hold true when the criminal laws are in play? As the chair of any public company ruefully will attest, there always will be occasions in which some company employee will commit a crime. A company can do only so much to prevent that. Why should a company be held liable—not for tort, but for a *crime*—when its senior management did not authorize or ratify the offense? Why should a company be held liable—not for tort, but for a *crime*—when it had a clearly stated and vigorously enforced policy against such misconduct?

Most lawyers and many judges assume these questions cannot even be raised in a federal criminal case. They believe that a century ago the Supreme Court decided that ordinary civil rules of respondeat superior should govern corporate criminal liability, and so the issue is foreclosed from reconsideration.

But, in fact, the case that is cited, *New York Central & Hudson River Railroad v. United States*, 212 U.S. 481 (1909), does not stand for that proposition. In *New York Central*, the Court considered whether it was constitutional for Congress to pass the Elkins Act, Ch. 708, 32 Stat. 847 (1903), which made common carriers criminally responsible for a wrongful act by an employee "acting within the scope of his employment," 32 Stat. at 880, the ordinary civil rule of respondeat superior. *New York Central*, 212 U.S. at 491-92.

In the Supreme Court, the defendant company "contended that these provisions of law are unconstitutional because Congress has no authority to impute to a corporation the commission of criminal offenses. . . ." *Id.* at 492. Rejecting that constitutional challenge, the Court found that Congress could have found the standards set forth in the Elkins Act to be rationally "in the interest of public policy":

> 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 . . . may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting on the premises.

Id. at 494.

Thus, the Court held that Congress had the power under the Constitution to enact a statute utilizing civil rules to determine criminal liability for a corporation. But in the intervening century, Congress has not generally exercised this power. There are few or no federal laws like the Elkins Act, imposing criminal liability on corporations based on the doctrine of respondeat superior. To the contrary, most federal criminal statutes simply impose liability on a "person" or "whoever" violates the laws.

To be sure, in 1 U.S.C. § 1, Congress has defined "a person" or "whoever" to include corporations. Thus, Congress has plainly stated that corporations can be convicted of crimes. But that is a long way from prescribing the standard—whether respondeat superior or something else—under which a corporation can be found responsible for the acts of its employees.

In fact Congress has provided no guidance whatsoever about how to determine *which acts* of *which natural persons* should be imputed to the artificial "person" of the corporation for purposes of determining whether it has committed a crime. Unlike the Elkins Act, which spelled out the standard in detail and the constitutionality of which was upheld in *New York Central*, Congress has left that outcome-determinative analysis to the

(Please turn to page 58)

Trial Balloon

(Continued from page 6)

courts for the vast bulk of federal crimes.

In the intervening century, the Supreme Court never has addressed that question. It never has decided the general federal standard for determining criminal liability by a corporation. Meanwhile, the lower federal courts, in decisions typically more than half a century old, uniformly have resolved the question in favor of the ordinary rule of respondeat superior, always citing *New York Central*, sometimes as persuasive authority, sometimes as dispositive.

But *New York Central* is not dispositive; it does not even address the issue. Meanwhile, the current imbalance in the state of prosecutorial power, and its exercise, are very different from what existed when this body of law was being developed in the circuits many decades ago, when the prosecution of a corporation was the rare exception in the day-to-day business of federal prosecutors.

As Judge Kaplan suggested, it is time for a serious discussion about these issues. It is time for the federal appellate circuits to reconsider the issue in light of current circumstances. And it is time for the Supreme Court to consider it—for the first time.

It takes only a moment's reflection to see that there are many sound reasons to require a greater showing to subject a corporation to criminal liability than to civil liability. The Third Circuit recognized the distinction long ago, before its case law was swamped by the supposed *New York Central* "rule":

> Criminal liability of a principal or master for the act of his agent or servant does not extend so far as his civil liability. He cannot be held criminally liable for the acts of his agent, contrary to his orders, and without authority, express or implied, merely because it is in the course of his business and within the scope of the agent's employment, though he might be liable civilly.

Nobile v. United States, 284 F. 253, 255 (3d Cir. 1922).

The Model Penal Code, drafted in 1962 and adopted in whole or in part in 37 states, recognizes just such a distinction. Although respondeat superior may be just fine for purposes of civil liability, for purposes of criminal liability the Code proposes two important limitations on the concept. Both merit consideration, especially in tandem.

For purposes of this discussion, the Code recognizes two categories of crime: so-called ordinary crimes and those specifically directed at corporations. For ordinary crimes, the code sharply limits those agents of the company whose acts can create criminal liability for the corporation. Unless the legislature has plainly directed the particular statute at corporate crime, the crime must be authorized, performed, or "recklessly tolerated" by a "high managerial agent" of the corporation—a person whose responsibilities are so high that his or her acts "may fairly be assumed to represent the policy of the corporation." Model Penal Code §§ 2.07(1), (4)(c) (2006).

For the second category of crime, if it "plainly appears" that the statute is specifically intended to impose criminal liability on a corporation, the focus no longer is on the culpability of the high managerial agent. Instead, a different new defense is created, one that focuses on corporate compliance with such a law. An act is deemed not to be within the scope of employment, so as to subject the corporation to criminal liability, if the company exercised "due diligence" to prevent its commission. *Id.* § 2.07(5).

Adoption of these principles would alter the balance of power between federal prosecutors and corporations. Corporations would have actual defenses, and prosecutors would have to be able to prove conduct that warranted the opprobrium of criminal sanction before threatening indictment.

Could these ideas be accepted by the Supreme Court or by the circuit courts in light of current circumstances? Once it is recognized that *New York Central* does not foreclose the issue, the answer is yes. In fact, in somewhat similar contexts, the Supreme Court already has recognized the soundness of both ideas.

First, the need for action by a high managerial agent is a standard the Court has accepted in the context of punitive damages. Punitive damages are, of course, "quasi-criminal" in nature, "operat[ing] as 'private fines' intended to punish the defendant and to deter future wrongdoing." *Cooper Indus. Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 432 (2001) (internal citations omitted). In that context, as a matter of general federal jurisprudence, the Supreme Court long ago held that a principal, "though of course liable to make compensation for injuries done by his agent within the scope of his employment, cannot be held liable for exemplary or punitive damages, merely by reason of wanton, oppressive, or malicious intent on the part of the agent." *Lake Shore & M.S.R. Co. v. Prentice*, 147 U.S. 101, 107 (1893).

Rather, for a corporation to be punished for the acts of its agent, "the criminal intent, necessary to warrant the imposition of such damages, [must be] brought home to the corporation." *Id.* at 111. And that can happen only if a high managerial agent is involved.

> The president and general manager, or, in his absence, the vice president in his place, actually wielding the whole executive power of the corporation, may well be treated as so far representing the corporation and identified with it that any wanton, malicious or oppressive intent of his, in doing wrongful acts in behalf of the corporation to the injury of others, may be treated as the intent of the corporation itself . . . .

Id. at 114.

Although the Supreme Court has revisited punitive damages in a variety of contexts in modern times, it never has challenged this rule. Indeed, it recognized as recently as 1982 that the federal rule on punitive damages is more demanding than that of most states. *Am. Society of Mechanical Engineers, Inc. v. Hydrolevel Corp.*, 456 U.S. 556, 575 n.14 (1982). If the federal standard for the award of punitive damages against a corporation requires some action by a high managerial agent, it is difficult to see why it should be any easier to convict a corporation of a federal crime.

Likewise, the Supreme Court has recognized the importance of considering a corporation's compliance efforts in assessing whether an employee's act is within the scope of his or her employment. In a series of Title VII cases, the Court focused on whether it is fair to consider an employee's act to be within the scope of employment when the act is contrary to a clearly stated and rigorously enforced company policy. Critically, the Court recognized that determining whether a particular act is within the scope of employment is ultimately a judi-

cial value judgment about what is fair—a "judgment[] about the desirability of holding an employer liable for his subordinates' wayward behavior." *Faragher v. City of Boca Raton*, 524 U.S. 775, 796 (1998). As the Court observed:

> the highly indefinite phrase [the scope of employment] is devoid of meaning in itself and is obviously no more than a bare formula to cover the unordered and unauthorized acts of the servant for which it is found to be expedient to charge the master with liability, as well as to exclude other acts for which it is not.

Id. (internal citations and quotations omitted).

Focusing therefore on the value judgment, "the desirability of holding an employer liable" based on a strict application of respondeat superior when the corporation nonetheless had a vigorous program to comply with the law, the Court demurred. It noted that the "primary objective" of Title VII, "like that of any statute meant to influence primary conduct, is not to provide redress but to avoid harm." *Id.* at 806.

> It would therefore implement clear statutory policy and complement the Government's Title VII enforcement efforts to recognize the employer's affirmative obligation to prevent violations and give credit here to employers who make reasonable efforts to discharge their duty.

Id.

Based on this reasoning, the Court created an affirmative defense in certain Title VII actions, allowing the defending employer to prove that "the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior. . . ." *Id.* at 807.

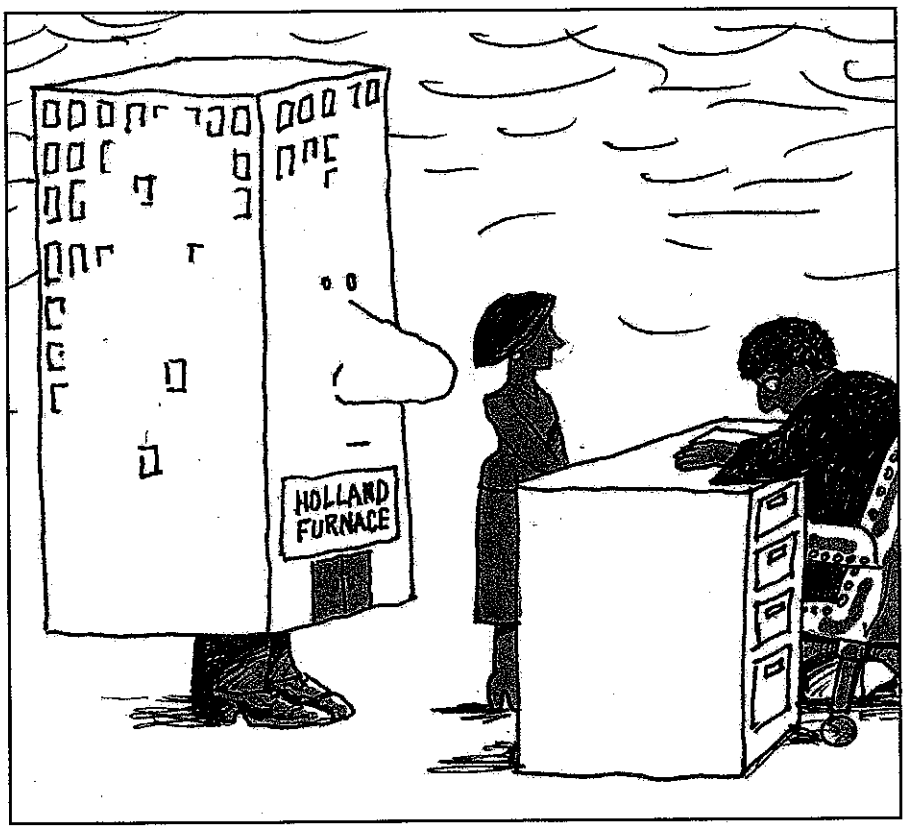
Ironically, the Court's discussion of the importance of giving credit to those corporations who seriously endeavor to comply with the law echoes the analysis of decades-old federal criminal cases before the uniform adoption of the *New York Central* "rule." In 1946, for instance, the Sixth Circuit confronted allegations of war profiteering by a company, notwithstanding the "total lack of proof" that any corporate officer was involved and the company's repeated and "emphatic admonition" to obey the law. *Holland Furnace Co. v. United States*, 158 F.2d 2, 8 (6th Cir. 1946).

The court recognized that the case was "diametrically opposite" from *New York Central*, *id.* at 7, because the statute at issue (unlike the Elkins Act) was a typical federal criminal statute that did not purport to define the standards for corporate criminal liability. Thus, the court could form its own rule. The court reasoned that, because of the defendant's aggressive compliance program, "to hold the corporation, Holland Furnace Company, criminally liable for [the employee's] unlawful acts" would carry corporate responsibility "beyond the boundary to which we think corporate criminal responsibility should be carried." *Id.* at 8. *See also John Gund Brewing Co. v. United States*, 204 F. 17 (8th Cir. 1913).

The Supreme Court's reasoning in the recent Title VII cases is readily translatable into the criminal context, producing the same outcome as in *Holland Furnace* and the Model Penal Code. The "primary objective" of the criminal laws is "to influence primary conduct" and "to avoid harm" to the public welfare. There is "clear statutory policy" that it is desirable for public corporations to have active compliance programs. Indeed, for courts looking for reasons to depart from *New York Central* based on changed circumstances, the change in this area of law is compelling.

Sarbanes-Oxley now requires public corporations to create a compliance program or to tell their shareholders why they have not, and so most public companies have such programs. Sarbanes-Oxley Act of 2002 § 406, 15 U.S.C. § 7264 (2007); 17 C.F.R. § 229.406 (2007). Meanwhile, the Sentencing Guidelines recognize that credit should be given to corporations that have effective programs, *see* U.S. Sentencing Guidelines Manual §§ 8C2.5, 8B2.1 (2007), acknowledging that deterrence of corporate crime is a critical governmental interest and a reason for a diminution in criminal liability.

It would therefore implement these policies and complement the government's criminal law enforcement efforts to "give credit here to employers who make reasonable efforts to discharge their duty." *Faragher*, 524 U.S. at 806. And it would seem reasonable to provide corporations charged with crimes the affirmative defense that they have created a reasonable corporate compliance program designed to prevent and correct the occasional wayward behavior of their employees. If so, then



employee misconduct in violation of company standards is not within the scope of employment and is not criminal conduct *by the corporation.*

Writing on a clean slate, these arguments are persuasive, and they are fair. They would lead to the adoption of the ideas set forth in the Model Penal Code, or some variant thereof, as the federal standard for corporate criminal liability. The Court has looked to the Model Penal Code in the past as persuasive authority, *see, e.g., Leary v. United States*, 395 U.S. 6, 46 n.93 (1969); *Salinas v. United States*, 522 U.S. 52, 64-65 (1997), and the Code's analysis would be informed here by the Supreme Court's own precedents.

If the standard were changed, the Model Penal Code experience provides guidance about where the new fault lines would be in the ongoing debate about corporate criminal liability. State courts have struggled to determine whether a particular company executive is or is not a "high managerial agent." *Compare State v. Chapman Dodge Center, Inc.*, 428 So.2d 413, 420 (La. 1983) (general manager not "high managerial agent") *with State v. Christy Pontiac-GMC, Inc.*, 354 N.W.2d 17, 20 (Minn. 1984) (middle manager was "high managerial agent").

State judges have reacted dubiously to generalized proof of "due diligence" because, if merely telling employees to act "in a lawful manner" meets the test, it would be "practicably impossible to impose criminal responsibility on corporations." *People v. White Bros. Equipment Co., Inc.*, 63 Ill. App. 3d 445, 450 (Ill. App. Ct. 1978). But where a company is "diligent" in its efforts to avoid crimes that its employees commit notwithstanding its best efforts, state courts have protected the company, finding that imposing criminal liability "would amount to a strict criminal liability in the absence of proof of fault." *State v. Abboud, Inc.*, No. 68611, 1995 WL 680920, at *5 (Ohio App. Nov. 16, 1995).

In this slightly reordered universe, individual employees could still be prosecuted for crimes when they commit them. And corporations would still be liable for damages in civil litigation arising from the misconduct of their employees, if committed within the scope of their employment. But the ultimate sanction of our judicial system, a criminal conviction, would be reserved for true corporate malefactors—those where top executives authorized or approved the crime or where there was no adequate program in place to prevent or correct that.

The relative power of the government versus target corporations would shift, restoring some degree of balance to our adversary system. And the public would benefit from even greater emphasis on serious corporate compliance programs, seriously enforced, potentially preventing far more crimes than the government would ever have the resources to prosecute on its own.

Would such a change cause the rescission of the McNulty Memorandum or a different outcome in the KPMG case? That is hard to say. If a corporate guilty plea were not the preordained outcome of a government decision to indict, it seems likely that the government would be less aggressive in what it demands from those under investigation. It would focus more on its ability to prove the elements of the offense, and those under investigation would be less inclined to give up all their rights to avoid charges.

If KPMG thought it had any actual defenses to a criminal indictment under the new standards, it presumably would be less willing to do whatever the government asked. Whatever the outcome, however, it would be the result of true give and take, a true focus on whether KPMG, as an institution, had engaged in conduct worthy of criminal sanction, not on whether the government could identify an employee anywhere in the enterprise who had committed a crime.

There is, of course, an elephant in the room. The reforms proposed here may be acceptable to the Supreme Court, which would be writing on a clean slate. But they are contrary to the law of every federal circuit, where respondeat superior still rules. How can reform be achieved?

As a theoretical matter, reform could come either from Congress, which could for the first time write laws defining corporation criminal liability, or from the courts, which could revisit the doctrine of respondeat superior. Congress is an unlikely white knight. It is all but inconceivable to imagine Congress rewriting the rules of corporate criminal liability to make it more difficult to convict corporations. Regardless of the persuasive force of the arguments for change, the political consequences of "going light" on corporate crime render the prospects of legislative reform slimmer than none.

Thus, if reform is to occur, it must come from the courts. That would be altogether fitting because the courts are the source of the problem in the first place. It is the lower federal courts that have fashioned the current rules. Those same courts may now be willing to revisit the issue. As Judge Kaplan's rulings and public statements make clear, there are federal judges who are interested in these issues and who might provide a receptive audience for powerful and logical legal arguments. The challenge will be to find vehicles in which to present those arguments to the courts.

Defense counsel can begin by presenting these issues to the government during the investigatory stage, arguing that charges should not be brought absent the actions of a high managerial agent or in the face of a vigorous corporate compliance program. If charges are nonetheless brought, they can press the issue further with motions to dismiss and proposed jury charges. Even so, it must be acknowledged that only a corporation with little to lose—like Arthur Andersen—will be willing to go to trial and litigate this issue all the way to the nation's highest court. Indeed, even bringing a motion to dismiss is a challenge because the usual corporate defendant pleads guilty when the indictment is filed in order to reduce the publicity associated with the charges.

There is another possibility. The federal rules permit a defendant to plead guilty while preserving an issue for appeal. Fed. R. Crim. P. 11(a)(2). Although the agreement of the government and the district court is necessary to such a plea, in a factually favorable setting a corporation might secure such agreement as a condition of a plea. This would allow an appellate court to grapple with the problem and the corporation otherwise to resolve the issue with a guilty plea.

If the issue can be presented by these or some other means, there undoubtedly are district judges willing to write sympathetic opinions on this issue, even if bound by the precedent in their circuits to deny the motion. And there should be circuits willing to reconsider their precedents because no Supreme Court precedent dictates the result.

The actual and perceived fairness of our system of criminal justice is a critical part of this nation's fabric. However popular easy prosecutions of corporations may be, in the long run unbridled prosecutorial power over any of our citizens—even our corporate citizens—exerts a pernicious influence on our democracy. The time for change is now. ☐