

# Managing the Risks of Legal Compliance: Conflicting Demands of Law and Ethics

by John Hasnas\*

## I. Introduction

Commentators and academics concerned with white collar crime frequently refer to the present as the post-Enron era, thereby raising the image of a major corporation brought low by the fraudulent practices of its executives to emblematic status. I regard this as unfortunate because it suggests that American business is beset by a higher than usual level of corruption—something I believe to be untrue. American business is no more and probably no less corrupt now than it has been at any time in the past. What is distinct about the present business environment is not the level of corrupt practices, but the federal government’s reaction to it. The Department of Justice (DOJ) is currently engaged in a vigorous law enforcement campaign against white collar crime. This suggests that the present period may be more aptly described as the post-Arthur Andersen era—a designation whose emblematic image is a major business organization destroyed by a federal indictment.

Recognition of the stepped up level of federal law enforcement activity explains why it makes sense for an academic such as myself, who specializes in white collar crime and business ethics, to be giving a keynote address at a conference on Integrated Risk Management and

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Corporate Governance. In the post-Arthur Andersen era, the risk posed by federal criminal investigation and indictment is one no major business organization can afford to ignore. In fact, I would argue that, in the present political environment, devising a business strategy without explicitly taking this risk into account constitutes managerial malpractice.

I have spent most of my career as a professor, ensconced in the ivory tower. However, I did spend two years in the legal department of Koch Industries, Inc., which is now the largest private corporation in the world. While I was there, KII was in the process of instituting what I regard as a very wise policy. Most companies create business strategies, and then run them by the legal department or outside counsel to ensure compliance with all legal requirements. This, by the way, is why business people hate corporate counsel. We are always vetoing their brilliant business plans. KII decided it wanted the legal department's input to be an integral part of the creation of its strategies. In this way, KII hoped to create business strategies that incorporated "legal risk assessment." This is a very good idea. Businesses can avoid costly mistakes and the need for expensive *post hoc* revisions by considering potential civil liability, regulatory impediments, and the risk of criminal indictment in the formation of their business plans.

The problem is that although the latter sounds easy, it is not. Most business people are exceedingly naive about the nature of federal criminal law. Their view, which was probably reinforced by the ethics course they were required to take in business school, may be summed up as: "What could be easier than avoiding criminal indictment? Just don't do anything wrong." This is a very dangerous attitude—one that can produce serious negative consequences both for one's firm and for oneself. To understand why, let us examine some of the basic features of federal criminal law and enforcement policy.

## II. Corporate Criminal Liability

Business ethicists frequently debate whether it makes sense to ascribe moral responsibility to a business as a corporate entity. Some say it doesn't, arguing that only individuals can bear moral responsibility. Some say it does, claiming that corporations are morally responsible for the corporate policies that result from their internal decision procedures<sup>1</sup> or that corporations are morally responsible for the actions of their employees when they maintain a corporate culture that encourages wrongdoing.<sup>2</sup>

It is essential to understand that all such considerations are irrelevant to the question of a corporation's *criminal* liability. Business organizations are criminally liable for the actions of their employees taken within the scope of their employment with the intent to benefit the organization *no matter what*.<sup>3</sup> This is the case even if the employee's actions are directly contrary to corporate policy; even if they contravene explicit instructions to the contrary; and even if the organization maintains the most pristine corporate culture and undertakes the most vigorous efforts to prevent employee wrongdoing.<sup>4</sup> Under federal criminal law, business organizations are strictly liable for

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<sup>1</sup>See, e.g., Peter French, *The Corporation as a Moral Person*, 16 AM. PHIL. Q. 207 (1979).

<sup>2</sup>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, 767-773 (1992); Ann Foerschler, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287 (1990).

<sup>3</sup>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 (5<sup>th</sup> Cir. 1962); Steere Tank Lines, Inc. v. United States, 330 F.2d 719 (5<sup>th</sup> Cir. 1964).

<sup>4</sup>United States v. Hilton Hotels Corp., 467 F.2d 1000, 1007 (9<sup>th</sup> Cir. 1972).

the crimes of their employees. The legal term for this form of vicarious culpability is *respondeat superior* liability.

Why is this the standard by which we impose criminal punishment on business organizations? There is a justification for employing the doctrine of *respondeat superior* in assigning *tort* liability to businesses. Employees are anything but deep pockets. They are often judgment-proof, and hence, cannot be deterred from engaging in risky activities that they believe will earn them rewards from their employer by the threat of personal civil liability. *Respondeat superior* tort liability creates an incentive for employers to deter such risky conduct by their employees. But no employee is criminally “judgment-proof.” All are subject to the threat of criminal punishment for criminal activity. So why do we criminally punish a business organization for the actions of its employees?

A facile response sometimes given to this question is that corporations are legal persons. It is often claimed that because corporations are invested with the right to utilize the legal system as a unitary entity, they should be treated the same as all other legal persons, which means being subject to criminal punishment. But this response is a *non sequitur*. Legal personhood does not entail criminal responsibility. Infants and the incompetent or the insane are legal persons, but are not criminally responsible for their actions. Criminal law is that portion of our law that *punishes* those who engage in wrongdoing. Hence, the criminal sanction applies not to all legal persons, but only to those who can be deserving of punishment. Whether corporations have this characteristic is precisely the question we are asking.

Does subjecting corporations to the criminal sanction advance any legitimate purpose of punishment? Can it be justified on either retributivist, deterrent, or rehabilitative grounds?

Retribution can justify punishment only for those who have acted in a blameworthy way. Retribution clearly justifies punishing those who personally commit an offense. But how can it justify punishing a corporation? Corporations, as collective entities, cannot be imprisoned; they can only be fined. When a corporation is fined, it is the owners, i.e., the shareholders, who pay the fine. But the defining characteristic of modern corporation is the separation of ownership and control. The shareholders, who own the corporation, have no control over the actions of the employees who commit the offense. Hence, inflicting punishment on a corporation's shareholders (and its other employees who had no hand in the wrongdoing but may nevertheless lose their jobs) is punishing the innocent. Punishing those who are innocent of wrongdoing cannot be justified on retributivist grounds.

What about deterrence? A major purpose of criminal punishment is to deter wrongdoing. But not by *any* means; not by punishing the innocent. Much of the crime attributable to teenagers could undoubtedly be deterred by punishing parents for their children's offenses. The Nazis sought to deter acts of resistance by punishing innocent members of the communities in which such acts occurred. Although such measures may be effective, they are not permitted under our system of law. Deterrence as a justification for criminal punishment refers to punishing those who engage in wrongdoing to deter others from similar activities. It does not refer to punishing the innocent to pressure them into suppressing the criminal activity of their fellow citizens. Threatening innocent shareholders (and employees) with punishment for the offenses of culpable corporate employees may be an effective means of reducing criminal activity within business organizations, but it does not constitute the type of deterrence that can justify criminal punishment in a liberal legal system.

Punishment can also be justified for purposes of rehabilitation. I have personally appeared on several panels with current or former prosecutors who argued that *respondeat superior* criminal liability can be justified on rehabilitative grounds because fear of corporate prosecution can make business people behave better. Please consider the nature of this argument. For punishment to be justified on rehabilitative grounds, it must be designed to reform the character of the wrongdoer, or at least, reduce the tendency of the wrongdoer to engage in future wrongful acts. One can rehabilitate only wrongdoers. Threatening those who have not engaged in wrongful conduct with punishment in order to make them “behave better” is not rehabilitation. It is coercing them to act in the way the coercive agent believes they should. “Rehabilitating” the innocent is simply depriving them of their liberty. This form of rehabilitation was familiar in the Soviet Union and Mao’s China in which those whose conduct was unacceptable to the government were sent to psychiatric hospitals and “re-education” camps. Threatening to punish shareholders (and innocent employees) in order to make corporate executives behave in ways that prosecutors believe that they should is not a form of rehabilitation that can be countenanced in a liberal system of justice.

It has been argued that punishing corporations for the actions of their employees is not distinct from any other form of criminal liability. After all, criminal punishment always wreaks harm on the innocent. The families and dependents of convicted criminals are inevitably adversely affected by the incarceration or impoverishment of the offender, both materially and emotionally. Hence, criminal liability always punishes the innocent, and corporate criminal liability is no

different.<sup>5</sup>

This line of reasoning elides a crucial distinction, however. In the case of traditional criminal liability, punishment is directed solely toward the wrongdoer. The harm that results to innocent third parties is not the intended object of the punishment regime. Such harm is always viewed with regret as an unfortunate collateral effect of visiting punishment on the blameworthy that should be minimized as much as possible. In the case of corporate criminal liability, however, punishment is intentionally directed toward those who have not committed an offense. Punishing the innocent is not a regrettable side effect and is certainly not to be minimized, but is the very object of the punishment regime. It may be true that all criminal punishment wreaks incidental harm on innocent parties, but this fact cannot justify a form of vicarious criminal liability that is *intended* to punish those who have not themselves broken the law.

But if *respondeat superior* corporate criminal liability does not serve any of the purposes of punishment, why does the government punish businesses for the offenses of their employees? I have found that an honest and forthright answer to this question is usually provided by federal prosecutors and representatives of DOJ. They are typically quite emphatic in asserting that they have no interest in prosecuting the innocent. They simply want businesses to cooperate with them and aid them in their efforts to prosecute corporate employees who violate federal law.

Prosecutors themselves will frankly admit that the purpose of corporate criminal liability is *not* to punish corporations, but to force them to help in the prosecution of their employees. As evidence, they will offer the fact that indictments are rarely issued against business organizations and then

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<sup>5</sup>I am grateful to Professor David Luban of the Georgetown Law Center for pointing this line of argument out to me.

only when the organization has not been sufficiently “cooperative.”

This represents a fairly explicit statement that the purpose of corporate criminal liability is to pressure those who are innocent of violating the law into acting as deputy law enforcement agents. Call me civil libertarian, but this appears to be an entirely illegitimate use of state power. As a matter of principle, I am unable to differentiate this from the collective punishment employed by the Nazis described above. The only distinction I can perceive is the claim that corporate criminal liability is directed toward a more laudable end.

The present address, however, is not the proper place to pursue the ethical justification (or lack thereof) for corporate criminal liability. It is, rather, to note that, contrary to the conventional naive assumption, the currently operative standard of corporate criminal liability requires business people do more than merely refrain from wrongdoing to avoid corporate indictment. To prevent their firm from becoming the next Arthur Andersen, corporate managers must take affirmative steps to ensure that it conforms to the federal government’s definition of a cooperative organization.

What does this require?

### III. The Organizational Sentencing Guidelines and McNulty Memorandum

Under a *respondeat superior* standard of corporate criminal liability, no business organization can ensure that it will not be guilty of a criminal offense. No matter how good an organization’s internal controls may be, they cannot ensure that there will be no intentional violations of law by rogue employees, or, in today’s highly regulated business environment where many offenses do not require intentional conduct, that no employees will inadvertently commit a criminal offense. Since under the *respondeat superior* standard, the organization’s good behavior

is no defense, the firm can be convicted whenever such violations occur. Under these circumstances, rational corporate managers who are aware that they cannot guarantee that their firm will not incur criminal liability will wish to institute measures designed to reduce the punishment the firm will receive if such violations occur. Such measures must be sought in the Organizational Sentencing Guidelines<sup>6</sup> that contain the federal law governing the punishment of corporations.

Further, as the *Arthur Andersen* case demonstrated, federal indictment alone can be a corporate death sentence. Because companies may be suspended from government contracting upon indictment,<sup>7</sup> any firm dependant on such contracts is unlikely to survive long enough to have its day in court. And for professional service firms or other organizations that undertake fiduciary obligations, and hence, are highly dependant upon their reputation for honest dealing, the stigma of a federal indictment is frequently sufficient to drive away a fatal proportion of their client base.<sup>8</sup> Because the financial health and frequently the continued existence of a corporation may thus rest entirely on whether the corporation is indicted, rational corporate managers will wish to institute

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<sup>6</sup>UNITED STATES SENTENCING COMMISSION, GUIDELINES MANUAL, ch. 8 (1992) (Sentencing of Organizations) [hereinafter U.S.S.G.].

<sup>7</sup>See 48 C.F.R. § 9.407-2 (2006). Examples of laws governing regulated industries that disqualify indicted firms include the following: Securities Act of 1933, 15 U.S.C. §77t(b) (2000); Securities Exchange Act of 1934, 15 U.S.C. §§78o(b)(4)-(6), 78u(d)-(e) (2000); Investment Advisers Act of 1940, 15 U.S.C. §80b-3(e) (2000); Commodity Exchange Act, 7 U.S.C. §12a (2000); Federal Deposit Insurance Act, 12 U.S.C. §1818(a)(2) (2000); Medicare and Medicaid Patients and Program Protection Act, 42 U.S.C. §1320a-7 (2000).

<sup>8</sup>See Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 526 (2006); Pamela H. Bucy, *Organizational Sentencing Guidelines: The Cart Before the Horse*, 71 WASH. U. L.Q. 329, 352 (1993) (“In some instances adverse publicity alone can cause corporate devastation.”).

measures designed to reduce the likelihood of indictment as much as possible. Such measures must be sought in the McNulty Memorandum<sup>9</sup> that contains DOJ policy on the prosecution of business organizations.

Upon consulting these sources, our rational managers will find that they are under virtually irresistible pressure to do two things: adopt an effective compliance program and cooperate with federal criminal investigations. They will also find instructions as to what constitutes an effective compliance program and cooperation.

To have an effective compliance program, an organization must “exercise due diligence to prevent and detect criminal conduct.”<sup>10</sup> Such due diligence requires that the organization engage in adequate “monitoring and auditing [of the behavior of its employees] to detect criminal conduct.”<sup>11</sup> What constitutes adequate monitoring and auditing? I don’t know, but because white collar crimes are usually crimes of deception in which the criminal activity is disguised to look like legal business practices, it must involve more than the ordinary level of surveillance that companies engage in to ensure adequate employee performance. Perhaps some insight can be gained from the fact that one of the services Deloitte & Touche currently offers its corporate clients is the creation of psychological profiles of employees to help identify those likely to engage

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<sup>9</sup>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).

<sup>10</sup>U.S.S.G. § 8B2.1(a)(1).

<sup>11</sup>*Id.* §8B2.1(b)(5)(A).

in illegal conduct.<sup>12</sup> It may not be a coincidence that Wal-Mart has assembled an internal investigative unit comprised of former C.I.A., F.B.I., and Justice Department officials.<sup>13</sup>

The government's definition of cooperation is quite an interesting one in that it requires at the outset that the corporation accept responsibility for criminal conduct.<sup>14</sup> That is, unless a business organization is willing to declare itself guilty of the offense for which it is being investigated, it is not cooperating.<sup>15</sup> Please consider what this means. Corporations can act only through their employees. For a corporation to accept responsibility for criminal conduct, it must accuse its employees of criminal activity. This may not be problematic if the employees are guilty and the corporation knows this, but the point of a criminal *investigation* usually is to determine whether this is the case. When there is any uncertainty about an employee's guilt, cooperation with the government requires the corporation to adopt a presumption of guilt, not innocence.

Cooperation also requires corporations to refrain from "shielding culpable employees."<sup>16</sup> Since to cooperate, a corporation must begin by presuming all employees under investigation to be culpable, this requires corporations to refrain from helping any employee mount a defense. Thus, "cooperative" corporations will refuse to enter into joint defense agreements with their

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<sup>12</sup>See Karen Richardson, *Find the Bad Employee: A Tool Can Do It, Privacy Issues Aside*, WALL ST. J., Feb. 1, 2006 at C3.

<sup>13</sup>See Michael Barbaro, *Bare-Knuckle Enforcement for Wal-Mart's Rules*, N.Y. Times, March 29, 2007 at A1.

<sup>14</sup>U.S.S.G. §8C2.5(g)(1). The McNulty Memorandum adopts the Guidelines definition of cooperation in all respects relevant to the present discussion.

<sup>15</sup>U.S.S.G. §8C2.5 cmt. 13.

<sup>16</sup>McNulty Memorandum at §VII(B)(3).

employees, refuse to inform them what documents and information it is supplying to the government, and fire employees who choose to put on a defense or decline to cooperate with prosecutors by, for example, asserting their Fifth Amendment rights.<sup>17</sup>

In addition, cooperation requires corporations to disclose “all pertinent information known by the organization,”<sup>18</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>19</sup> This typically requires providing the government with the results of the organization’s internal investigation, including any information that was obtained under a pledge of confidentiality, and may also require that the corporation waive its attorney-client and work product privileges.<sup>20</sup>

### III. The Challenges of Legal Risk Management

Legal risk management apparently requires businesses to adopt compliance programs that conform to the requirements of the Organizational Sentencing Guidelines and to meet the Justice Department’s definition of cooperation. Why should this be a problem? After all, businesses already have strong incentives to have effective compliance programs and cooperate with law enforcement. The vast majority of crimes committed by employees are directed against the companies for which they work. Businesses should want to have compliance programs and

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<sup>17</sup>See McNulty Memorandum at §VII(B)(3); Laurie P. Cohen, *Prosecutor’s Tough New Tactics Turn Firms Against Employees*, WALL ST. J., June 4, 2004 at A1.

<sup>18</sup>U.S.S.G. §8C2.5 cmt. 12.

<sup>19</sup>*Id.*

<sup>20</sup>See McNulty Memorandum at §VII(B)(2).

cooperate as a matter of self-interest.

The problem is that adopting compliance programs and cooperation policies that meet the government's criteria may be neither the most effective way to reduce employee criminality nor consistent with a business's ethical obligations to its employees.

A great deal of empirical research has been done on how to reduce illegal and unethical conduct in the corporate environment. This research demonstrates that there are two distinct approaches to reducing the level of criminal activity among a firm's employees—the “command-and-control” approach and the “self-regulatory” approach.<sup>21</sup> The former consists of attempting to control employee behavior through intense monitoring and the threat of punishment for misbehavior. The latter consists of attempting to align employees' personal values with adherence to corporate rules and policies by instituting and adhering to programs of procedural justice. Such programs typically require business organizations to 1) treat their employees with respect—i.e., to refrain from constantly monitoring their activities and making them feel spied upon, to reward trustworthy behavior with trust, and to scrupulously honor all promises made to employees; 2) undertake serious and ongoing self-assessment to discover potential wrongdoing; and 3) take swift action against those whose wrongdoing has been established *by fair procedures* and reward

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<sup>21</sup>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).

those who behave ethically and abide by the organization's rules.

The intrusive monitoring and punitive measures associated with the command and control approach can reduce law breaking by employees—but not very much. The empirical research demonstrates that the self-regulatory, procedural justice approach is significantly more effective at reducing the level of illegal and unethical behavior among an organization's employees than the command-and-control approach.<sup>22</sup> Apparently, treating employees fairly causes them to identify their interests with those of the organization, thereby increasing their personal commitment to follow the organization's rules. More significantly, when employees feel that they are being treated fairly by the organization, they are more willing to come forward and inform management about those within the organization who are breaking the rules. When employees' values are aligned with those of the organization for which they work, employees tend to regard the rule breaking of others as an offense against themselves rather than as someone else's problem. Although it may seem counterintuitive, treating employees fairly is, in fact, a better way of generating legal compliance than threatening to punish them for noncompliance.

Interestingly, the two approaches to compliance cannot be combined 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>23</sup> Consequently, business ethicists frequently exhort corporations to adopt programs of procedural justice in preference to a regime of sanctions. But for a company concerned with legal risk management, this is not necessarily good

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<sup>22</sup>See sources cited in note 21.

<sup>23</sup>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).

advice.

To develop the level of trust required to make programs of procedural justice work, corporations must refrain from intrusive monitoring of employee behavior. Continually spying on one's employees is a clear manifestation of a lack of trust and will be taken as such by the employees. But under the Organizational Sentencing Guidelines and the McNulty Memorandum, a corporation that does not monitor its employees activities sufficiently to detect and prevent criminal conduct does not have an effective compliance program.

To encourage employees to come forward with information about potential wrongdoing by their co-workers, companies often promise to keep such reports strictly confidential. But a corporation that honors such promises by refusing to share confidential reports with federal prosecutors is failing to disclose all pertinent information, and hence, is not cooperating with a federal criminal investigation.

To adhere to programs of procedural justice, corporations must sanction their employees only after their wrongdoing has been established by fair procedures and on the basis of objective evidence. But under the McNulty Memorandum, cooperation requires the corporation to immediately accept responsibility for its criminal activity and refuse to shelter its "culpable" employees. Hence, a corporation that refuses to presume its employees to be guilty and refrains from sanctioning those who wish to assert their Constitutional rights or otherwise elect not to talk to prosecutors cannot meet the government's definition of cooperation.

As counterintuitive as it sounds, a business can actually increase its risk of federal indictment by adopting the most effective methods of reducing employee criminal activity.

Clearly, legal risk management is no simple matter. And its complexity is only magnified

when one considers a business's ethical obligations to its employees. This is because it is unclear how a business can conform to the government's requirements without violating several of these obligations.

Consider a business organization's duty to respect the privacy of its employees. Do employees have any right to privacy in the workplace? Certainly not to the extent they do in their homes. Employers are clearly entitled to monitor employees to the extent necessary to ensure that they are capable of doing their jobs and are, in fact, doing them. Yet this does not imply that employers have carte blanche to investigate any aspect of their employees' lives.

All human beings possess a fundamental right to privacy. Accepting employment constitutes a voluntary waiver of some of the protections afforded by that right. Employees implicitly grant their employers permission to monitor their job performance. In the absence of an explicit contractual provision to the contrary, however, merely accepting employment does not waive one's right to privacy in the personal, non-job-related aspects of one's life. There is a fairly convincing ethical argument that businesses have an obligation to respect their employees' residual right to privacy.

Yet how can a responsible business meet this obligation and still have an effective compliance program? An effective program must involve a level of monitoring and auditing sufficient to detect and prevent criminal activity. But, as noted above, this level of monitoring is necessarily greater than that required merely to monitor job performance. Buying Deloitte & Touche's service may be a good means of managing an organization's legal risk, but it is difficult to see how the organization can ethically make the purchase without obtaining the explicit consent of all of its employees.

Consider next a business's duty to maintain promised confidentiality. To obtain information about potentially unethical or illegal practices within the organization, a corporation must supply employees with confidential avenues 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. Only by promising confidentiality can a business guarantee that it will receive the information necessary for it to run not only efficiently, but ethically and legally as well.

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.

Yet how can a responsible business meet its obligation to maintain promised confidentiality and still conform to the government's definition of cooperation? Cooperation requires the business to disclose all pertinent information to the government. Whenever information obtained through a promise of confidentiality suggests possible criminal activity within the firm, the company must disclose it to the government or risk indictment and increased

finer. Hence, decreasing its legal exposure can require a firm to reduce its promise of confidentiality to a fraud.

Further, a corporation cannot avoid this dilemma by refusing to make promises of confidentiality that it knows it will have to breach in order to cooperate with the government. For in doing so, the corporation 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, mean that it does not have an effective compliance program.<sup>24</sup> Indeed, in some circumstances, the Sarbanes-Oxley Act of 2002, requires publicly traded companies to establish procedures for “the confidential, anonymous submission by employees of issues or concerns regarding questionable accounting or auditing practices.”<sup>25</sup>

Businesses could, of course, honestly inform employees that any putatively confidential information they supply to the company will be shared with federal prosecutors whenever it is in the company’s interest to do so, but then how many employees would be willing to come forward? Managing legal risk without violating one’s ethical obligations can be quite difficult when there exist legal incentives to both make and breach promises of confidentiality.

Another difficulty concerns a corporation’s duty to undertake ethical and legal self-assessments. All businesses have an obligation to make good faith efforts to maintain an ethical

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<sup>24</sup>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.” U.S.S.G. § 8B2.1(b)(5)(C) (2005). 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>25</sup>Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 776.

working environment. But to do so, executives have to know what is going on within their organization. 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>26</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 and legal audits. Therefore, it can reasonably be argued that businesses have an ethical obligation to undertake such audits.

The problem is that under the Organizational Sentencing Guidelines and the McNulty Memorandum, undertaking such audits can be a dangerous proposition. This is because 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. This, in turn, may require the organization to waive its attorney-client and work product privileges. Because courts do not recognize the doctrine of selective waiver,<sup>27</sup> waiving the privileges for the purpose of cooperating with a criminal investigation waives it for all other purposes as well—something that practically invites plaintiff's lawyers to bring civil lawsuits against the company. 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-

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<sup>26</sup>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 118-130.

<sup>27</sup>See *United States v. Massachusetts Institute of Technology*, 129 F.3d 681, 685 (1<sup>st</sup> Cir. 1997).

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>28</sup> In these circumstances, the rational business executive may conclude that there are things that it would be better not to know.

Finally, consider the question of organizational justice. I argued above that the self-regulatory, procedural justice approach to compliance was a more effective means of reducing employee wrongdoing than the command and control approach mandated by government policy. But independent of any considerations of efficacy, don’t businesses have an ethical obligation to treat their employees fairly? Don’t loyal employees who come under suspicion have some claim to organizational due process? Aren’t they entitled to a minimal presumption of innocence in the sense that no adverse action be taken against them in the absence of adequate evidence of wrongdoing? Yet, to meet the government’s definition of cooperation, businesses must begin by accepting responsibility for the criminal offense—that is, by declaring their employees guilty. They must then follow this declaration by refusing to support their “culpable” employees. How can corporations afford their employees even a modicum of due process while firing them if they choose to mount a defense, assert their Constitutional rights, or otherwise refuse to cooperate with prosecutors? How can corporations treat their employees fairly while enlisting as deputies in their prosecution?

Of course, not everyone sees current federal law enforcement policy as imposing ethical dilemmas on corporate actors. For example, former Deputy Attorney General Larry D. Thompson

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<sup>28</sup>David A. Nadler, *Don’t Ask, Don’t Tell*, WALL ST. J., Nov. 25, 2003 at B2.

is now the general counsel for PepsiCo. In recent remarks, he stated that to fulfill his duty to zealously represent his corporate client when it becomes the subject of a federal criminal investigation, his job would be to get the government off his company's back as quickly and efficiently as possible—which means cooperating fully with prosecutors as a means to terminating the investigation.<sup>29</sup> This is fully consistent with his authorship of the Thompson Memorandum, the predecessor of the current McNulty Memorandum. However, not all corporate counsel are as sanguine about the duty to protect their corporate clients by sacrificing their employees. Many report the anguish they feel when giving the *Upjohn* warning—the statement indicating that although communications to counsel are protected by the attorney-client privilege, the client is the corporation—with the awareness that most employees do not understand that this means any incriminating statement they make will be disclosed to federal prosecutors as part of the corporation's cooperation.

The ethical challenges of legal risk management may be neatly illustrated by recent federal investigation of the accounting firm, KPMG. Between 1996 and 2003, 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 officially 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

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<sup>29</sup>Remarks made at a round table discussion at The Heritage Foundation following his address on *The Future of the Attorney-Client Relationship in White-Collar Prosecutions* on November 30, 2006.

Congress, sending one of its partners to testify as to their legality. Subsequently, the Department of Justice opened a criminal investigation into KPMG's marketing of the shelters.

In response to the DOJ investigation, 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>30</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. 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 or to retain any employee who makes such a statement. And it agreed to pay a \$456 million fine.<sup>31</sup>

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<sup>30</sup>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. The currently operative McNulty memorandum does not contain such a provision.

<sup>31</sup>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;

KPMG took these measures to avoid the type of federal indictment that destroyed Arthur Andersen. In doing so, KPMG was clearly practicing good legal risk management. But it is not as clear that KPMG was doing the right thing. Given that the illegality of the questionable shelters has never been officially established and that prior to the criminal investigation, KPMG publicly argued that the shelters were legal, it is not unreasonable to believe that some of KPMG's partners or employees may have taken the company at its word and acted with the belief that the shelters were legal. Such employees would not be guilty of any offense. Yet, by dismissing and failing to advance the attorney's fees of any 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 everything in its power to have them convicted of a criminal offense. Unless KPMG actually knew that its shelters were fraudulent and that every one of its suspected employees possessed this knowledge as well, its efforts at legal risk management constitute grossly unethical treatment of the firm's potentially innocent employees.

#### IV. Conclusion

In the ideal world, managing the risk of criminal indictment and conviction would be an easy task—simply refrain from wrongdoing and adopt the most effective policies to discourage employees from violating the law. Unfortunately, we do not live in the ideal world. In our world,

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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>.

managing the risk of criminal indictment and conviction is a complex undertaking fraught with serious ethical dilemmas. The purpose of my talk today has been to suggest to you that managing this form of legal risk is a subject that deserves much more attention than it currently receives from either business strategists or business ethicists. In the post-Arthur Andersen era, even the most ethical corporation ignores the risk of criminal prosecution at its peril.