CRIMINALIZING THE AMERICAN COMPANY
A MAMMOTH GUILT TRIP

Corporate America is finding it ever harder to stay on the right side of the law

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IT IS a rare month that goes by without announcements of big legal settlements by large companies doing business in America. August ended with an agreement by Bank of America to pay $17 billion, eclipsing a $1.2 billion settlement by Goldman Sachs and one of $300m by Standard Chartered in the same month. Those are additions to a list for this year that already includes deals with Morgan Stanley, Citigroup, Credit Suisse, Toyota, Marubeni, Barclays, Rabobank, General Electric and Bank of America (in another case). There have also been reports of investigations or possible settlement negotiations with Walmart, the world's largest retailer; Hospital Corporation of America, the world's largest private-hospital chain; and General Motors, America's largest car company, among many others.

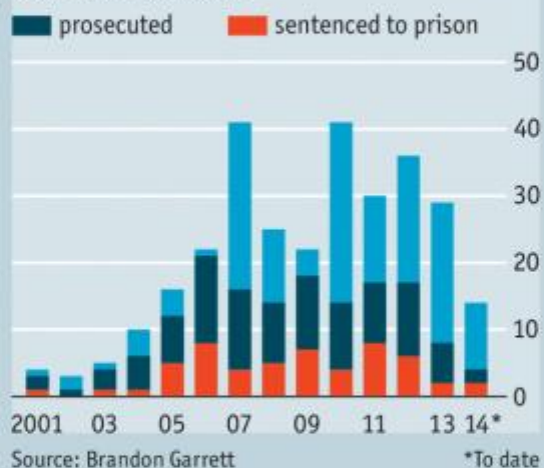
Brandon Garrett, a professor at the University of Virginia Law School, has compiled a database of actions taken against companies by the federal government since 2000. It lists 2,163 corporate convictions and guilty pleas and shows that both the number of convictions and the size of the fines have grown impressively over the period. Another 303 companies have reached "deferred" and "non-prosecution" agreements, an option that has recently, and controversially, become available to large companies. Mr Garrett has yet to add in litigation by individual states and sanctions imposed by dozens of independent federal agencies such as the Environmental Protection Agency and the Fish and Wildlife Service.

This proliferation of cases is not a preordained consequence of America's capitalist system. Instead, it reflects profound changes over the past century or so in thinking about the respective responsibilities of individuals and institutions and about the role of the state as an increasingly active participant in many areas of business. Collective responses to crises, notably war and depression, have also played a part, as has the embodiment in law of (often transient) economic theories.

A legal fog

The results have been deeply troubling. The problem is not just that companies are ever more frequently treated as criminals. It is that the crimes they are accused of are often obscure and the reasoning behind their punishments opaque, and that it is far from obvious that justice is being done and the public interest is being served.

Cleaning up and doing deals



It is true that many of the alleged wrongdoings take place as part of a complex set of activities, especially in the financial markets, which can make them hard to understand. But the secrecy that surrounds many of the settlements makes the best attempts at such understanding futile. In July, for example, the Justice Department announced that as part of a large settlement Citigroup would pay $2.5 billion in "consumer relief", vaguely defined, for its contributions to the financial crisis, even more vaguely defined, and as a result the bank would not be prosecuted for actions in another area, the sale of collateralised debt obligations. There was no indication of how these elements were related.

The only thing that is clear about this case is that, as part of a $7 billion deal, Citigroup agreed to pay $2.5 billion to atone for this ill-defined part of its wrongdoings. Without a full understanding of all the circumstances, public attention settles easily on clarity of this type. Regulators and prosecutors—some of whom have to stand for election—are not shy about encouraging the media to focus on such outcomes, particularly if they can be described as a record. They often can; Mr Garrett's database shows that penalties are growing remorselessly (see chart).

In January, using 2013 figures that will surely be dwarfed by this year's tally, Eric Holder, the attorney-general, announced that criminal prosecutions of companies resulted in the Justice Department collecting $5.5 billion in direct payments and played a part in the collection of another $2.6 billion by other federal agencies, states and designated recipients. This represented almost three times the $2.8 billion cost of the 94 United States attorneys' offices and the Justice Department's main litigating divisions, he said. That was a bit misleading because the payments included some won by agencies and states, whereas the costs were just those borne by the Justice Department. But the idea Mr Holder was putting over—that prosecutions can be treated as a government profit centre—is gaining ground. In February Manhattan's federal prosecutor, Preet Bharara, announced that his office alone had, over a fiscal year that differed slightly from Mr Holder's, collected $2.9 billion.

Vast amounts are also being scooped up as civil fines. A report by The Taxpayers Against Fraud Education Fund, an interest group based in Washington, DC, found that since 2012 state and federal authorities have received $20 billion from settlements tied to a single law, the False Claims Act, signed by Lincoln in 1863 to protect the government from being ripped off by suppliers fitting out the Union army. The return to the Justice Department on these sorts of cases, often started off by whistleblowers who receive a share of the settlements, is 20:1, says Patrick Burns, co-executive

director of the fund. That makes pursuing them attractive: “We are on the edge of a new era of incentivised integrity programmes.”

That kind of money can come in handy. For example, the office of Rhode Island’s attorney-general recently bought the building next door to its headquarters, adding to a statewide shopping spree by law-enforcement institutions that included squad cars, tasers, rifles, a police station and the replenishment of underfunded police pensions. Footing the bill is Google, which chose to pay $500m, split between the state and the federal government, to settle claims arising from its acceptance of ads for prescription drugs from Canada. The only unusual feature about this case is that Rhode Island has provided information on how the cash is being used.

“Contrary to the conventional wisdom,” write Margaret Lemos and Max Minzner in an article in January’s *Harvard Law Review*, “public enforcers often seek large monetary awards for self-interested reasons divorced from the public interest in deterrence. The incentives are strongest when enforcement agencies are permitted to retain all or some of the proceeds of enforcement—an institutional arrangement that is common at the state level and beginning to crop up in federal law.”

The bigger question about such fines is what they are meant to achieve. David Uhlmann, a professor at the University of Michigan Law School, argues that allowing companies involved in lethal activities to settle their claims with prosecutors, instead of having the harm they have done made evident through an unequivocal criminal conviction, amounts to a moral and practical failure.

If the main aim is deterrence, companies may be the wrong targets for prosecution. In a speech before the New York Bar Association last November that was widely shared on social media, Jed Rakoff, a federal judge in New York, argued that the focus should be on individuals, and that not prosecuting individual malefactors after the financial crisis, despite widespread indications of fraud, may “be judged one of the more egregious failures of the criminal justice system in many years”.

No body to kick

Until the 20th century, companies were usually sued privately, through nuisance claims. If they alleviated the problem and paid for any damage caused, the thinking went, that would put things right without any involvement by the government. Corporate criminal liability was thought to make no sense. In a phrase attributed to Edward Thurlow, an 18th-century British Lord Chancellor, a company had “no soul to be damned, no body to kick.”

Only individuals were able to exercise free will, and punishments “are only inflicted for that abuse of free will”, wrote William Blackstone, another eminent legal figure at that time. When Robert Morris, who in the 1780s had served as America’s first treasury secretary (then called superintendent of finance), set up a company that got into trouble selling bad mortgage-backed securities, he was sent to debtors’ prison. His company was not prosecuted.

New economic and legal ideas took hold at the end of the 19th century. In 1909 the Supreme Court upheld the first criminal conviction in a federal court of a company, the New York Central & Hudson River Railroad, for the bizarre offence of cutting prices. The decision established three principles: that a company need not have any evil intention to be guilty; that it is responsible for the actions of its employees; and that it can be prosecuted as if it were a person. Otherwise, wrote Justice William Day, “many offences might go unpunished and acts be committed forbidden in the interest of public policy.”

A string of similarly important cases followed in short order. In 1916 a broken wheel on a General Motors car caused product liability to be expanded beyond an explicit violation of contract. In 1917 the Trading With the Enemy Act was passed to deal with German-owned assets in America in wartime. Originally set to expire in 1921, it was cited in recent cases in which HSBC and BNP Paribas, two banks, were charged with sanctions-busting in Iran and Sudan. As the 20th century wore on, a slew of federal regulatory agencies with legal authority were created, and individual states expanded their own reach.

All this has made the legal environment for companies staggeringly complex. In 1991 John Coffee, a professor at Columbia University, estimated the number of regulatory statutes carrying criminal penalties at around 300,000; this number continues to be widely cited, although if it was accurate at the time it will certainly be an underestimate today. Under a bill before Congress, the Justice Department and 35 federal agencies would have to list criminal offences that fall within their jurisdiction, along with the penalties imposed and the use to which the fines have been put.

The costs to companies of complying with all these legal requirements are huge. Large companies have to spend more than $40m a year each on keeping documents merely to respond to potential regulatory requests, concludes a working paper based on a survey of 128 companies by William Hubbard at the University of Chicago Law School. Smaller companies cannot afford to keep documents on this scale, putting them at risk of breaching statutes even if they have done nothing wrong.

On top of that, there are opportunity costs which are impossible to measure. Enormous amounts of time and money are now being put into compliance programmes that may placate judges, prosecutors, regulators and monitors but undermine innovation and customer services. And even the most diligent company may not escape censure. “No matter how gold-plated your corporate compliance efforts, no matter how upstanding your workforce, no matter how hard one tries, large corporations today are walking targets for criminal liability,” said Larry Thompson, a former deputy attorney-general, in a speech delivered to the National Association of Defence Lawyers in 2011.

In 1994 Mary Jo White, then America’s attorney for Wall Street and now head of the Securities and Exchange Commission (SEC), agreed not to press charges against Prudential Securities in exchange for a “non-prosecution” agreement that included a large fine, remedial steps and a contingent confession of guilt, rescinded after a probationary period. This was done out of concern that a criminal indictment could by itself kill a financial institution, but it gave prosecutors powers usually reserved for a judge or jury, such as the ability to determine penalties.

Lesser evils

The result has been a series of novel, complex arrangements. For example, in a product-liability case against Toyota last year, the facts of which were strongly contested, the company settled for $1.2 billion and agreed to a criminal charge of wire fraud (a catch-all provision) for misleading customers, in a variant of a non-prosecution agreement under which the charge is likely to be expunged in three years.

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 allowed prosecutors more time to bring cases, compel testimony and apply a lower burden of proof in cases involving banks. It was meant to protect them against property sharks and borrowers after an earlier crisis, but since 2008 it has been used in prosecutions against the banks themselves.

Historically, when the government's role in a part of the economy increases, so does its appetite for prosecution. Thus the False Claims Act passed 150 years ago to procure the means to fund a war is finding new uses in health care. It has generated millions of dollars in fines from companies marketing drugs not approved for that use by the Food and Drug Administration (FDA). Doctors can prescribe drugs to treat conditions for which they have not been approved, but the drugs' makers cannot market them for such purposes, and the government has been cracking down on them where they have done so.

But FDA approval may not be the best yardstick for a drug's utility. It can be slow and costly, and doctors and researchers believe quite a few unapproved drugs to be effective. A federal-appeals-court ruling in 2012 reversed a conviction against an independent pharmaceutical salesman, Alfred Caronia, for marketing a drug for an unapproved use on the ground that speech is protected. If that is true for an individual, perhaps it should also apply to a company, or an individual employed by one.

Attempts to increase companies' liability yet further continue. In June a federal prosecutor in San Francisco indicted Federal Express for shipping illegal prescription drugs. If successful, the case would extend a shipping company's responsibility from its own conduct to the conduct of its customers. It raises a lot of questions about what a company can and should know about those customers.

What makes the Federal Express case different is that the company has chosen to fight it out in court. Businesspeople generally argue that an indictment or a criminal charge can cause unacceptable damage, including the loss of operating licences, government contracts and customers, so their only realistic choice may be to settle, even if they have a good chance of being acquitted. Some think this gives prosecutors too much power, and that settlements feel more like shakedowns.

In some industries an indictment in itself can be lethal. E.F. Hutton (1987), Drexel Burnham (1990), Riggs National Bank (2005) and Bankers Trust (1999) all lost their independence soon after being charged. "The simple truth is that a criminal indictment leading to trial has been fatal for financial institutions," observes John Savarese, an attorney at Wachtell, Lipton, Rosen & Katz, a law firm. In 2002 Arthur Andersen, an accountancy giant, collapsed after being convicted of hindering investigations into Enron, a crooked energy company. By the time the Supreme Court reversed the verdict, there was nothing left of Andersen to resurrect.

Chief executives now say it would be simply irresponsible for them to run the risk of an indictment and trial. The result is "regulation through prosecution", argues James Copland of the Manhattan Institute, a think-tank. The mere threat of an indictment forces a negotiation which can lead to an entire new construction of law.

So how does a legal process without an open trial operate? The kind answer is "mysteriously"; a harsher one might be "coercively". A highly influential $1.4 billion deal in 2003 involving Eliot Spitzer, then New York's attorney-general, and Wall Street banks over equity research was justified by arguing that it would restore integrity to financial markets. But the terms of the agreement, if any,

and the reasoning behind the size of the fine were never made clear. At the time many people thought the main point of it was the shock value of a large number.

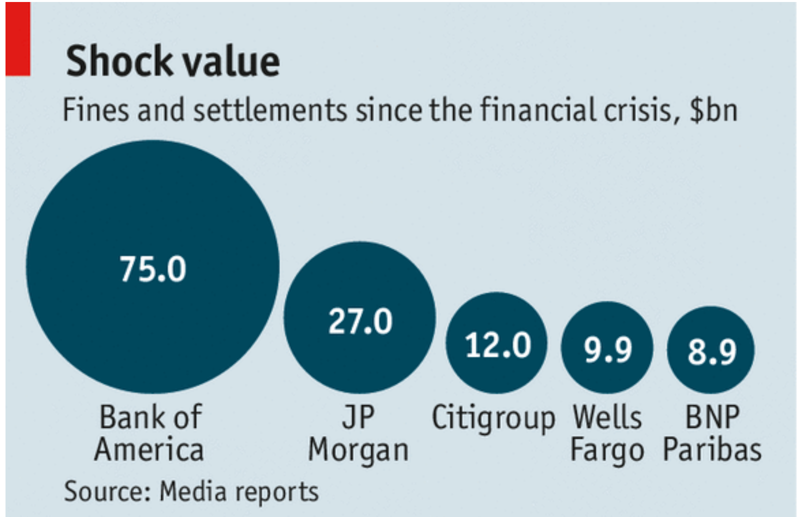
In 2009 a New York court criticised the way the proceeds of that fine were handled, painting a picture of gross mismanagement. The disarray stemmed from the lack of a coherent plan to compensate defrauded investors. In a forthcoming article in the *Stanford Law Review* Urska Velikonja, a professor at Emory University, argues that this reflects the failure to identify specific misconduct when setting up the deal.

In private, many companies contend that despite this debacle, the Spitzer standard—a requirement for a big fine with a tenuous economic rationale, along with murky additional requirements—remains in force. When a case is settled, the supporting documents often fail to provide information on the method used for determining the penalties.

The one bright spot, writes Ms Velikonja, is at the SEC, which in 2002 was given the right to distribute the money raised by fines. It has become steadily more adept at collecting money and distributing it to individuals who were harmed. But the system breaks down when the recipient is not a specific individual—which prosecutors claim is frequently the case.

To the victors, the spoils

Some fines—especially big ones—set off unseemly squabbles. A $9 billion settlement in June between BNP Paribas and five different regulators for circumventing sanctions on Iran and Sudan almost fell apart, according to a Reuters report, when New York's governor, Andrew Cuomo, demanded a bigger slice of the action. The governor and the state attorney also clashed over the distribution of $613m from a settlement by JPMorgan Chase.



These sums add up. In August New York disclosed in a budget report that it had received a total of $4.2 billion from settlements so far this year. Proceeds from a $25 billion national settlement reached with five banks in 2012 was intended to "provide substantial financial relief to borrowers harmed by bank fraud". In fact, the money has gone to a hotch-potch of entities, including the offices of the state attorneys-general who signed on to the settlement but played no real part in it, as well as state budgets.

Who's in charge?

But fines pale before the other changes in the relationship between companies and the state in recent years, particularly the idea that the state should play a direct role in rehabilitating companies. "The big story of the 21st century is not corporate fines or corporate convictions, but prosecutors changing the ways that corporations are managed," writes Mr Garrett in a forthcoming book, "Too Big to Jail: How Prosecutors Compromise with Corporations". "This represents an ambitious new approach to governance—in which federal prosecutors help to reshape the policies and culture of

entire institutions—much as federal judges oversaw school desegregation and prison reform in the heyday of the Civil Rights Era in the 1960s and 1970s."

So now complex agreements are being drawn up between prosecutors and companies, covering new compliance procedures, curtailment of business activities and operational and managerial changes. These can be intrusive. In 65 cases a monitor with wide-ranging authority over a company's operations has been appointed. One such monitor forced Bristol-Myers Squibb, an American pharmaceutical company, to sack its chief executive in 2006. And last November Apple publicly objected to a monitor appointed to settle charges of price-fixing for electronic books. Apple claimed that the monitor ran up huge bills and went far beyond his mandate; Apple, in turn, was accused of being insufficiently forthcoming. A federal appeals court rejected Apple's petition in February, but at the same time appeared to support the company's efforts to limit the monitor's reach, suggesting that resistance was not entirely futile.

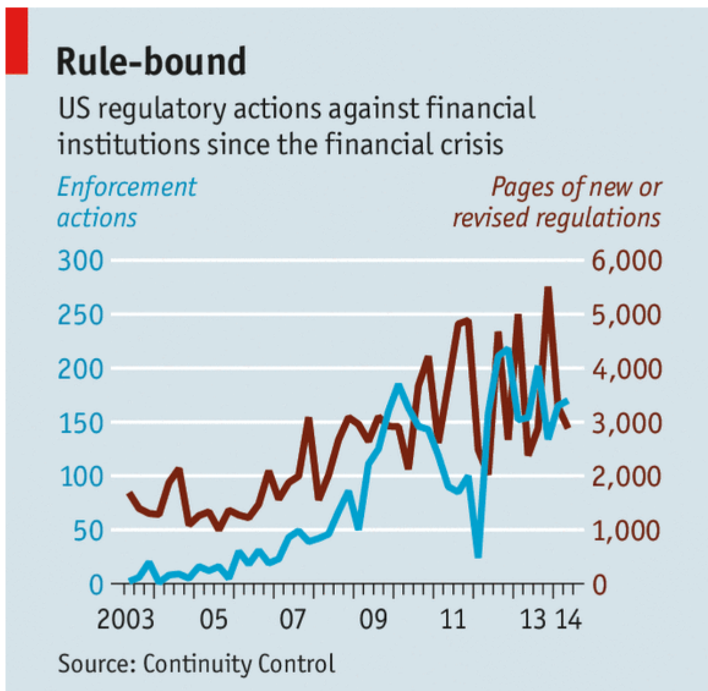
Beyond such snippets, little is known about the process. In dozens of cases, says Mr Garrett, the government has refused to release the prosecution agreement, and in a handful even the name of the monitor. In March, though, the Justice Department settled a suit filed by Mr Garrett's students, agreeing to release the details of a non-prosecution agreement with a small Texas company. Others may follow.

Yet even if the agreement is public, the results are rarely, if ever, disclosed. In 2010 a reporter working for two trade publications, *Corporate Counsel* and *American Lawyer*, filed a suit against American International Group, a failed insurance behemoth, to see reports drawn up by a monitor appointed in 2004 to oversee the company, following a consent decree over a fraud accusation. Those reports might have provided an insight into the company's collapse during the financial crisis, the role of the government in its management and the process of rehabilitation that followed. An appeals court in Washington, DC, rejected the petition in 2013, arguing that the "reports are not judicial records."

To the surprise of prosecutors and corporate attorneys, in July John Gleeson, a federal judge in Brooklyn, approved a deferred prosecution for a money-laundering case against HSBC, but stipulated that the bank should remain under court supervision. His decision raised the prospect that courts would reclaim authority over the resolution of the judicial processes, which they had seemingly ceded to prosecutors.

If there is any consensus about the developments described in this briefing, it is that nobody is happy. In January this year two senators, Elizabeth Warren and Tom Coburn, proposed a "Truth in Settlements Act", which would require fuller disclosure about settlement terms. In February Better Markets, an advocacy organisation that claims to promote transparency and accountability in financial markets, filed a suit in a federal court in Washington, DC, asking the Justice Department to explain the reasoning behind a $13 billion settlement with JPMorgan Chase in 2013, one of many in which it is involved. Better Markets and Ms Warren both revel in bashing banks. But many bankers say they actually support these measures, which they hope would expose double standards for crime and the intellectual sloppiness of a populist regulatory system championed by politicians like Ms Warren.

One big virtue of more openness would be to bring more clarity to the current legal sprawl. The endless, unfathomable quantity of rules undermines the "moral force and moral legitimacy" of the system because enforcement cannot be comprehensive and thus becomes discretionary, said George Terwilliger, a former deputy attorney-general, in testimony before Congress in June 2013.



And if the goal is to redress harm and create disincentives for bad behaviour, a better understanding of how to apply justice is needed. Research by John Armour, Colin Mayer and Andrea Polo at Oxford University's law faculty and the Saïd Business School, and Jonathan Karpoff at the University of Washington's Foster School of Business, shows that when a corporate action harms investors (for example through fake accounting) or customers (for example through shoddy products), the company's share price drops far in excess of a fine. This indicates that the underlying value of the business has been damaged, pushing up the cost of attracting capital and generating sales. A reasonable conclusion would be that in this sort of case there is little reason for the company to pay a large fine: the market imposes a larger penalty in any event.

In contrast, if the harm is being done to outsiders—for example, through bad environmental practices—the decline in the company's share price after the wrongdoing is announced is generally limited to the size of the fine. The authors conclude that in such cases the company itself should be held accountable.

In another era this sort of research might have been of purely academic interest; but now it is needed to create a more reasonable, disinterested, cohesive and transparent system. The recent flood of actions against companies has damaged the reputation of many private entities, but it has also done serious harm to America's legal system and the rule of law.

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