

# UP FROM FLATLAND: BUSINESS ETHICS IN THE AGE OF DIVERGENCE

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*Abstract:* The corporate scandals of the past few years have brought renewed attention to the problem of curtailing dishonest and fraudulent business practices, a problem on which strategic, ethical, and law enforcement interests should be aligned. Unfortunately, several features of federal criminal law and federal law enforcement policy have driven a wedge into this alignment, forcing managers to choose between their ethical obligations and their obligation to obey the law or aid law enforcement. In this article, I examine the nature and implications of the growing divergence between managers' ethical and legal obligations. After describing the traditional approach to business ethics analysis, I identify the features of federal criminal law and law enforcement policy that are responsible for the divergence and show how they are undermining the efficacy of the traditional approach. I illustrate this effect with the issue of workplace confidentiality. I then argue that the traditional approach must be reformed to give explicit recognition to the legal dimension of normative analysis, and demonstrate how such a reformed approach would function by applying it to three illustrative issues—organizational justice, privacy, and ethical auditing—and supplying a case study—KPMG's allegedly abusive tax shelters.

## *I. Introduction*

In *Flatland*,<sup>1</sup> Edwin Abbot's classic account of life in a two-dimensional world, the protagonist, A Square, is granted the wisdom of the third dimension when a sphere appears and lifts him into space. Having seen his world from above, he can never again accept what are regarded as obvious truths by the intelligentsia of his world.

I have had a similar experience. After years of teaching business ethics, I was shown a new normative dimension when I began teaching courses in white collar criminal law. Having seen the world of business from the legal perspective, I can no longer accept what is regarded as the proper method of analyzing normative issues by the mainstream business ethics community. Like A Square, who attempted to bring the perspective of the third dimension to Flatland, I hope to bring the perspective of the federal criminal law to the world of business ethics. That, at least, is the purpose of this article.

In business ethics circles, the present period is quickly becoming known as the post-Enron era. The corporate scandals of the past few years and the resulting criminal prosecution of high-ranking corporate executives have brought renewed attention to the problem of curtailing dishonest and fraudulent business practices. Indeed, this is a topic on which strategic, ethical, and law enforcement interests appear to be aligned. Good management requires the elimination of fraudulent practices that can damage the firm's reputation and subject it to costly civil and criminal liability. Ethical management similarly requires the suppression of dishonest practices that contravene fundamental normative principles and otherwise lack integrity. And effective law enforcement requires successful prosecution and deterrence of conduct that violates federal statutes aimed at suppressing white collar crime.

Appearances, however, can be deceiving. It is an unfortunate and largely unremarked fact that several features of federal criminal law and federal law enforcement policy have driven a wedge into this alignment. The civil libertarian features inherent in American criminal law make it exceedingly difficult to successfully prosecute those who commit white collar crimes. Congress and the Department of Justice (DOJ) have responded to this difficulty with statutes and policies that greatly facilitate the efforts of prosecutors.<sup>2</sup> These statutes and policies have significantly altered the conditions under which firms must operate—frequently in ways that do not correspond to principled ethical behavior. Managers are now often forced to choose between their ethical obligations to stakeholders and their obligation to obey the law or aid law enforcement. As a result, current federal law and law enforcement policy are driving up the financial costs firms must incur to meet their ethical obligations both in advance of, and especially after, becoming the subject of a federal criminal investigation.

In this article, I propose to examine the nature and implications of the growing divergence between managers' ethical and legal obligations. I begin by describing the traditional approach to business ethics analysis. I then identify the features of federal criminal law and law enforcement policy that are responsible for the divergence, and show how they are undermining the efficacy of the traditional approach. I illustrate this effect with the issue of workplace confidentiality. I then argue that the traditional approach must be reformed to give explicit recognition to the legal dimension of normative analysis, and demonstrate how such a reformed approach would function by applying it to three illustrative issues—organizational justice, privacy, and ethical auditing—and supplying a case study—KPMG's allegedly abusive tax shelters. Finally, I conclude with a reflection on the prospects of my proposal gaining acceptance.

## *II. A Flaw in the Traditional Approach to Business Ethics*

Because businesses function in a competitive market environment, their survival is always at stake. A firm that uses resources so wastefully that its revenue cannot cover its costs will go bankrupt and disappear from the market. But even a firm that

uses resources relatively efficiently will fail if its competitors are so much more efficient that they can sell their goods or services at a price the firm cannot profitably match. Hence, managers face a market imperative to reduce their costs relative to output to the greatest extent possible—that is, to maximize profits.<sup>3</sup>

Within the range of actions that will increase a firm's profits, there will be many that are not normatively acceptable. Burning down a competitor's plant, for example, may well increase a firm's profits, but is obviously outside the realm of normatively permissible action. Legal restrictions and ethical principles limit the range of actions managers may take in pursuit of profit.

The traditional approach to business ethics views managers as confronted with twin imperatives—the strategic market imperative to increase profits and the normative legal/ethical imperative to utilize only appropriate means to do so. The competing theories of business ethics are seen as specifying the extent to which the normative imperative curtails pursuit of the strategic one. For example, an extreme adherent of the stockholder theory may argue that the only normative restrictions on the pursuit of profit are those embodied in law,<sup>4</sup> while an adherent of integrative social contracts theory may argue that managers' actions are circumscribed not only by law, but by hypernorms and microsocial contracts as well.<sup>5</sup> This approach assumes that law and ethics always pull in the same direction, and, by doing so, reduces the essential challenge of business ethics to determining the point at which the normative demands override the strategic ones.

The traditional approach reflects the long-established convention within business ethics literature of viewing the legal and ethical imperatives as aligned. In this tradition, the law is viewed as embodying only a minimal set of normative requirements designed to eliminate the most harmful forms of behavior—a set which in itself cannot provide an adequate prescription for ethical business practice. Such a prescription requires that the law be supplemented by extra-legal, ethical obligations. Thus, although business ethics literature traditionally views the law as providing merely a subset of managers' normative obligations, it nevertheless views the obligations imposed by law as consistent with those imposed by ethics.<sup>6</sup>

Unfortunately, this tradition suffers from two serious defects. The first is that it rests on the false assumption that the criminal law prohibits only morally blameworthy behavior. The second is that it ignores the practical effects of the legal standard for corporate criminal responsibility and contemporary federal law enforcement policy. Due to these features of federal criminal law, there is a large and increasing number of cases in which the legal and ethical imperatives are not aligned—in which the law and ethics impose conflicting demands on managers. In these situations, the traditional approach to business ethics not only provides little practical guidance, but also obscures many highly significant normative issues. Thus, the growing divergence between the legal and ethical imperatives indicate that the traditional approach to business ethics needs supplementation.

### *III. The Source of the Divergence*

The assumption underlying the traditional approach to business ethics is that ethics and the law are consistent.<sup>7</sup> Under this assumption, it is always possible to simultaneously comply with the law and meet one's ethical obligations. If the law were merely a subset of ethics—if the law commanded only ethically appropriate actions—this assumption would be unobjectionable. Unfortunately, in the contemporary business environment, the assumption is unfounded. Today, the law frequently imposes legal duties or creates financial incentives that conflict with managers' ethical obligations.

The source of the divergence between managers' legal and ethical obligations can be traced to two sources: the recent expansion of federal criminal law and the practical necessities of effective law enforcement.

#### *A. The Expansion of Federal Criminal Law*

Over the course of several decades, Congress has vastly expanded the scope of federal criminal law. It has done so by 1) enacting extremely wide-ranging anti-fraud legislation, 2) creating a myriad of new regulatory "public welfare" offenses, and 3) outlawing actions which, although innocent in themselves, make it more difficult for the government to prosecute other substantive offenses.

##### 1. Federal Anti-Fraud Legislation

Recently, Congress has passed a sweeping array of anti-fraud legislation<sup>8</sup> that criminalizes virtually all forms of dishonest business practices. The federal fraud statutes outlaw not only completed frauds, but participation in "any scheme or artifice to defraud."<sup>9</sup> These offenses do not require proof that the scheme was designed to obtain the property of another because Congress has defined a scheme or artifice to defraud to include "a scheme or artifice to deprive another of the intangible right of honest services."<sup>10</sup> They also require no proof that the defendant actually obtained the property of the victim or deprived the victim of the intangible right of honest services or that the victim relied on any representation of the defendant because "[b]y prohibiting the 'scheme to defraud,' rather than the completed fraud, the elements of reliance and damage would clearly be inconsistent with the statutes Congress enacted."<sup>11</sup> Finally, the federal fraud statutes require no proof that there was a misrepresentation of fact because

it is just as unlawful to speak "half truths" or to omit to state facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading. The statements need not be false or fraudulent on their face, and the accused need not misrepresent any fact, since all that is necessary is that the scheme be reasonably calculated to deceive persons of ordinary prudence and comprehension.<sup>12</sup>

The reach of the federal fraud statutes is so great as to be, in the words of the Second Circuit Court of Appeals, "virtually limitless."<sup>13</sup> Federal fraud charges have been brought against a developer who claimed its homes were good investments,<sup>14</sup>

a physician who failed to disclose to his patients that he received a fee for referring them to a hospital,<sup>15</sup> a Senator's brother for secretly lobbying him on behalf of a corporation,<sup>16</sup> and an employee of the IRS for looking at confidential tax returns in contravention of IRS policy.<sup>17</sup> The breadth of these statutes is perhaps best illustrated by the recent prosecution of Martha Stewart for securities fraud. The government charged Stewart with fraud for publicly and, in the opinion of the government, falsely declaring her innocence of trading stocks on non-public information in an effort to "stop or at least slow the steady erosion of MSLO's [Martha Stewart Living Omnimedia, Inc.] stock price caused by investor concerns."<sup>18</sup> As these examples make clear, the reach of the federal fraud statutes is so broad and the border between legal and illegal conduct so indistinct that it is entirely possible to commit a fraud offense with no awareness that one is doing so.

## 2. Regulatory Offenses

Traditionally, criminal law required intentional or reckless conduct for one to be convicted of an offense. This changed as Congress created a myriad of regulatory "public welfare offenses"—criminal offenses that can be committed innocently or inadvertently. Public welfare offenses may require a showing that one has acted negligently, i.e., that one has failed to exercise the degree of care that a reasonable person would exercise,<sup>19</sup> but they frequently require no culpable state of mind, or *mens rea*, at all. In the latter case, one can be guilty of a criminal offense even though he or she has used his or her best efforts to obey the law. Thus, a company that ran a tank farm near Boston Harbor was convicted of violating the Refuse Act<sup>20</sup> for allowing oil to seep into a part of Boston Harbor even though the government made no allegation of a lack of care by the company and the company "immediately undertook to clean up the oil and to trace its source . . . [and] worked diligently to divert or drain the accumulation."<sup>21</sup>

In addition, under the "responsible corporate officer" doctrine, any person that has "authority to exercise control" over one who commits a public welfare offense may be charged with his or her subordinate's offense.<sup>22</sup> Thus, the CEO of Acme Markets, Inc. was convicted of a criminal violation of the Federal Food, Drug, and Cosmetic Act<sup>23</sup> when rat droppings were found in one of Acme's food warehouses and a roadmaster employed by the Pacific & Arctic Railway and Navigation Company was convicted of a criminal violation of the Clean Water Act<sup>24</sup> when a backhoe operator on his crew negligently pierced an oil pipeline, causing a discharge of oil into a nearby river.<sup>25</sup>

As these examples illustrate, there is no requirement that one engage in morally blameworthy conduct to be convicted of a criminal offense.

## 3. "Secondary" Offenses

Traditionally, criminal offenses consisted of actions that either directly harmed or violated the rights of others or were immoral in themselves. Recently, however, Congress has created a wide array of "secondary" offenses—offenses that consist of actions that are innocent in themselves, but that make it more difficult for the

government to prosecute other offenses. Currency reporting offenses consist in the failure of financial institutions and other covered businesses to report transactions involving more than \$10,000 to the federal government.<sup>26</sup> Federal money laundering statutes criminalize virtually any use of money generated by criminal activity.<sup>27</sup> The false statements statute makes it a felony to lie to or otherwise deceptively conceal material information from officials investigating any matter within the jurisdiction of the federal government.<sup>28</sup> Finally, the obstruction of justice statutes criminalize any actions that could reasonably be foreseen to impede a federal investigation, which ranges from destroying, altering, or concealing documents to persuading others not to cooperate with federal investigators or to assert their Fifth Amendment rights.<sup>29</sup> There is no requirement that one be aware that he or she is violating the law to be convicted of these offenses.

### *B. The Practical Necessities of Law Enforcement*

It is extremely difficult to enforce the expanded federal code within the confines of American criminal law. The federal fraud offenses are directed against the type of deceptive behavior that is intentionally designed to be indistinguishable from non-criminal activity. As a result, considerable investigation may be required merely to establish that a crime has been committed, and even then, a great deal of legal and accounting sophistication may be required to unravel the deception. Proving such an offense beyond reasonable doubt can therefore be an arduous and expensive task. Furthermore, because such behavior often occurs within corporations in which decision-making responsibility is diffused among many parties, it can be exceedingly difficult to prove that any individual acted with the level of intentionality required by the fraud statutes. In addition, the evidence necessary for a conviction, which will predominately consist in the business records of the individual or firm under suspicion, will frequently be protected by the individual's Fifth Amendment right against self-incrimination or the firm's attorney-client privilege, and hence be unavailable to the government.<sup>30</sup> And although there is no need to prove that a defendant acted intentionally to obtain a conviction for a public welfare offense, such offenses are so numerous, and frequently so technical and arcane, that no police agency could have a budget large enough to enforce them in a country as populous as the United States.

These difficulties made it apparent that the growing body of federal criminal law could not be effectively enforced without the active cooperation of the corporations themselves. Consequently, Congress, the federal judiciary, and DOJ responded with innovations that either required or provided incentives for such cooperation. The most important of these innovations were the advent of an especially strict form of corporate criminal responsibility and the creation of the Organizational Sentencing Guidelines and DOJ policy on the prosecution of corporations.

### 1. Corporate Criminal Liability

What does it mean to say that a corporation committed a crime? Because a corporation is an abstract entity with no mind in which to form intentions, no heart in which to conceive a guilty will, and no body that can perform prohibited actions, it can be guilty of a criminal offense only if it is held vicariously liable for the actions of at least some of the individuals who comprise it. Ethicists have offered many theories of corporate responsibility designed to identify the conditions under which it is ethically appropriate to hold a corporation liable for the actions of its employees.<sup>31</sup> When the conditions specified by these theories are met, the corporation is said to have a sufficiently “bad character” to be deserving of punishment as a collective entity.<sup>32</sup>

Such ethical theories of corporate responsibility are irrelevant to a corporation’s criminal liability.<sup>33</sup> A corporation is guilty of a criminal offense whenever any of its employees, acting within the scope of his or her employment, commits an offense that benefits or was intended to benefit the corporation.<sup>34</sup> This is the case even if the employee’s actions are directly contrary to corporate policy and contravene explicit instructions to the contrary.<sup>35</sup> Thus, a corporation is strictly liable for the crimes of its employees. In addition, federal criminal law charges a corporation with the collective knowledge of all of its employees.<sup>36</sup> Therefore, a corporation may be guilty of a criminal offense even though no individual employee is aware that an offense is being committed.

In sum, a corporation is guilty of a criminal offense whenever it fails to prevent any of its employees from committing an offense as individuals and whenever an offense is committed as a result of the ill-informed or poorly coordinated actions of its employees as a group. This is so regardless of any considerations of the corporation’s ethical “character.” Even a corporation that uses its best efforts to abide by the law is liable if a rogue employee commits a crime or if two or more partially informed employees inadvertently take actions that constitute an offense. This standard of corporate criminal responsibility virtually conscripts corporations into becoming deputy law enforcement agents because the only way for them to avoid liability is to monitor the behavior of their employees adequately to ensure that none of them violates the law either individually or through inadvertent collective action.

### 2. The Organizational Sentencing Guidelines and DOJ Policy

Firms cannot be imprisoned, only fined. The standard for determining the amount of financial penalty a corporation receives upon conviction of a federal offense is provided by the Organizational Sentencing Guidelines.<sup>37</sup> The Guidelines fix a corporation’s punishment by multiplying a “base fine,”—an amount ranging from \$5000 to \$72,500,000 that is assigned in proportion to the severity of the offense—by a number between .05 and 4.00 that is derived from the corporation’s “culpability score”—a figure designed to measure the quality of a firm’s corporate character.<sup>38</sup> The culpability score can range from zero to ten and is determined by assigning every corporation a starting point of five which is then adjusted upward

or downward on the basis of seven aggravating or mitigating factors. There are only two mitigating factors—a three point reduction for having an effective program to prevent and detect violations of law and a five point reduction for self-reporting, cooperation, and acceptance of responsibility.<sup>39</sup>

For illustrative purposes, consider the recent prosecution of Martha Stewart for securities fraud for attempting to prop up the stock price of Martha Stewart Omnimedia, Inc. (MSO) by publicly declaring her innocence of insider trading.<sup>40</sup> Imagine that because Stewart was an employee of MSO, the government decided to charge the corporation with the offense. Assuming that Stewart's statements caused losses to between 50 and 250 people totaling between \$2.5 and \$7 million, the corporation's base fine would be \$17.3 million.<sup>41</sup> Beginning at five, MSO's culpability score would be increased by three because MSO has between 200 and 999 employees and Martha Stewart was a high level official of the corporation.<sup>42</sup> In the absence of any mitigating factors, MSO would have a culpability score of eight, which would result in a fine range of from \$27.68 million to \$55.36 million.<sup>43</sup> However, should MSO have an effective compliance program and fully cooperate with the government's investigation, it could reduce its culpability score to zero, which would result in a fine range of from \$865,000 to \$3.46 million.<sup>44</sup>

As this illustration makes apparent, achieving the culpability score reductions for having an effective compliance program and for cooperation can be crucially important to corporations' financial well-being should any of its employees engage in dishonest business practices.<sup>45</sup> To have an effective compliance program, the corporation must "exercise due diligence to prevent and detect criminal conduct,"<sup>46</sup> and to cooperate, the corporation must disclose "all pertinent information known by the organization"<sup>47</sup> including information that "is sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct."<sup>48</sup> Thus, to protect itself against excessive financial liability, a corporation must both investigate the conduct of its employees and turn the results of such investigations over to the federal government.

The Guidelines' incentives are reinforced by DOJ policy contained in a memorandum entitled "Principles of Federal Prosecution of Business Organizations."<sup>49</sup> Currently known as the McNulty Memorandum,<sup>50</sup> this document instructs federal prosecutors to base their decision whether to indict a corporation in part on "the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents"<sup>51</sup> and the "adequacy of the corporation's pre-existing compliance program."<sup>52</sup> Under the McNulty Memorandum, a corporation's cooperation may depend on its willingness to waive attorney-client and work product privileges, to fire or sanction employees who assert their Fifth Amendment rights or otherwise elect not speak with prosecutors, and to refuse to enter into joint defense agreements with its employees; and the adequacy of its compliance program may depend on the extent to which it disciplines or terminates those suspected of illegal conduct.<sup>53</sup>

Like the Organizational Sentencing Guidelines, the McNulty Memorandum gives corporations the strongest possible incentives to become deputy law enforcement agencies. Taken together, they define good corporate citizenship in terms of a corporation's willingness to aid in the prosecution of its own employees.

#### *IV. The Nature of the Divergence*

The expansion of the federal criminal law and the innovations introduced to aid in its enforcement create both a legal obligation and a practical incentive for corporations to behave in ethically questionable ways. The legal obligation arises from corporations' strict vicarious liability for the conduct of their employees (and from the responsible corporate officer doctrine). Under this standard of corporate criminal liability, measures designed to promote good corporate character will not protect a firm (or a responsible corporate officer) from criminal liability. Therefore, corporations can obey the law only by taking the actions necessary to prevent their employees from violating the law. This implies that corporations are legally obligated to monitor and control the behavior of their employees closely enough to prevent them from committing criminal offenses.

To the extent that this requires corporations to adopt measures designed to suppress morally blameworthy actions, there may be little divergence between managers' ethical and legal obligations.<sup>54</sup> Because of the expansion of federal criminal law, however, many criminal offenses may be committed with no intent to violate the law and no awareness that one is doing so. The indefinite nature of the federal fraud offenses draws an extremely indistinct line between aggressive but legal practices and illegal deceptive ones. Public welfare offenses may be committed innocently or through inadvertence. Apparently innocuous actions such as complying with a corporate document retention policy or depositing a check can constitute obstruction of justice or money laundering depending on the circumstances. And under the collective knowledge doctrine, the uncoordinated actions of several employees will be treated as the intentional action of the corporation for purposes of criminal punishment. Hence, corporations are legally required to monitor and control the behavior of their employees sufficiently to prevent not only intentional wrongdoing, but all violations of criminal law, whether morally blameworthy or not.<sup>55</sup> But this level of monitoring and control may conflict with managers' ethical obligations to respect employees' privacy and autonomy and otherwise abide by the requirements of organizational justice.<sup>56</sup>

The practical incentive arises from the Organizational Sentencing Guidelines and DOJ policy. Prudent managers are aware that no matter how well-crafted, no system of monitoring and control can guarantee either that there will be no bad actors within a firm's workforce or that no employee will innocently or inadvertently violate the law. They will therefore wish to take prophylactic measures to ameliorate the consequences of any violations that do occur. Under the Guidelines and the McNulty Memorandum, the only such measures available are the creation

of an effective compliance program and the adoption of a corporate policy of full cooperation with government investigations. Such measures, however, effectively turn the corporation into a deputy prosecutor—requiring it to investigate its employees, turn all incriminating information over to the government, fire or otherwise discipline suspected employees, and refuse to help suspected employees mount a defense. Such actions may conflict with managers' ethical obligations to respect employees' privacy, honor promises of confidentiality, and abide by the requirements of organizational justice.<sup>57</sup>

### *V. A Defining Case of Divergence: Confidentiality*

To facilitate the flow of information about potentially unethical or illegal practices through the corporation, managers must supply employees with a confidential avenue of communication. Employees will often be unwilling to reveal information when they believe they will suffer adverse consequences if it becomes known they have done so. This is especially true with regard to information indicating that they, their colleagues, or their superiors are involved in unethical or illegal behavior. Thus, only by promising confidentiality can managers guarantee that they will receive the information necessary for them to run their corporations not only efficiently, but ethically and legally as well.

Corporations usually promise confidentiality in two ways. First, as a means of gathering sensitive information that otherwise would not be forthcoming, corporations create lines of communication that circumvent the ordinary corporate chain of command, such as employee hotlines or corporate ombudsmen.<sup>58</sup> To encourage employees to utilize such alternative lines of communication, corporations typically promise to keep any information transmitted through them confidential. Second, to accumulate the information necessary both to defend the corporation against civil lawsuits and criminal charges and to ensure that the corporation is complying with the law, corporations encourage their employees to provide information to corporate counsel under the protection of the attorney-client privilege. That is, corporations promise their employees that if they talk to the corporation's attorneys, what they say will not be revealed to outsiders unless it meets one of the recognized exceptions to the privilege.

When a corporation promises to keep information confidential, it assumes an ethical obligation to do so. The principle involved is the basic ethical obligation to keep one's word. If one party reveals information to a second only because the latter promises to keep the information confidential, the promise ethically binds the second party to do so. This is equally true when the second party is a corporation that is promising confidentiality to its employees. To obtain information under a promise of confidentiality and then disclose it under circumstances not agreed to by the confiding party is essentially to obtain the information by means of a false promise on which the confiding party relied in revealing the information. Such action is ethically indistinguishable from fraud.

Now consider the effect of the incentives created by federal criminal law and DOJ policy. The combination of corporations' strict liability for the offenses of their employees and the requirements of the Organizational Sentencing Guidelines and McNulty Memorandum imply that organizations can avoid indictment or reduce their exposure to financial penalties only by cooperating with government investigations of their employees. But under the Guidelines/DOJ standard, cooperation requires "the disclosure of all pertinent information known by the organization,"<sup>59</sup> which in turn, may require the waiver of the attorney-client privilege. Refusing to disclose relevant information on the ground that doing so would violate a promise of confidentiality could subject a corporation to both indictment and an extremely large increase in liability.

This places corporate managers in an extremely difficult situation. To generate the information necessary to maintain an ethical workplace and ensure that the corporation's employees are complying with the law, management must promise its employees confidentiality. But to avoid subjecting the corporation to indictment and large monetary fines, management must breach that promise whenever it uncovers potentially illegal activity.

Furthermore, management cannot avoid the dilemma by making only a conditional promise to keep information confidential unless disclosure is necessary for the corporation to cooperate with the government. Such a promise would be patently self-defeating since it is tantamount to saying that the corporation will keep the information confidential unless it is in the corporation's interest to disclose it to investigators. This type of promise is obviously of limited value and will elicit little or no useful information from the corporation's employees that would not otherwise be forthcoming.<sup>60</sup>

But even a corporation that decided not to promise any confidentiality for employees' communications could not escape the dilemma. By refusing on ethical grounds to make a promise of confidentiality that it knows it will not keep, such a corporation could decide to conduct its business without the information that such a promise would generate. But in doing so, it would be willingly foregoing one of the most effective means of detecting and preventing violations of law by its employees—a decision which would, under DOJ policy and the Guidelines, subject the corporation to an increased risk of indictment and cost it the three point reduction in culpability score for having an effective compliance program. One of the requirements for such a program is that the corporation "have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation."<sup>61</sup> But since whistleblowers are usually subject to retaliation if their identity is known, such a reporting system not merely "may," but virtually must be one that promises confidentiality.<sup>62</sup> Thus, even the decision not to make a promise of confidentiality would significantly increase a corporation's potential liability. In sum, federal

criminal law and DOJ policy bring intense pressure to bear on corporations to both make and breach promises of confidentiality.

The resulting divergence between managers' *prima facie* ethical obligations and the requirements and incentives of federal criminal law raises many difficult questions. If a corporation promises to keep employee communications confidential, is it ethical to breach that promise to protect the corporation as a collective entity? On the other hand, to what extent is it ethical to expose the stockholders and other stakeholders to the risk of loss associated with corporate indictment and increased criminal penalties in order to honor the corporation's commitment to individual employees, many of whom may have engaged in criminal wrongdoing? What should conscientious corporate managers tell employees about the corporation's commitment to preserve the confidentiality of communications made through the employee hotline or under the protection of the attorney-client privilege? Currently, out of the 185 of the Fortune 200 companies for which information is readily available, 181 promised their employees the ability to make confidential or anonymous communications. Although thirty-eight of these indicate that they will reveal the content of these communications to the extent necessary to conduct internal investigations, only three inform their employees that the corporation will breach the promised confidentiality when doing so is necessary to cooperate with federal criminal investigations.<sup>63</sup> Is this ethically acceptable? If managers explicitly inform employees that the corporation will disclose any incriminating communications made to the "confidential" employee hotline or to corporate counsel under the protection of the attorney-client privilege whenever doing so is necessary to conform to the Guidelines/DOJ's conception of good corporate citizenship, will the corporation be able to gather the information necessary to ensure that it is functioning ethically and in compliance with the law? Would any employee involved in an offense be willing to come forward? If not, how deceptive may managers ethically be on this point?

Questions such as these are not matters of idle speculation. In 2004, three executives of Computer Associates International, Inc. were indicted for obstruction of justice on the basis of allegedly false statements they made to the corporation's outside counsel during an internal investigation.<sup>64</sup> Prosecutors learned of the executives' statements when the corporation waived its attorney-client privilege in order to avoid indictment by cooperating with the government.<sup>65</sup> Did the corporation act rightly in conforming to the legal definition of a good corporate citizen or should it have faced indictment in order to honor its commitment to preserve the confidentiality of its employees' communications?

This is a difficult question, and like those above, it is one for which the injunction supplied by the traditional approach to business ethics to pursue profit in conformity with one's legal and ethical obligations provides no useful guidance. It is, in fact, one that the traditional approach with its assumption that law and ethics are consistent typically overlooks. As useful as the traditional approach is for cases in which the law and ethics are congruent, it is simply not equipped to address the ever-increasing range of cases in which they are not.

## *VI. Up From Flatland: Adding a Dimension to Business Ethics Analysis*

In *Flatland*, A Square treats the monarch of Lineland with disdain for his obtuseness in failing to understand that he can move sideways through the second dimension. He is later embarrassed to learn that he has been similarly obtuse about the third dimension when the sphere lifts him into space.

When I first taught business ethics, I shared the disdain expressed by many business ethicists for the obtuseness of economists who argued that managers' sole obligation was to comply with the strategic imperative to maximize profits.<sup>66</sup> Why couldn't they see that business had an ethical dimension as well? How could they be blind to the fact that the pursuit of profit had to be tempered by fundamental ethical principles? Later, when I began teaching courses on white collar crime, I was embarrassed to learn that I had been similarly obtuse about the legal dimension of normative analysis.

Like most business ethicists, I am critical of "instrumental ethics,"—the position that managers should behave ethically because doing so will, as a matter of fact, maximize profits.<sup>67</sup> There is, of course, no doubt that ethical behavior confers strategic advantages in a wide array of situations. Developing a reputation for honoring commitments, for example, can provide a firm with a significant competitive advantage. In such situations, the strategic and ethical imperatives are aligned and there is no conflict between doing good and doing well. But I and most other ethicists believe that this is not always the case, and that adherence to ethical principle frequently requires forgoing profit opportunities. Further, focusing on the cases in which strategic management prescribes ethical behavior is pointless since such cases pose no genuine ethical controversy. The heart of business ethics lies in the difficult and important cases in which the strategic and ethical imperatives diverge. Hence, we reject instrumental ethics because, by collapsing the ethical imperative into the strategic one, it produces a "myopic,"<sup>68</sup> one-dimensional view of business ethics that falsely suggests that the sole obligation of managers is to pursue their firm's strategic interests.

Rejecting this instrumentalist world view, we conventionally analyze normative business issues in terms of a tension between the strategic demands of the market and the ethical demands of moral principle. Yet in doing so, we invariably fail to take account of the demands of the law, merely assuming them to be a subset of the larger class of ethical demands.<sup>69</sup> Like our benighted instrumentalist brethren who collapse the ethical imperative into the strategic one, we collapse the legal imperative into the ethical one. Like them, who overlook most of the important ethical issues by focusing on the relatively uncontroversial cases in which strategy and ethics are aligned, we overlook important ethical issues by focusing on the relatively less controversial cases in which the law and ethics are aligned.

The evidence of our myopia is legion. Business theorists have produced a wealth of articles addressing various aspects of corporate criminality. Virtually all of them identify criminal activity with intentionally engaging in morally blameworthy conduct.<sup>70</sup> There can, of course, be no gainsaying the importance of learning what

causes and how to suppress intentional wrongdoing in business. But by making this the object of our attention, we are focusing on what are, normatively speaking, rather uncontroversial cases. Not much of a brief can be made in favor of the type of intentional wrongdoing that is condemned by both law and ethics. Thus, by indulging the patently false assumption that criminal conduct is limited to morally blameworthy conduct, we render ourselves blind to many truly difficult cases in which the law either penalizes ethical conduct or rewards unethical conduct.

When law and ethics pull in different directions, our failure to incorporate legal considerations into our ethical analyses means that we are not serving our constituents in the corporate world well. Managers must make decisions in a world in which their actions have legal as well as strategic and ethical consequences. For them to make informed and proper ethical decisions, they require knowledge of not only their ethical obligations, but also the legal ramifications of meeting them. Therefore, a proper approach to business ethics requires the explicit consideration of the legal dimension of ethical decision-making.

What does such consideration entail?

### *VII. Three Illustrations*

#### *A. Organizational Justice*

Consider the following hypothetical situation, which is not atypical of what may be assigned to students in a business ethics course.

Stone Fund is a large mutual fund company. The majority of investors in the Stone Fund are small investors, but the fund has several large investors as well as several institutional investors. Until recently, Gordon Gekko was one of the fund's most successful manager/brokers. He was responsible for acquiring most of the large investors in the fund. He apparently did this by allowing several of these investors to make trades after 4:00 p.m., which is illegal. Budd Fox, a junior broker who worked for Gekko, processed many of the late trades. Fox, who had been hired right out of business school, was not at first aware that he was doing anything wrong. Gekko's high status in the company, his forceful personality, and his assurance that the late trades were perfectly acceptable and were standard operating procedure in the industry led Fox to carry out Gekko's orders without qualm. Eventually becoming suspicious, Fox approached Stone Fund's corporate counsel in confidence to inquire about the legality of his actions. Upon thus learning of the late trades, Stone Fund immediately fired Gekko and reported his actions to the Department of Justice and Securities and Exchange Commission. What action should Stone Fund take with regard to Fox?

How might the discussion of this hypothetical proceed? Clearly, Fox bears considerable responsibility for his predicament. But does he bear all? The corporation hired him straight out of business school and placed him under a forceful and corrupt senior executive. Doesn't it bear some responsibility for leading Fox astray? Does it have an ethical obligation to help him mount a legal defense? To

rehabilitate his career? Should it fire him or is it obligated to retain him and place him under the guidance of an ethical mentor? The corporation learned of Gekko's activities because Fox came forward with the information. Does this obligate the corporation to protect Fox's interests in any way? Is it ethically required to maintain the confidentiality of Fox's communications to corporate counsel?

Business ethicists regard cases such as this as giving rise to questions of organizational justice. To the extent that there are principles of interpersonal justice that are binding on human beings generally, such principles are equally binding in the corporate context. Thus, managers have an ethical obligation not to treat employees in a way that violates these principles. Further, considerations of reciprocity can give rise to more specific obligations of justice. To the extent that corporations expect their employees to exhibit loyalty to the corporation and to advance its interests in preference to those of competitors or outside groups, it is reasonable to believe that corporations have a corresponding duty to exhibit a similar loyalty to employees by giving their interests preference over those of outside parties.<sup>71</sup>

There may be considerable controversy over the exact contours of the principles of organizational justice. But whatever these principles consist of, attempting to apply them without considering the legal dimension of the situation can only result in idle speculation akin to that apocryphally ascribed to the scholastics who debated how many angels could dance on the point of a needle.

In the hypothetical, both Gekko and Fox were acting within the scope of their employment for the benefit of the corporation when they violated the law.<sup>72</sup> Hence, under the legal standard of corporate criminal responsibility, Stone Fund is guilty of all of their offenses. Under the McNulty Memorandum and Organizational Sentencing Guidelines, the corporation can hope to avoid indictment and reduce its potential fine only by cooperating with the government and demonstrating that it has an effective compliance program—that is, only by firing or otherwise sanctioning Fox, refusing to help him prepare his defense, and disclosing to the government all information in its possession that may incriminate him.<sup>73</sup>

The principles of organizational justice may suggest that Stone Fund is ethically obligated to retain Fox, or to help him defend himself or rehabilitate his career, or to place him under an ethical mentor, or to maintain the confidentiality of his communications.<sup>74</sup> But the law imposes large costs on the corporation for taking such actions. It may be the case that when the demands of both ethics and the law are fully considered, justice requires that Stone Fund accept potential indictment and increased financial liability in order to honor its obligation to Fox. But it is also reasonable to believe that, given that indictment alone can destroy a financial services corporation (think Arthur Andersen), Stone Fund's obligation to protect its other stakeholders may override its obligation to Fox. Whatever the outcome, it is clear that no proper ethical analysis can ignore the legal dimension of the problem.

An impressive body of empirical research suggests that corporations can reduce the level of illegal and unethical behavior among their employees more effectively by adopting a "self-regulatory" rather than a "command-and-control" approach to

doing so.<sup>75</sup> The former consists of attempting to align employees' personal values with adherence to corporate rules and policies by instituting and adhering to programs of procedural justice. The latter consists of attempting to control employee behavior through the threat of punishment for misbehavior.<sup>76</sup> Apparently, treating employees fairly is a better way of generating legal compliance than threatening to punish them for noncompliance. Empirical evidence further suggests that the two approaches cannot be used concurrently because the use of extrinsic punishment and rewards by the command-and-control approach undermines the intrinsic motivation necessary to the self-regulatory approach.<sup>77</sup> Consequently, business ethicists frequently advocate that corporations adopt programs of procedural justice in preference to a regime of sanctions.

This can appear to be a good idea, *as long as one ignores the legal dimension of ethical analysis*. Programs of procedural justice require the corporation to repose significant amounts of trust in employees, rigorously honor commitments it makes to them, and provide them a modicum of due process. The latter requires, at least, that the corporation not take adverse action against employees in the absence of adequate evidence of wrongdoing, i.e., that it recognize an organizational "presumption of innocence." But under the McNulty Memorandum and the Organizational Sentencing Guidelines, adopting such a program would mean that the corporation could never have an effective compliance program and could never fully cooperate with the government. No compliance program that does not incorporate sanctions will be legally regarded as effective, and affording employees a presumption of innocence and honoring promises of confidentiality makes it impossible for the corporation to become the active prosecutorial agent that is required for it to be regarded as fully cooperating.<sup>78</sup>

It may well be that adopting a program of procedural justice will produce a greater reduction in the criminal violations by a corporation's employees than will instituting a regime of sanctions. But this is not necessarily beneficial if every violation that occurs carries a heightened risk of corporate indictment and considerably larger fines upon conviction. Matters of organizational justice simply cannot be usefully analyzed without explicitly considering the legal ramifications of the proposed courses of action.

### *B. Privacy*

Corporations can reap strategic benefits from gathering personal information about their employees and monitoring their employees' behavior both on and off the job. Information about employees' health habits can help firms lower their health care outlays and reduce absenteeism. Information about employees' moral, political, and religious beliefs can help them avoid internal conflicts and lower governance costs. Information about employees' family life and recreational activities, including alcohol and drug use and sexual proclivities can help them assemble a more reliable workforce and avoid potential civil liability (e.g., for the actions of impaired employees, sexual harassment, etc.). In addition, the ability to closely

monitor employee conduct can allow firms to reduce shirking and the improper use of corporate resources, and to better enforce discipline. Therefore, the ability to amass information about and monitor the conduct of corporate employees can enhance a firm's profitability.

Ethical principles limit the extent to which a corporation may invade its employees' privacy. All human beings possess a basic right to privacy that protects them against excessive intrusion into their personal affairs, the public dissemination of their secrets, and the type of constant supervision and monitoring associated with Orwell's *1984*. When one enters into an employment relationship, he or she partially waives this right. Employers are entitled to job-related information about their employees—information that is necessary to ensure that employees can adequately perform their jobs in an appropriate manner.<sup>79</sup> In addition, employers are entitled to monitor their employees' behavior to the extent necessary to ensure that they do so perform.<sup>80</sup> But an employee does not waive the right to privacy with respect to non-job-related information and monitoring merely by accepting employment.<sup>81</sup> Therefore, in the absence of an explicit agreement to the contrary, managers have an ethical obligation not to intrude upon their employees' privacy in ways that are not related to their job performance.

A traditional analysis of the issue of employee privacy might regard the matter as relatively uncomplicated. It would recognize that gathering information about and monitoring the conduct of employees can increase corporate profitability, and hence, that there is a strategic imperative to do so. It would also recognize that there is an ethical constraint on invading employees' privacy in ways that are not related to their job performance, and hence that there is an ethical imperative not to do so. Since the purpose of the ethical imperative is to place normative limits on the strategic one, the analysis would conclude that managers should not gather personal information about their firm's employees or otherwise monitor their conduct in ways that are not related to job performance.

Adding a legal dimension to the analysis considerably changes its aspect. Such a "three dimensional" analysis would recognize not only the strategic and ethical imperatives, but also that there is a legal imperative that directs managers to both gather information about and closely monitor their firm's employees. Corporations violate the law whenever any employee commits a criminal offense within the scope of his or her employment and whenever the firm's employees act collectively in a way that would constitute an offense if anyone possessed their collective knowledge.<sup>82</sup> Therefore, the only way for a corporation to obey the law is to take action to ensure that neither of these events occur. But such action can only consist in information gathering about and the continual monitoring of the conduct of the firm's employees. Indeed, the Organizational Sentencing Guidelines and McNulty Memorandum specifically encourage this because to have an effective compliance program, a corporation must engage in "monitoring and auditing to detect criminal conduct."<sup>83</sup> And because employees who intend to commit an offense will attempt to disguise it within their ordinary activities, the necessary surveillance will have to be

considerably more intense than the strictly job-related monitoring that is consistent with the ethical imperative.<sup>84</sup> In short, there is a legal imperative to engage in what would otherwise be ethically objectionable behavior.

Consideration of the legal dimension thus transforms what would otherwise be a rather simple analysis into a complex and difficult one. Due to the divergence between the ethical and legal imperatives, managers are confronted with a situation in which compliance with the law and the legal conception of good corporate citizenship is at odds with their *prima facie* ethical obligations. To know how to act, managers need some standard for determining when their legal obligations override their ethical ones and vice versa. Further, the divergence makes it more difficult to assess the financial costs of the alternatives—in this case because the cost of respecting employee privacy includes not merely the loss of the profit-enhancing efficiency gains described above, but also the increased risk of criminal indictment should an employee commit an offense, significantly larger fines if the corporation is convicted, the concomitant damage to the firm's reputation, and the civil liability that inevitably accompanies criminal indictment and conviction.

A good argument can be made for the proposition that managers' ethical obligations trump their duty to ensure compliance with the law, and that they are obligated to respect their employees' privacy with regard to non-job-related matters despite the strategic *and legal* costs of doing so. On the other hand, it is not unreasonable to argue that managers should not substitute their personal ethical judgments for those the democratically elected representatives of the people have enacted into law. Whichever is the case, it is clear that the issue cannot be properly resolved without the explicit consideration of its legal dimension.

### C. Ethical Audits

Under the traditional approach to business ethics, there is widespread agreement that managers are obligated to engage in ethical and legal self-assessments. Regardless of the position a business ethicist may take with respect to the substance of managers' ethical obligations, he or she will agree that managers are required to make good faith efforts to honor them. This requires, at a minimum, that managers know what is going on within their corporation. Because many features of a corporation's structure can impede the flow of information up the chain of command, e.g., the so-called "organizational blocks" and bureaucratic "moral mazes,"<sup>85</sup> managers cannot meet their ethical obligations merely by reviewing the information that reaches their desks. They must actively seek out the information necessary to form an accurate picture of what is taking place within their corporation. One of the most effective ways of doing this is to undertake regular ethical audits.

Ethical audits are not without costs, but under the traditional approach, these costs are seen as limited to the reduction in profits attributable to the financial outlay required to perform them. Ethicists frequently argue, however, that these costs are more than offset by the savings corporations realize from the reduction in unethical and illegal workplace behavior that the audits produce, e.g., a more harmonious

and committed workforce, reduced exposure to liability, etc. Yet, even if this were not the case, a cogent argument can be made that because the purpose of the ethical imperative is to limit the strategic one and because ethical audits help corporations and managers more effectively comply with the ethical imperative, the costs of the audits are ones that corporations are obligated to bear. Thus, under the traditional approach, managers appear to have a clear duty to undertake ethical audits.

Adding a legal dimension to the analysis renders this conclusion considerably less clear. This is because current federal criminal law and law enforcement policy radically increase the costs of undertaking ethical audits. Under the Organizational Sentencing Guidelines and the McNulty Memorandum, any ethical audit that produces evidence suggestive of criminal activity triggers a duty to immediately report the potential violation to the government and fully cooperate in any resulting investigation. Because corporations are strictly liable for the offenses of their employees, this places them in the position of having to aid in their own prosecution. Further, because cooperation can require waiver of the attorney-client privilege, any information suggestive of wrongdoing discovered through the audit may be made available to private parties as well,<sup>86</sup> thereby greatly increasing the risk of adverse civil litigation.

In the current legal environment, ethical audits do more than merely provide managers with information they need to meet their ethical and legal obligations. If they discover anything suggestive of criminal activity, they also turn corporations into deputy prosecutorial agents and greatly increase the corporation's exposure to civil liability. These additional consequences, which are overlooked by the traditional approach, significantly increase the potential costs of undertaking ethical audits. Indeed, a survey of major U.S. corporations undertaken by the Center for Effective Organizations at the University of Southern California suggests that corporate self-assessments are underutilized because corporate directors "are worried that any record of self-criticism might come back to haunt them in a shareholder suit or a government investigation" and "are fearful that [damaging] statements will show up in court proceedings (or be leaked to the press by plaintiffs' attorneys)."<sup>87</sup>

There is a good argument that because ethical audits are effective means of improving a corporation's ethical environment, managers are obligated to undertake them despite the legal risks they entail. But there is also a reasonable argument that because ethical audits not only increase the risk of corporate criminal and civil liability, but also trigger a legal duty for the corporation to aid in the prosecution of its employees in ways that may be inconsistent with the principles of organizational justice, the financial and ethical costs they impose are too great for them to be undertaken. Once again, however, we cannot even begin to make a proper evaluation of the issue unless its legal dimension is considered.

### *VIII. Business Ethics in the Age of Divergence: A Case Study*

Between 1996 and 2003, the accounting firm KPMG marketed several tax shelters designed to allow wealthy investors to avoid federal taxes. In July 2001, the Internal

Revenue Service “listed” two of these tax shelters, putting taxpayers on notice that the IRS considers them suspect and subject to challenge in tax court. The IRS did not, in fact, challenge any of KPMG’s shelters in court. Hence, whether the shelters are legal or not has never been determined.

In 2003, Congress began an investigation of potentially abusive tax shelters including those marketed by KPMG. KPMG defended the marketing of its shelters before Congress, sending one of its partners, Jeffery Eischeid, to testify as to their legality. Subsequently, the Department of Justice opened a criminal investigation into KPMG’s marketing of the shelters. KPMG’s management was aware that the Arthur Andersen accounting firm had collapsed following its indictment in 2002.

Over the course of 2004 and 2005, KPMG took the following measures. It agreed not to assert any legal privilege including its attorney-client and work product privileges and to disclose all information in its possession regarding the actions of its present and former partners, agents, and employees that the government deemed relevant. It agreed to identify any witnesses that may have information relevant to the investigation and to use its best efforts to induce its present and former partners and employees to provide information and testimony to the government. It refused to advance the legal fees of any partner or employee who refused to cooperate with federal investigators.<sup>88</sup> It refused to enter into any joint defense agreements with any of its present or former partners or employees. It agreed to inform the government which documents its partners and employees were requesting to prepare their defenses. It refused to inform its partners and employees of the documents it was supplying to the government to aid in their prosecution. It placed on leave, reassigned, or forced the resignation of many of its tax partners, including Mr. Eischeid. It officially stated that a number of its tax partners engaged in unlawful fraudulent conduct and agreed not to make any statement, in litigation or otherwise, that is inconsistent with that assertion<sup>89</sup> or to retain any employee who makes such a statement.

In return for these and other concessions and for the payment of \$456 million, the Department of Justice agreed not to indict KPMG. At the time of this writing, the government has indicted seventeen former partners or employees of KPMG, including Mr. Eischeid.<sup>90</sup>

How would this case be analyzed under the traditional approach to business ethics? If the management of KPMG knew that all of its partners and employees under federal investigation fraudulently sold what they knew to be illegal tax shelters, then its conduct might be ethically appropriate. Yet, the illegality of the shelters has never been established, and prior to the criminal investigation, KPMG publicly argued before Congress that they were legal. If any of KPMG’s partners or employees acted under a similar belief, they are not guilty of a criminal offense. In such a case, KPMG’s conduct would appear to be ethically indefensible.

The principles of organizational justice instruct KPMG not to take adverse action against its employees in the absence of sufficient evidence of wrongdoing. Yet, by dismissing and failing to advance the attorney’s fees of employees who

elect to defend themselves, publicly stating that such employees are guilty of fraud, informing the government of the documents such employees need for their defense, and otherwise refusing to aid in their employees' defense, KPMG has done precisely that.

In soliciting information from its tax partners and employees to prepare its defense before Congress, KPMG promised them the confidentiality inherent in the attorney-client privilege. By waiving the attorney-client privilege and disclosing all potentially incriminating statements made by its partners and employees to the government, KPMG breached this promise in a way that is highly detrimental to those who relied upon it.

To function ethically in the future, KPMG needs employees who are willing to come forward with information of unethical or illegal conduct within the firm. By demonstrating that it will sacrifice the interests of partners and employees who may be innocent of wrongdoing in order to help the government prosecute those suspected of illegal activity, KPMG has made it significantly less likely that its employees will bring questionable conduct to management's attention.

Adding a legal dimension to the analysis helps explain what from the traditional perspective must seem to be incomprehensible behavior. As a matter of law, KPMG is guilty of tax fraud if any of its partners or employees participated in the sale of the shelters with the belief that they were illegal or if the pooled knowledge of all of its employees is sufficient to justify such a conclusion. Further, as the Andersen case demonstrated, mere indictment can amount to a corporate death sentence for an accounting firm. Under DOJ policy, the only way to avoid indictment was to fully cooperate with the government's investigation of KPMG's employees as defined by the then-in-effect Thompson Memorandum (the McNulty Memorandum's predecessor) and the Organizational Sentencing Guidelines. But that required KPMG to affirmatively accept responsibility for its criminal conduct,<sup>91</sup> waive attorney-client privilege and disclose all potentially incriminating information to the government, refuse to help suspected employees mount a legal defense, and otherwise do everything in its power to ensure the cooperation of its employees, including sanctioning any who refuse to cooperate. Hence, KPMG's behavior can be seen as an effort to protect the firm's employees, investors, and other stakeholders from the fate suffered by Arthur Andersen's stakeholders.

The decision KPMG's management faced was a difficult one. The demands of the law and law enforcement policy confronted it with the strongest possible incentives to act as it did. KPMG had to balance these legal demands against conflicting ethical demands to abide by the principles organizational justice, honor promises of confidentiality, and maintain a working environment in which employees are willing to come forward with their ethical concerns. Precisely how to strike this balance may have no obvious answer, but it is clearly an important question to ask. Adding a legal dimension to our ethical analysis will not in itself answer this question, but, unlike the traditional approach to business ethics, it will ensure that the question is asked.

### IX. Conclusion

In *Flatland*, A Square attempts to bring the knowledge of the third dimension to his world knowing that his message would be poorly received by the intelligentsia whose status and position were derived from their superior ability to discern figures in two dimensions. Despite his trepidation, he was unable to restrain himself from proclaiming the truth that had been revealed to him. And indeed, his reward for trying to enlighten his brethren was to be condemned to perpetual isolation from the rest of society.

Similarly to A Square, I am attempting to bring the knowledge of the legal dimension to the world of business ethics knowing that my message may be poorly received by many ethicists whose professional standing derives from their superior ability to discern the relationships between the strategic and ethical dimensions of business. Incorporating a legal dimension into ethical analysis must prove discomfoting to those who, although excellent philosophers or social scientists, have little legal expertise. Doing so will certainly add to their work load by requiring them to amass the necessary legal knowledge, and may require some of them to re-evaluate positions that they may have spent much of their professional lives developing. Despite this, I find that, like A Square, I am unable to restrain myself from proclaiming the truth as I have come to understand it, and hence, I have written this article. All that remains is for me to learn whether by doing so I have earned a fate similar to his.

### Notes

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1. EDWIN A. ABBOT, *FLATLAND* (1884).

2. For a detailed account of this process, see John Hasnas, *Ethics and the Problem of White Collar Crime*, 54 AM. U. L. REV. 579, 588–630 (2005).

3. For purposes of concision, I speak exclusively in terms of for-profit enterprises. However, my point is general. Non-profits must still use resources as efficiently as possible in order to best achieve their goals. Charitable organizations that dissipate their resources while only poorly serving the ends of their donors will soon find themselves without donors. Although such organizations are not maximizing profits, their managers are still bound to strive to accomplish their organizations' missions at the lowest possible cost.

4. See Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES MAG. Sept. 13, 1970. Note that Friedman's version of the stockholder theory is not that referred to in the text. Friedman does not assert that the only restrictions on the pursuit of profit are those embodied in law. He explicitly recognizes the additional normative obligations to refrain from rent-seeking and deceptive practices, i.e., "engage[] in open and free competition without deception or fraud."

5. See Thomas Donaldson & Thomas Dunfee, *Toward a Unified Conception of Business Ethics: Integrative Social Contracts Theory*, 19 ACAD. MGMT. REV. 252, 254–71 (1994).

6. See, e.g., CHRISTOPHER D. STONE, WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR 111–12 (1975); Norman E. Bowie, *Fair Markets*, 7 J. OF BUS. ETHICS 89 (1988); THOMAS DONALDSON & THOMAS DUNFEE, TIES THAT BIND 156–60 (1999).

7. Business ethicists recognize that this is not always the case, typically citing American Jim Crow, South African apartheid, or Nazi anti-Semitic legislation as illustrations of cases in which the law and ethics are at odds. However, once such obvious and egregious counter-examples have been excluded, analysis usually proceeds under the assumption that the law does not command unethical behavior. This is the assumption that is being challenged in this article.

8. See, e.g., mail fraud, 18 U.S.C. §§ 1341, 1346 (2005), wire fraud, 18 U.S.C. § 1343 (2005), bank fraud, 18 U.S.C. § 1344 (2005), health care fraud, 18 U.S.C. § 1347 (2005), computer fraud, 18 U.S.C. § 1030 (2005), and securities fraud, 18 U.S.C. § 1348 (2005).

9. 18 U.S.C. § 1341 (2005).

10. 18 U.S.C. § 1346 (2005).

11. *Neder v. United States*, 527 U.S. 1, 25 (1999).

12. *United States v. Townley*, 665 F.2d 579, 585 (1982).

13. *United States v. Rybicki*, 287 F.3d 257, 264 (2d Cir. 2002).

14. *United States v. Brown*, 79 F.3d 1550 (11th Cir. 1996).

15. *United States v. Jain*, 93 F.3d 436 (8th Cir. 1996).

16. *United States v. D’Amto*, 39 F.3d 1249 (2d Cir. 1994).

17. *United States v. Czubinski*, 106 F.3d 1069 (1st Cir. 1997).

18. Indictment at 37, *United States v. Stewart*, (S.D.N.Y. 2003) (No. 03 Cr. 717). This charge was dismissed at trial for lack of evidence.

19. *United States v. Hanousek*, 176 F.3d 1116, 1121 (9th Cir. 1999).

20. Rivers and Harbors Act of 1899 § 13, 33 U.S.C. § 407 (2005).

21. *United States v. White Fuel Corporation*, 498 F.2d 619, 621 (1st Cir. 1974).

22. *United States v. Iverson*, 162 F.3d 1015, 1025 (9th Cir. 1998).

23. 21 U.S.C. § 331(k) (2005).

24. 33 U.S.C. §§ 1319 (c)(1)(A) & 1321 (b)(3) (2005).

25. *United States v. Hanousek*, 176 F.3d 1116, 1121 (9th Cir. 1999).

26. 31 U.S.C. § 5322 (2005) makes it a felony to willfully fail to file required currency transaction reports (CTRs). 31 U.S.C. § 1313 (2005) requires banks and financial institutions to report transactions of more than \$10,000. 31 U.S.C. § 1316 (2005) requires casinos and person persons moving currency in and out of the country to report transactions or currency movements of more than \$10,000. 26 U.S.C. § 6050I(a) (2005) requires all persons receiving more than \$10,000 in cash in the course of one’s business to file a report. 31 U.S.C. § 5324 (2005) makes it a felony for anyone to structure his or her financial transactions to avoid federal reporting requirements.

27. See 18 U.S.C. §§ 1956, 1957 (2005); *United States v. Jackson*, 935 F.2d 832 (7th Cir. 1991) (in which the court upheld the money laundering conviction of an alleged drug dealer for writing checks to purchase cell phones and pay his rent and for cashing checks for small amounts at his local bank).

28. See 18 U.S.C. § 1001 (2005). The reach of § 1001 is so broad that it makes it a new federal offense to falsely deny one’s guilt of another substantive offense, *Brogan v. United States*, 522 U.S. 398 (1998).

29. See 18 U.S.C. §§ 1503, 1505, 1510, 1512, 1519–20 (2005); *United States v. Shotts*, 145 F.3d 1289 (11th Cir. 1998); *United States v. Thompson*, 76 F.3d 442 (2d Cir. 1996).

30. For a more detailed account of the difficulties of enforcing federal anti-fraud legislation, see Hasnas, *supra* note 2 at 588–95 (2005).

31. See, e.g., Peter French, *The Corporation as a Moral Person*, 16 AM. PHIL. Q. 207 (1979); LARRY MAY, *THE MORALITY OF GROUPS*, chs. 1–4 (1987); PATRICIA WERHANE, *PERSONS RIGHTS, AND CORPORATIONS*, chs. 1–2 (1985); Kenneth E. Goodpaster & John B. Matthews, Jr., *Can a Corporation Have a Conscience?* HARV. BUS. REV., Jan.–Feb., 1982, at 132–41.

32. See, e.g., Pamela Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1103–05 (1991); Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 767–73 (1992); Ann Foerschler, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287 (1990).

33. Although corporate character is not relevant to a corporation's guilt or innocence, it may be relevant to the severity of punishment. See *infra* Part III(B)(2).

34. *New York Central & Hudson River Railroad Co. v. United States*, 212 U.S. 481 (1909); *Standard Oil Co. v. United States*, 307 F.2d 120 (5th Cir. 1962); *Steere Tank Lines, Inc. v. United States*, 330 F.2d 719 (5th Cir. 1964).

35. *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1007 (9th Cir. 1972).

36. *United States v. Bank of New England*, 821 F.2d 844, 856 (1st Cir. 1987).

37. UNITED STATES SENTENCING COMMISSION, *GUIDELINES MANUAL*, ch. 8 (1992) (Sentencing of Organizations) [hereinafter U.S.S.G.].

38. Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 785 (1992).

39. See U.S.S.G. § 8C2.5 (2005).

40. See *supra* note 18 and accompanying text.

41. The offense would have an offense level of 32 comprised of 6 for the Base Offense Level (U.S.S.G. § 2B1.1(a) (2005)), 18 for the Specific Offense Characteristics (§ 2B1.1(b)), 4 for the number of victims (§ 2B1.2(B)), and 4 for a violation of securities law by a director of a publicly traded company (§ 2B1.15(A)). Offenses with an offense level of 32 are assigned a base fine of \$17.3 million (§ 8C2.4).

42. See U.S.S.G. § 8C2.5(b) (2005).

43. *Id.* § 8C2.6.

44. *Id.*

45. The impact of the Guidelines is so significant that Professor John Coffee of Columbia University law school has declared that “[f]or a general counsel to ignore these guidelines is professional malpractice.” Michele Galen, *Keeping the Long Arm of the Law at Arm's Length*, BUS. WK., Apr. 22, 1991, at 104.

46. U.S.S.G. § 8B2.1(a)(1) (2005).

47. *Id.* § 8C2.5 cmt. 12.

48. *Id.*

49. Memorandum from Deputy Attorney General Paul J. McNulty to Heads of Department Components, *Principles of Federal Prosecution of Business Organizations* (Dec. 16, 2006), [hereinafter *McNulty Memorandum*] available at [http://www.usdoj.gov/dag/speech/2006/mcnulty\\_memo.pdf](http://www.usdoj.gov/dag/speech/2006/mcnulty_memo.pdf).

50. The memorandum was originally known as the Holder Memorandum, after Deputy Attorney General Eric Holder who first issued it in 1999. It subsequently became known as the

Thompson Memorandum when Deputy Attorney General Larry Thompson revised and reissued it in 2003. Deputy Attorney General Paul McNulty issued the current version of the Memorandum in December of 2006 to supercede the Thompson Memorandum, which had been subject to intense criticism for instructing United States attorneys that a corporation's refusal to waive its attorney-client and work product privileges or its willingness to advance its employees' legal fees could be regarded as a lack of cooperation with the government. In reaction to court rulings holding that the Thompson Memorandum's instruction regarding legal fees violated the Fifth and Sixth Amendments, (*See* U.S. v. Stein (Stein I), 435 F.Supp.2d 330 (S.D.N.Y. 2006); U.S. v. Stein (Stein II), 440 F.Supp.2d 315 (S.D.N.Y. 2006)), the McNulty Memorandum rescinded the latter instruction. In addition, the McNulty Memorandum softened the Department of Justice's position on the waiver of the attorney-client and work product privileges by requiring United States attorneys to obtain the approval of the Assistant Attorney General for the Criminal Division before requesting such a waiver.

51. *Id.* § III(A)(4).

52. *Id.* § III (A)(5).

53. *Id.* §§ VII–VIII. At the time of this writing, legislation is pending before the Senate Judiciary committee that would bar DOJ from asking for waivers of attorney-client. If ultimately adopted, such legislation would alter the DOJ's definition of cooperation.

54. Little, perhaps, but not necessarily none. For example, if the level of monitoring required to prevent intentional wrongdoing improperly invades employees' privacy, a manager's ethical and legal obligations may conflict. *See infra* Part VII(B).

55. This requirement is strongly reinforced by the responsible corporate officer doctrine under which supervisors may themselves be criminally punished for the unintentional crimes of their subordinates.

56. *See infra* Part VII.

57. *See infra* Part VII.

58. *See* James A. Waters, *Catch 20.5: Corporate Morality as an Organizational Phenomenon*, in *CONTEMPORARY MORAL CONTROVERSIES IN BUSINESS* 160 (A. Pablo Iannone ed., 1989); *see also* THOMAS DONALDSON, *CORPORATIONS AND MORALITY* 154–55 (1982) (describing how many United States companies utilize “hot-lines” and “operator” policies to encourage employees to speak truthfully).

59. U.S.S.G. § 8C2.5 cmt. 12 (2005).

60. The Supreme Court has explicitly recognized this fact in the context of the attorney-client privilege, stating “if the purpose of the attorney-client privilege is to be served, the attorney and client must be able to predict with some degree of certainty whether particular discussions will be protected. An uncertain privilege . . . is little better than no privilege at all.” *Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981).

61. U.S.S.G. § 8B2.1(b)(5)(C) (2005).

62. Indeed, in the Sarbanes-Oxley Act of 2002, Congress required publicly traded companies to establish procedures for “the confidential, anonymous submission by employees of issues or concerns regarding questionable accounting or auditing practices.” Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776.

63. These findings were compiled by the author by individually reviewing ethics and compliance policies for each of the Fortune 200 companies, which are available on each company's website. Research results are on file with the author.

64. Page 13, ¶ 27 of both Kaplan and Rivard indictments (*available at* <http://www.usdoj.gov/dag/cftf/chargingdocs/kaplaninfo.pdf> and <http://www.usdoj.gov/dag/cftf/chargingdocs/>

rivardinfo.pdf and page 16, ¶ 33 of Zar indictment (*available at* <http://www.usdoj.gov/dag/cfttf/chargingdocs/zarinfo.pdf>).

65. See Laurie P. Cohen, *Prosecutor's Tough New Tactics Turn Firms Against Employees*, WALL ST. J., June 4, 2004, at A1; E. Lawrence Barcella, Jr., et al., *Cooperation with Government is a Growing Trend*, NAT'L L.J., July 19, 2004, at S2.

66. See, e.g., THOMAS DONALDSON, *THE ETHICS OF INTERNATIONAL BUSINESS* 45 (1989) (describing the theory as "corporate Neanderthalism . . . with morally pernicious consequences"); ROBERT C. SOLOMON, *ETHICS AND EXCELLENCE* 45 (1992) (describing the position as "not only foolish in theory, but cruel and dangerous in practice" and misguided "from its nonsensically one-sided assumption of responsibility to his pathetic understanding of stockholder personality as *Homo economicus*"); William M. Evan & R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation: Kantian Capitalism*, in *ETHICAL THEORY AND BUSINESS* 75, 77 (Tom L. Beauchamp & Norman E. Bowie eds., 4th ed., 1993); Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 ACAD. MGMT. REV. 65, 81–82 (1995).

67. See Dennis P. Quinn & Thomas M. Jones, *An Agent Morality View of Business Policy*, 20 ACAD. MGMT. REV. 22, 25–30 (1995). This position is almost always articulated by corporate executives when they are asked to comment on ethical matters. See, e.g., Comments of Benjamin W. Heineman, Jr, Senior Vice-President for Law and Public Affairs, General Electric, in *Corporate Social Responsibility: Good Citizenship or Investor Rip-off?*, WALL ST. J., January 9, 2006, at R6–R7.

68. THOMAS DONALDSON, *THE ETHICS OF INTERNATIONAL BUSINESS* 45 (1989).

69. See *supra* note 6 and text accompanying.

70. See, e.g., Gary R. Weaver and Linda Klebe Treviño, *Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior*, 9 BUS. ETHICS Q. 315 (1999) (identifying legal compliance and ethics programs); Eugene Sz wajkowski, *Organizational Illegality: Theoretical Integration and Illustrative Application*, 10 ACAD. MGMT. REV. 558, 558–60 (1985); Anthony J. Daboub, et al., *Top Management Team Characteristics and Corporate Illegal Activity*, 20 ACAD. MGMT. REV. 138, 146–48 (1995); Donna M. Randall, *Commitment and the Organization: The Organization Man Revisited*, 12 ACAD. MGMT. REV. 460, 466 (1987).

71. See NORMAN BOWIE, *BUSINESS ETHICS* 140–43 (1982); Sissela Bok, *Whistleblowing and Professional Responsibilities*, 11 N.Y.U. EDUC. Q. 2, 3 (1980).

72. Fox's lack of knowledge that he was acting illegally does not relieve him of liability. With only a few exceptions, see *Cheek v. United States*, 498 U.S. 192 (1991), knowledge of the law is not a required element of a criminal offense.

73. U.S.S.G. § 8C2.5 cmt.12 (2005); *McNulty Memorandum supra* note 49 § VI(B).

74. How much more would this be the case if the employee had innocently or inadvertently committed a public welfare offense or was charged as a responsible corporate officer?

75. See Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings*, 70 BROOK. L. REV. 1287 (2005). See also Andrew A. King & Michael J. Lenox, *Industry Self-Regulation Without Sanctions: The Chemical Industry's Responsible Care Program*, 43 ACAD. MGMT. J. 698 (2000); Clifford Rechtschaffen, *Deterrence vs. Cooperation and the Evolving Theory of Environmental Enforcement*, 71 S. CAL. L. REV. 1181 (1998); Marius Aalders & Ton Wilthagen, *Moving Beyond Command and Control: Reflexivity in the Regulation of Occupational Safety and Health and the Environment*, 19 L. & POL'Y 415 (1997); Darren Sinclair, *Self-Regulation Versus Command and Control? Beyond False Dichotomies*, 19 L. & POL'Y 529 (1997); Mark Suchman, *Managing Legitimacy: Strategic and Institutional Approaches*, 20 ACAD. MGMT. REV. 571 (1995).

76. See Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings*, 70 BROOK. L. REV. 1287, 1290–93 (2005).

77. Tom R. Tyler & Stephen L. Blader, *Can Business Effectively Regulate Employee Conduct?: The Antecedents of Rule Following in Work Settings*, 48 ACAD. MGMT. J. 1143, 1154 (2005).

78. To be regarded as cooperating, a corporation must demonstrate “affirmative acceptance of responsibility for its criminal conduct,” U.S.S.G. § 8C2.5(g) (1) (2005). Because a corporation that “puts the government to its burden of proof at trial by denying the essential factual elements of its guilt” is regarded as not having accepted responsibility for its conduct, *id.* § 8C2.5 cmt. 13, cooperation requires a corporation to be willing to plead guilty. But a corporation is guilty of an offense only when its employees are. Therefore, cooperation requires a corporation to presume its employees are guilty. Hence, no corporation that accords its employees a presumption of innocence can satisfy the legal requirements for cooperation.

79. Laura B. Pincus & Clayton Trotter, *The Disparity between Public and Private Sector Employee Privacy Protections: A Call for Legitimate Privacy Rights for Private Sector Workers*, 33 AM. BUS. L.J. 51, 88 (2001).

80. See George Brenkert, *Privacy, Polygraphs, and Work*, in BUSINESS ETHICS: READINGS AND CASES IN CORPORATE MORALITY 294, 295 (W. Michael Hoffman & Jennifer Mills Moore eds., 2d ed. 1990); Joseph R. Des Jardins & Ronald Duska, *Drug Testing in Employment*, in BUSINESS ETHICS: READINGS AND CASES IN CORPORATE MORALITY 301, 302 (W. Michael Hoffman & Jennifer Mills Moore eds., 2d ed. 1990).

81. *Id.*

82. See *supra*, text accompanying notes 34–36.

83. U.S.S.G. § 8B2.1(b)(5)(A) (2005).

84. For example, Deloitte & Touche now offers to create psychological profiles of employees designed to help employers identify those likely to engage in illegal conduct as one of its services. See Karen Richardson, *Find the Bad Employee: A Tool Can Do It, Privacy Issues Aside*, WALL ST. J., Feb. 1, 2006, at C3.

85. See James A. Waters, *Catch 20.5: Corporate Morality as an Organizational Phenomenon*, in CONTEMPORARY MORAL CONTROVERSIES IN BUSINESS 160 (A. Pablo Iannone ed., 1989); Robert Jackall, *Moral Mazes: Bureaucracy and Managerial Work*, HARV. BUS. REV. Sept.–Oct. 1983, at 118–30.

86. Courts do not recognize the doctrine of selective waiver. Waiving the privilege for one purpose, *e.g.*, cooperation with a criminal investigation, waives it for all purposes. See *United States v. Massachusetts Institute of Technology*, 129 F.3d 681, 685 (1st Cir. 1997).

87. David A. Nadler, *Don’t Ask, Don’t Tell*, WALL ST. J., Nov. 25, 2003, at B2.

88. This was in conformity with the provision in Thompson Memorandum (the McNulty Memorandum’s predecessor) that permitted prosecutors to consider the payment of such fees as a lack of cooperation. As noted above, this provision was removed from the McNulty Memorandum. See *supra*, note 50.

89. In conformity with this agreement, KPMG has agreed to settle a class action lawsuit brought by purchasers of its tax shelters for \$225 million and is in the process of settling other outstanding suits. Nathan Koppel, *Law Firm Offers an Unusual Fee in KPMG case*, WALL ST. J., Jan. 27, 2006, at C1.

90. The facts of this account of the KPMG case are taken from Laurie P. Cohen, *Prosecutor’s Tough New Tactics Turn Firms Against Employees*, WALL ST. J., June 4, 2004; Leonard Post, *Deferred Prosecution Deal Raises Objections*, Nat’l. L. J. Jan. 30, 2006, at 4; *KPMG in Wonderland*, WALL ST. J., Oct. 6, 2005, at A14; Deferred Prosecution Agreement (Re: KPMG) from

David N. Kelley, US Attorney for the Southern District of New York (Aug. 26, 2005), *available at* <http://www.usdoj.gov/usao/nys/Press%20Releases/August%2005/KPMG%20dp%20AGMT.pdf>; Press Release, Internal Revenue Service, KPMG to Pay \$456 Million for Criminal Violations (Aug. 29, 2005), *available at* <http://www.irs.gov/newsroom/article/0,,id=146999,00.html>.

91. As previously noted, this requires the corporation to be willing to plead guilty, which in turn requires it to regard its employees as guilty. See *supra* note 78. Hence, the corporation must make no public statements inconsistent with this assumption.