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The Criminalization of Corporate Conduct

A noted entrepreneur and a former U.S. Attorney General illuminate a growing problem facing business leaders and advance several possible solutions.

BY J.P. DONLON

Criminal law has strayed very far from its historical roots. Many statutes today punish those whose acts are wrongful only by virtue of legislative fiat. Some of the distortion of classic criminal law has arisen from benign motives, but the unintended consequences of innumerable "reforms" are overly broad restrictions that often trap honest but unwary people. For example, many employers will agree that California is an expensive place to do business. Intricate provisions of that state's labor code dictate requirements—from the length and time of meal breaks to the details that must be provided on an employee pay stub. Failure to comply with these laws can be costly. Not many realize that the penalty for noncompliance carries a greater risk than mere fines. It can also result in criminal liability, including jail time.

Most are familiar with what happened to Arthur Andersen in the wake of the Enron scandals. A venerable firm of many years was destroyed because it could not withstand the allegations that were leveled at the entire firm even though only the Houston partners were actually under indictment. The Supreme Court eventually overturned Andersen's conviction, but too late to save the 100,000 jobs lost and the shattered lives that resulted.

Perhaps the most egregious example took place in the wake of the tech bubble's bursting in 2000, when then-Attorney General Eliot Spitzer targeted a number of insurance companies, mutual fund companies, banks and financial institutions with allegations of fraud. Using a clueless press and threats of prosecutions, Spitzer caused stock prices to crater and extracted expensive settlements. In 2002, he targeted Merrill Lynch with allegations that it was pushing its customers to buy inflated shares in companies that were said to be paying Merrill high investment banking fees at the time. Merrill paid \$100 million in fines—not to the supposedly injured investors, mind you, but to the government.

Then there are uncelebrated companies most have never heard of, such as WellCare, a Midwestern healthcare firm, that saw three-fourths of its market value disappear after federal investigators descended upon its offices without ever saying why they were there.

There is no question that the general trend of criminalizing corporate conduct, often thought to be confined to headline-grabbing cases, will ultimately reach down to medium-size and smaller businesses. The question is, will this drift affect executive decision-making and have larger economic consequences for expansion, investment and employment?

To address this, the Manhattan Institute's Center for Legal Policy together with Chief Executive held a forum in New York with two experts with deep experience with this: Richard Thornburgh and Ken Langone. Thornburgh, a former Pennsylvania governor, earned acclaim in shepherding that state through the Three Mile Island crisis. He later served in the Justice Department and as U.S. Attorney General under Presidents Reagan and Bush. He has since been active in private law, as well as being Of Counsel with the Washington law firm of K & L Gates, LLP, where he has been active in precisely the sorts of criminal actions that arise from the criminalization of business. As a business leader heading his investment firm, Invemed, and a board director (GE, Yum Brands)—most famously with the NYSE when Richard Grasso's compensation came under attack—Ken Langone has faced prosecutors head-on both at the federal and state level. The co-founder of Home Depot and the textile firm Unifi, the former NYSE director was famously targeted by then-New York Attorney General Eliot Spitzer. But much to the politician's surprise, Langone stood his ground, inviting a courtroom shootout (which never happened) to clear his name.

Dick, how did we get into this mess?

Thornburgh: As a prosecutor and a defense lawyer I've worked both sides of the street on this issue, and I believe I have a balanced view of how we got here and what we might do to reduce some of the pressure on the mainsprings of our free enterprise system.

Keep in mind that corporations are artificial entities. They're not like the rest of us. They have powers and they acquire certain characteristics only from the laws that create them. This makes them fair game for those disposed against them for most anything that comes along.

About 100 years ago, the U.S. Supreme Court was faced with a question of whether or not a corporation had any liability under the criminal laws for activities that it undertook. Up to that time, as part of the common law there was a doctrine that lawyers will recognize—and to others I apologize—the Doctrine of Respondeat Superior. That is to say, that when an individual worked for you—and was acting in your interests—and did something wrong and there was a question of liability, it was not just that person, it was you that had to answer for any harm that was done.

Since 1909, we've had a developing field of criminal liability concerning corporations that far exceeds what anybody would have expected at the time.

One reason is that corporations are thought to be fair game for populist agitators—the Ralph Naders and Eliot Spitzers of the world—who see an easy target to promote their own personal interests. But what you really have here is a three-part play.

While it was the court that originally established the status of corporate liability under the criminal laws, they were aided and abetted as usual by the other two branches of government. Congress in particular embarked on an effort to proliferate criminal liability across the board in every field in which corporations are active.

Part of the Progressive movement in the early 20th century, but continuing to this day through Sarbanes-Oxley, is the notion of creating new liabilities for corporations. Part of this is the result on the part of congressmen needing to be seen to do something when a crisis emerges. This desire has resulted in a proliferation of now over 4,500 separate criminal laws, many of which—if not most of which—apply to corporations.

The court created the rights, Congress proliferated [them] and then the executive branch piled on. In recent years, a very activist group within the Department of Justice has sought to expand the presence of the federal government in recognizing wrong on the part of corporations, beginning with—unfortunately, our

now- Attorney General—Eric Holder in 1999, when he was a Deputy Attorney General, and continuing through four other Republican deputy attorneys general.



Let me take a step back and remind you that if criminal acts are committed by individuals—in the employ of a corporation or not—they have to answer to the criminal law for the consequences. But what's new and different here is the expansion of that individual liability to corporate liability, as was pointed out in the case of Arthur Andersen. That venerable firm faced a death sentence because of the attribution of criminal conduct to the entity itself rather than just the individuals involved with the Enron scandal.

Ken, you've been on the firing line of this. What were the circumstances?

Four Keys to Principled Criminal Law Reform

Former U.S. Attorney General Dick Thornburgh suggests four fundamental reforms that would check continued abusive and discriminatory prosecutions.

Revise the penal code. At the turn of the 20th century there were 165 federal criminal laws. Today there are close to 4,500 separate statutes, not including countless agency regulations, that may result in criminal prosecution upon violation.

Rationalize regulatory offenses. Enact a general statute prohibiting administrative sanctions and procedures for all regulatory features except in two instances: One, where the conduct involved poses significant harm to persons, property interests and institutions. This means only causing real harm to people—as opposed to using the wrong form—constitutes a true criminal offense. Two, permit criminal prosecutions, not for the breach of a regulatory provision but for a pattern of intentionally repeated breaches.

Greater supervision by the DoJ over prosecutorial activities. Those who are charged with bringing criminal prosecutions need adult supervision so only cases with merit are brought forward.

Restore attorney-client privilege. Enact a statute that restores the time-honored legal protection between client and attorney, including work-product privilege. ▲

Langone: The biggest mistake we make is to put a party label on this. May I remind you that the prosecution of Arthur Andersen happened under a Republican administration. Everybody's hands are dirty.

The criminalization of corporate behavior is one more example of self-interest run wild. The lawyers that become high-priced defenders, along with the lawyers who get high fees because people go to them on the basis that they understand how the other side works, benefit directly. There's one notable exception: New York City Schools Chancellor Joel Klein. He left as head of the Antitrust Division of the Justice Department to commit himself to helping kids get a good education in the City. But he's the exception. We've allowed unbridled behavior by our elected officials who pander to the public because they're mindful of headlines and what headlines can do for their political careers.

I don't have the answer. I know the answer in my case was to simply ask the question, "did I do anything wrong?" and if I did do anything wrong then the right thing to do would be for me to admit it and settle it. But we didn't do anything wrong. There were several instances where FINRA [Financial

Industry Regulatory Authority], the securities industry's self-regulating body, decided that my firm had engaged in so-called profit sharing, which was a law, created to protect the investor. [In 2003, NASD charged Invemed Associates with sharing in customers' profits from hot IPOs.] We got every single client of the firm—every single one—to sign an affidavit that they did not share profits with us, this is to protect them. And yet FINRA, which by the way was then run by Mary Schapiro, who now heads the SEC, on its own decided that they were going to bring a case anyway. In 48,000 pages of e-mails there was not one word or fact to support their charge, not one. It cost me \$20 million to defend myself. It's the best \$20 million I ever spent. Why?

During the hearing, the fellow arguing the case for FINRA ridiculed me to the three-man panel, alleging that I was spending an outrageous sum of money to defend myself. Their technique reminds me of Ray Donovan. [On May 25, 1987, Secretary of Labor Raymond Donovan (and all of the other defendants) were acquitted of charges of larceny and fraud in connection with a New York City subway line construction, after which Donovan was famously quoted as asking, "Which office do I go to, to get my reputation back?"]

This is where they get you. You whip them in court if the facts are on your side. But too often people are terrified to be convicted by the media. In my mind these people are no different than enforcers in the Mafia. They use high-pressure tactics to coerce.

In my case they called my attorneys at Wachtell, Lipton and told them that if I didn't start talking settlement—it was 20 minutes to 10 o'clock—they were going to issue a press release. When my lawyers told me this, I said call them back and tell them not to waste the 20 minutes. [Laughter]

[Vanguard founder and former CEO] John Bogle was an expert witness for FINRA. When asked on the stand, who should firms give hot [IPO] issues to, he said they should only give it to clients. My attorney was smart enough to ask, "what about customers?" He said, "oh no, you can give it to a client but you can't give it to a customer." My attorney asked, "can you help us by explaining the difference?" He said a client is a long-term investor and a customer is a short-term investor. Think of trying to enforce that distinction at Merrill Lynch where you've got 16,000 brokers and the brokers have to ask the person on the phone, "I have to know whether you are a client or a customer before I can give you the stock." This is the absurdity to which they went.

My satisfaction came when FINRA agreed that they would no longer issue press releases until after something is fully adjudicated. The only exception is if somebody is an embezzler or does something criminal where they feel they have to inform the public to warn the public against further damage.

Where are we today? We're at a point where selfish interests are dictating. And I can tell you as a businessman, we are going to pay a horrible, horrible price. My partner and I, Bernie Marcus, co-founders of Home Depot with Arthur Blank, would not be able to found Home Depot today. The rules that are in effect today would inhibit it.

Thornburgh: To address Ken's complaint, one of the problems in our criminal justice process today is that there is insufficient management and supervision in the Department of Justice as to what transpires in the U.S. Attorney's Office. I just finished a three-year representation of a prominent Democratic politician in my hometown of Pittsburgh, who was prosecuted on the flimsiest of charges because of his prominence and because he was a Democrat.

I repeatedly went to the Department of Justice, where I once hung my hat, and pointed out the inadequacies of this case and couldn't get a tumble. The problem was that they wanted to give the prosecuting U.S. attorneys a free hand. Nobody was going to overrule them. And today they're mortally embarrassed because recently the judge threw the whole case out. But this was after three years of an ordeal for a very prominent citizen of my hometown, simply because there wasn't an instinct for taking a second look at whether there was any true ground to base a case. For example, there were 43 counts of using the office fax machine for personal purposes, about \$4.20 apiece for misusing that fax machine, and the rest of the case wasn't much better. I was embarrassed for the Department of Justice. I was embarrassed for my profession but most of all I was appalled at the lack of supervision and management that went into the bringing of that case. I suspect when you get to these horror stories like Ken describes, 95 percent indicate the kind of deficient oversight that no business would tolerate in its field office or anywhere in its organization.

Ken, you are unique in that you faced a personal vendetta, with a New York Attorney General who singled you out by name and actually threatened you personally if you opposed him. How does one protect oneself from that?

Langone: Spitzer was a bully and by the way, he wants to run for Attorney General again! [Laughter] He is rehabilitating himself and has two PR firms and a political consultant. Think of the number of people he accused of criminal behavior and never brought a case [against], never brought one case. This is trial by press. He has destroyed more shareholder value than all the crooks in the last ten years on the corporate side!

You can't imagine the number of people, good friends of mine, that called me to ask, "why are you doing this? Are you crazy? Go downtown and settle with him and try and work it out." Of course what he didn't understand was something Dick Grasso said: "Spitzer doesn't understand that this has taken 10 years off Ken's life. He's having the time of his life!" [Laughter] It's true. I enjoyed it because I felt somebody had to fight this bastard.

Dick, considering what happened to Arthur Andersen and other firms that are not as well known, how would you advise them to defend themselves in these circumstances?

Thornburgh: It's hard, because the power of the Department of Justice and the U.S. Attorneys is plenary and it's often exerted in a way that constitutes the kind of bullying that Ken describes. The real flaw in the Arthur Andersen case was attributing to the entire organization the wrongs that were perpetrated by a small group in the Houston office. The Supreme Court's reversal of the ultimate finding of guilt against them pointed out the need for some kind of remedy. Maybe it's a legislative remedy but more often than not these things succumb to good sense and the need for better management from the Department of Justice. One might think that the mortification and embarrassment suffered by the Department of Justice, while it's no recompense for the people thrown out of work and who lost their savings, should impart a little bit of caution, but I wouldn't bet on it because the players change, time goes on and people tend to repeat the same mistakes over and over again.

Ken, one of the undiscussed ramifications of this is the impact on decision making in companies that feel at risk from this—namely, investments not made, business expansion not undertaken. As a board director and investor you are privy to a lot of discussions where risk aversion looms large. Will the criminalization of corporate conduct have adverse consequences for employment, innovation, new investment and for the economy?

Langone: I agree with your observations. Business is about taking chances. We took a chance when we founded Home Depot 30 years ago. We opened up our first two stores 30 years ago last week. But if we didn't take a chance, there wouldn't be 325,000 people today in that company with high-paying jobs, career-path opportunities, kids that started as lot boys managing stores, making \$150,000 to \$200,000 a year.

You have no idea how constricted business decisions are and how all too often you sit in a boardroom and let the lawyers dictate your business decisions. I have nothing against lawyers. But you've got to be careful that you don't so constrict your business decisions, that you accomplish the short term at the expense of the long term. And that's happening too much, much too much. A good example is General Motors.

Thornburgh: Let me add this point. The attorney-client privilege goes back to Elizabethan times. It's probably one of the oldest privileges existing in the law. And yet 10 years ago it was frontally assaulted under the guise of working out some ways and means by which corporations should be credited with cooperating by giving up the attorney-client privilege. This means that the next time a lawyer's advice is sought by someone within the corporation, they're going to be more circumspect, more indefinite, more vague about certain facts. I've been a lawyer long enough to know that your decisions, opinions and your advice are only as good as the facts upon which they're based. If a client isn't forthcoming, the advice may not be worth much.