The Law of Unintended Consequences: A Critique of the Dilutive Effects and Efficiency Costs of Multilayer Regulation.

Article Submission

April 30, 2009

By Ilya Podolyako

This Article examines the role obstruction charges play in the regulatory framework covering modern public corporations and their members. It finds that prosecutors' reliance on obstruction charges undermines the legitimacy of substantive rules for enterprise behavior. This pattern not only causes significant inefficiency on its own, but indicates a broader problem with multilayer regulation. That is, in a previously regulated arena, the pre-existing legal environment may warp a new set of rules in undesirable ways. The Article concludes by proposing a means to address this problem generally and remove unnecessary costs associated with the compliance regime specifically.

Multilayer Regulation and Efficiency Costs

Table of Contents

Introduction

The current financial crisis has led to a widespread public outcry for government action. Lay citizens and professional commentators are demanding that their elected leaders do "something" to stymie runaway fraud and greed on Wall Street. The collapse of several investment banks and extreme volatility in the markets have galvanized into a demand for more, or possibly better, regulation. Most specific proposals focus on a narrow subset of economic activities, which is unsurprising, given the enormous complexity of developed markets.[1] Yet many calls for a move towards centralized regulatory control[2] share a key deficiency of their narrow counterparts. Both types of approaches pitch their prescriptions largely in isolation. Once inserted into the living organism of existing law, however, these implants often function in unexpected, detrimental ways. This Article will expound on this simple observation in some detail by focusing on the compliance framework for corporate activity, an area where multiple layers of regulation promulgated at different points in time interact in an unpredictable, costly fashion. After doing so, it will propose an ex ante method for identifying and reducing conflict that arises from modernizing updates to existing prescriptions.

In absolute terms, public companies doing business in the United States are already subject to plenty of regulation. The federal government began asserting authority over the behavior of corporations decades ago.[3] The Enron scandal and the accompanying bankruptcies of the late

---

[1] *See, e.g.*, John Coates & David Scharfstein, *Lowering the Cost of Bank Recapitalization*, 26 YALE J. ON REG. (forthcoming 2009); Christopher Mayer, Edward Morrison, and Tomasz Piskorski, *A New Proposal for Loan Modifications*, 26 YALE J. ON REG. (forthcoming 2009); Alan S. Blinder, *Nationalize? Hey, Not So Fast*, N.Y. TIMES, March 7, 2009, at BU5; Peter Boone & Simon Johnson, *To Save the Banks We Must Stand Up to the Bankers*, FIN. TIMES (London), Jan. 26, 2009, at 13; John C. Coates & David S. Scharfstein, *The Bailout is Robbing Banks*, N.Y. TIMES, Feb. 17, 2009, at A27; Martin Feldstein, *How to Stop the Mortgage Crisis*, WALL ST. J., March 7, 2008, at A15; Kevin Hassett, *New $3 Trillion Bailout Is Coming to the Masses*, BLOOMBERG.COM, Dec. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601039&sid=a.YJmSfnHD9o&refer=columnist_hassett; R. Glenn Hubbard & Chris Mayer, *First, Let's Stabilize Home Prices*, WALL ST. J., Oct. 2., 2008, at A19.

[2] *See, e.g.*, Ron Scherer, Bernanke's Plan to Tame Wall Street, CHRISTIAN SCI. MONITOR, March 11, 2009, at 25.

[3] *See, e.g.*, Sherman Act, 15 U.S.C. §§ 1-7 (2006); Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. §§ 15c-15h (2006); National Labor Relations Act, 29 U.S.C. §§ 151-188 (2006); Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (2006) (establishing a national minimum wage, mandating overtime pay, and banning child labor); Civil Rights Act of 1964, Title VII, 42 U.S.C. § 2000e to 2000e-17 (2006) (prohibiting discrimination on "the basis of race, color, religion, sex, or national origin"); Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C. sections 9607-9675 (2006)); Railway Labor Act, 45 U.S.C. §§ 151-188 (2006); Banking Act of 1933 (Glass-Steagall Act), 48 Stat. 162 (codified as amended at scattered sections of 12 U.S.C. (2006)), *partially repealed by* Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C. (2006)). *See generally* Michael S. Raab, *The Transparency Theory: An Alternative Approach to Glass-Steagall Issues*, 97 YALE L.J. 603, 606-07 (1988) (arguing that the Glass-Steagall Act attempted to substantially modify incentives that shaped the behavior of commercial banks, as opposed to merely reducing the risk of comingled operations); Edward B. Rock, *Antitrust and the Market for Corporate Control*, 77 CALIF. L. REV. 1367 (1989) (arguing the federal antitrust law should play an important role in the scrutiny of corporate transactions); Mark J. Roe, *Delaware's* Competition, 117 HARV. L. REV. 588, 616 (2003) (detailing a history of extensive federal involvement in the behavior of enterprises); Patrick M. Madden, Note, *Federal Labor Law Preemption of State Anti-Takeover Law: A Case of First Impression* – Air Line Pilots Association, International v. UAL Corp., *874 F.2d 439 (7th Cir. 1989)*, 65 WASH. L. REV. 457 (1990) (describing the complex relationship between federal labor regulations and state corporate law); William C. Tyson, *The Proper Relationship Between Federal and State Law in the Regulation of Tender Offers*, 66 NOTRE DAME L. REV. (1990) (criticizing narrow interpretations of the Williams Act as the converse of its original intent to give substantive protections to shareholders subject to tender offers); Cynthia A.

1990's and early 2000's, however, spurred a wholehearted lunge towards greater regulatory control with the passage of the Sarbanes-Oxley Act.[4]

For the first time, positive law dictated how businesses should structure their boards and manage their internal decision-making.[5] In the wake of SOX, corporate executives bore criminal responsibility for misstatements or omissions in key disclosures; accounting practices had to follow not only the industry standards but also the rules set out by the Public Company Accounting Oversight Board (PCAOB), a quasi-public supervisory organ.[6]

Sarbanes-Oxley was only part of the regulatory framework, however. The Securities and Exchange Commission (hereinafter "SEC," "Commission") issued reams of rules and releases pursuant to its statutory authority to oversee public companies; the Federal Reserve and Comptroller of Currency continued to tightly control depository institutions; and state legislatures passed "stakeholder" laws protecting local interests.[7] Certainly, an insufficient number of rules alone cannot be blamed for the ongoing economic turmoil.

Much has been written about the flaws in the extant regulatory scheme. This Article will not attempt to replicate that work. Indeed, many critics have claimed that the misguided substance of the structure, not its size, was to blame for the various detrimental outcomes, including the financial collapse. These positions merit attention, but will not be the focus here. Rather, this Article will attempt to articulate an optimal regulatory posture for a government trying to minimize certain negative corporate behaviors with limited resources.

To this end, the present work will evaluate the theory of regulation and how well that theory agrees with the actual practice of the responsible agents. As such, the goal will be to analyze method, not substance. One observation will help bring the thesis of this Article into focus. Despite the rapid proliferation of substantive rules for corporate conduct over the past decade and a half, a large fraction of successful federal prosecutions for executives have not centered on their violations. While in the 1980's Rudy Giuliani made his name by aggressively going after individuals and companies deemed to have breached the prohibition of material omissions and misstatements in §10 of the Securities Exchange Act and SEC Rule 10b-5,[8] by 1998[9] the pattern

---

Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1206, 1237-38 (1999) (arguing that the SEC has broad statutory authority to protect shareholders and the public interest).

[4] Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of the U.S.C.).

[5] *See, e.g.*, Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353 (2004).

[6] *See* SOX § 101, 15 U.S.C. § 7211 (2006); Public Company Accounting Oversight Board, http://www.pcaobus.org/, last visited March 16, 2009); *see also* Free Enterprise Fund v. Pub. Co. Accounting Oversight Board, 537 F.3d 667 (D.C. Cir. 2008); David S. Hilzenrath, *Sarbanes-Oxley Upheld By Court as Constitutional*, WASH. POST, August 23, 2008, at D01 (describing the constitutional challenge to the PCAOB claiming that the entity violates the separation of powers principle).

[7] The precise form and goals of these statutes vary. The majority of states that have adopted such legislation permit directors to consider the interests of parties other than the shareholders when making decisions. Connecticut and Arizona, by contrast, have adopted a stronger version of the policy that requires directors to consider such outside interests. *See* A.R.S. § 10-1202 (2008); RISKMETRICS, 2008 U.S. PROXY VOTING MANUAL, at Ch. 6 (2008), *available at* http://www.issueatlas.com/content/free/content/menutop/content/subscription/usvmfiles/x6816.html. Connecticut mandates that directors consider "the interests of the corporation's employees, customers, creditors and suppliers[;] and . . . community and societal considerations including those of any community in which any office or other facility of the corporation is located" when discharging their duties. Conn. Gen. Stat. § 33-756 (2008).

[8] Though Giuliani charged defendants like Michael Milken with violations of § 10, most plead guilty to a 13(d) offense that did not give rise to private rights of action for material misstatements. *See generally* DANIEL FISCHEL, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION 98-102 (1996).

fell out of favor. Instead, in most high-profile cases, the prosecution reached favorable results when the defendants either plead guilty or were convicted of a crime did so for some variant of obstructing justice.[10]

This observation is rather puzzling. Rules become meaningless if nobody cares to enforce them or observe the violations. At best, they transform into heuristics, rough suggestions for what one may or may not do. So, if a prosecutor charges a defendant with obstruction every time the latter violates a provision of Sarbanes-Oxley, the obstruction category subsumes any substantive prescriptions of the statute. Simultaneously, concepts of justice and the rule of law demand that the acts that are punished carry some logical similarity that allows a citizen to identify prohibited behavior and the accompanying punishment ex ante. When certain business decisions count as a breach of positive requirements while others fall into a catchall category, executives are bound to get confused.

The lack of clarity here is not merely a concern for the well-being of the potential perpetrators. The regulations that currently cover public companies purport to be a guide to model behavior, not just an electric fence that will shock anyone who comes close with a forbidden boundary. Corporations are very diverse, both in business and in internal structure. No code could possibly describe the legality of all actions that take place within all companies. Instead, legislation and accompanying administrative pronouncements aim to articulate key principles for how corporation should behave. The drafters and jurists then hope that employees at all levels will internalize these axioms and use them to determine appropriate behavior in ordinary and novel situations alike.

The doctrine of disclosure is a good example of this approach. The Securities and Exchange Acts generally require companies to release all material information to the public at large. Judicial interpretation of this tenet has led to the development of the fraud on the markets theory,[11] an expansion of section 10(b) to cover insider trading,[12] and a restriction on aiding and abetting liability in securities cases, inter alia.[13] Judicial decisions and administrative pronouncements elaborating on these areas usually reference the concept of disclosure as a foundation of their conclusion.

At the same time, it is not the case that companies subject to the Exchange Act must report *all* information. The disclosure requirement is bounded by materiality provisions, causation constraints, and duty elements. Each of these considerations acts as a countervailing force that helps shape the actual doctrine of securities regulation and its rule-based implementation. A

---

[9] *See, e.g.*, WAYNE BARRETT, RUDY!: AN INVESTIGATIVE BIOGRAPHY OF RUDY GIULIANI 157-60 (2001); Steven K. Berenson, *Public Lawyers, Private Values: Can, Should, and Will Government Lawyers Serve the Public Interest?*, 41 B.C. L. REV. 789, 808 (2000); J. Kelly Strader, *White Collar Crime and Punishment: Reflections on Michael, Martha, and Milberg Weiss*, 15 GEO. MASON L. REV. 45 (2007).

[10] *See After 4 Years, Last Charges Dropped in Quattrone Case*, N.Y. TIMES, Aug. 30, 2007, http://www.nytimes.com/2007/08/30/business/30banker.html?_r=1&oref=slogin; *Quattrone is Indicted on Obstruction-of-Justice Charges*, THESTREET.COM, May 12, 2003, http://www.thestreet.com/markets/marketfeatures/10086664.html; "Short-Cuts" – Obstruction of Justice, White Collar Crime Prof Blog, http://www.typepad.com/t/trackback/89778/24959622 (last visited Dec. 8, 2008) ("Obstruction of justice, perjury, and false statements prove particularly easy charges for the government when the conduct would require extensive investigation prior to indictment. I often call them the government "short-cut" offenses. So it is no surprise to see the government using them extensively.").

[11] Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

[12] Chiarella v. United States, 445 U.S. 222 (1980); *see also* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646, 653-654, 657-59 (1983).

[13] Cent. Bank of Denver, N. A., v. First Interstate Bank of Denver, N.A, 511 U.S. 164 (1994).

manager at IBM does not have to check back to first principles of corporate governance to go through her daily agenda. She can rely on employee manuals, managerial training, and instructions from company executives and lawyers. Nonetheless, when the available authorities fail to provide a definitive answer, a decision deferring to first principles will likely be better than one ignorant of them. So, if said manager is contemplating whether or not to notify the Chief Operating Officer ("COO") that a manufacturing facility in Malaysia has found a defect in one of the three machines necessary for fabricating a microchip a week before the quarterly reporting deadline comes up, the tenet of disclosure would urge her to provide a detailed account of the issue to her superiors.

Suppose that the aforementioned COO discusses the manufacturing problem with the manager but decides to withhold it from the quarterly report until he has an opportunity to unload some of his stock in the company. A few months later, with the stock plunging, the SEC launches an investigation into suspicious sales and passes on data about the COO's behavior to the U.S. Attorney's office. If the latter decides to press charges for insider trading, he will reinforce the primacy of the disclosure principle as a conduct rule. The case will send a message: in situations like the one faced by the COO, the appropriate decision is to include information in the quarterly report.

By contrast, if the prosecutor chooses to pursue the defendant for an offense unrelated to business ethics, such as obstruction, rational observers will focus on the behavior following the actual transgression as a trigger for the punishment. They may not realize what corporate decision led to the criminal case. The demographic that should be paying closest attention to the proceedings will not be able to receive any clear signal on whether the lack of disclosure forms legitimate grounds for culpability. Moreover, in the absence of a trial, the prosecution's theory of the case will remain at least partially secret, making it difficult for managers to understand the application of the existing fact pattern and future situations.

It is important to note that this Article's concerns about the desirability of the aforementioned scenario do not center on the presence of prosecutorial discretion. This element of the American legal system has already received due coverage by other authors. [14] While it certainly plays a part in bringing about a scenario the remainder of this piece will argue to be undesirable, it is by no means the chief culprit. Indeed, the power of prosecutors to unilaterally threaten severe charges in high-profile cases could be the best way to police an enormous market apparatus with finite government resources. The resulting loss of shareholder value[15] and vague standards for corporate conduct would then be the fair price of orderly business.

This Article will argue, however, that a confluence of factors has increased these costs without providing a proportional benefit to society. It will attempt to articulate a method through which the United States can make any democratically determined set of guidelines for corporate behavior more robust, more transparent, and more efficient. This argument will proceed in four parts. Part I will briefly describe the substantive laws applicable to corporate behavior, lay out

---

[14] *See, e.g.*, McCleskey v. Kemp, 481 U.S. 279, 297 (1986) (demanding "exceptionally clear proof" in order to find that a prosecutor abused his discretion in a discriminatory fashion); Laurie L. Levenson, *Working Outside the Rules: The Undefined Responsibilities of Federal Prosecutors*, 26 FORDHAM URB. L.J. 553 (1999) (discussing the broad scope of discretionary powers allotted to prosecutors); James Vorenberg, *Decent Restraint of Prosecutorial Power*, 94 HARV. L. REV. 1521 (1981).

[15] *See* Edward B. Diskant, Note, *Comparative Corporate Criminal Liability: Exploring the Uniquely American Doctrine Through Comparative Criminal Procedure*, 118 YALE L.J. 126, 141 (2008); *see generally* Pamela H. Bucy, *Why Punish? Trends in Corporate Criminal Prosecutions*, 44 AM. CRIM. L. REV. 1287 (2007) (providing examples of the impact of corporate scandals on stock price).

compliance demands placed on businesses, and outline the statutes used for prosecuting obstruction. Part II will discuss several case studies highlighting the interaction between conduct rules, compliance requirements, obstruction, and other enforcement tactics. Part III will discuss the goals of corporate regulation broadly. It will then attempt to sketch out a test that would permit one to craft and detect both optimal and suboptimal enforcement postures. Part IV will apply this test to the current state of affairs and make recommendations on any necessary course corrections. The Article will conclude by integrating the solution to the problem of compliance costs with broader recommendations derived from the multilayer regulation paradigm.

Part I. Criminal and Civil Regulation of Public Companies

I.A. Delaware State Law

While this Article will deal primarily with federal regulation of publicly traded companies, traditionally, the majority of legal constraints on these entities' behavior came from their state of incorporation.[16] For a variety of reasons,[17] Delaware has long held the title of the most popular originating jurisdiction in the United States, hosting over 50% of companies listed on the New York Stock Exchange ("NYSE") or NASDAQ.[18] This Part will briefly review the key state-level doctrines to enable the reader to carry out a more detailed comparative analysis later on in the Article.

Delaware General Corporate Law sets out three primary responsibilities for corporate officers and directors. The duty of loyalty requires them to avoid situations that stand in the way of the shareholders' profit-making interest.[19] The duty of care requires that directors and officers act diligently and on an informed basis when they carry out their responsibilities to the company.[20] Finally, the duty of good faith resides in the continuum between the two and stipulates that persons cannot act loyally towards a company unless they "act[] in the good faith belief that her actions are in the corporation's best interest."[21]

Generally, as long as a board is informed of material facts that are reasonably available, it can claim the benefit of the "business judgment rule," which assumes the directors' decisions to

---

[16] Though some publicly traded partnerships exist (e.g., Real Estate Investment Trusts, the Blackstone Group, see Ryan J. Donmoyer, *Blackstone Says IPO Tax Stance May Prompt IRS Action*, BLOOMBERG.COM, March 29, 2007, http://www.bloomberg.com/apps/news?pid=20601103&sid=aaPFVuozAq8E), they are rare and come about primarily due to tax considerations for the main earning stream. This Article will focus on corporations exclusively.

[17] *See generally* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

[18] About Agency, Department of State: Division of Corporations, State of Delaware: The Official Website for the First State, http://www.corp.delaware.gov/aboutagency.shtml (last visited Dec. 8, 2008).

[19] *See* DEL. CODE ANN. tit. 8, §§ 141, 144 (2008); Broz v. Cellular Info. Sys., Inc., 673 A.2d 148 (Del. 1996); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

[20] *See* DEL. CODE ANN. tit. 8, § 251(b) (2008) ("a director has a duty "to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders."); *see, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[21] Guttman v. Jen-Hsun Huang, 832 A.2d 492, 506 (Del. Ch. 2003); *see also* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) ("[I[t follows that because a showing of bad faith conduct, in the sense described in Disney and Caremark, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty."). Whereas a violation of either the duties of care or loyalty necessarily lead to director liability in the absence of specific carve-outs in the corporate charter, a beach of the duty of good faith does not always do so. *See also In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003) (finding that corporate directors did not necessarily have the best interests of the company in mind when they approved the CEO's options package and disposition schedule).

be correct.[22] To succeed in court against the application of the business judgment rule, plaintiffs must prove irrationality or a breach of one of the aforementioned duties. If the business judgment rule does not apply, corporate actors may have to defend the "entire fairness" of a transaction.[23]

Delaware corporate law also vigorously protects the shareholder franchise.[24] Shareholders retain rights to access corporate records with proper purpose, as long as they do not unduly interfere with the company's business.[25] Finally, the combination of statutory duties and case law imposes specific restrictions on the behavior of directors and officers in the context of mergers, where they generally must take reasonable efforts to maximize value returned to the shareholders.[26]

I.B. The Sarbanes-Oxley Act of 2001

The passage of the Sarbanes-Oxley Act of 2001 ("SOX") in the wake of the Enron collapse significantly altered the playing field for corporate regulation. Previously, business matters were governed primarily by state law, as described above. The new statute massively expanded federal reach in this area. Passed by a 99-0 vote after a series of high-profile bankruptcies (Adelphia, WorldCom, Global Crossing, etc.), SOX included many of the popular proposals that had been floating around the public domain. [27]

Its main focus fell on regulating the auditing function. To this end, Section 102 of the Act required all accounting companies that represented public companies to register with a new body, the Public Company Accounting Oversight Board.[28] In an effort to minimize conflicts of interest and improve the precision with which financial statements reflected the state of the enterprise, said registered accounting firms were prohibited from providing consulting or book-keeping (they could still provide tax advice).[29] At least two partners had to sign off on any public company audit; the main audit partner had to be rotated every five years. PCAOB had the ability

---

[22] Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
[23] *See* Cede & Co. v. Technicolor, Inc., 684 A.2d 289 (Del. 1996); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).
[24] *See* Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replae incumbent board members."); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953-54 (Del. 1985) (quoting Cheff v. Mathes, 199 A.2d 548 (Del. 1964)) (permitting selective treatment of a hostile shareholder to combat strategic threat to company)).
[25] DEL. CODE ANN. tit. 8, § 220 (2008).
[26] See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (specifying that in the face of an imminent takeover, the directors have a duty to maximize company value); Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 44 (Del. 1994) ("In the sale of control context, the directors must focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders – and they must exercise their fiduciary duties to further that end.").
[27] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1527-30 (2005); Jonathan R. Macey & Maureen O'Hara, Essay, *Regulation or Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 111 (2009); United States Senate, U.S. Senate Roll Call Votes 107th Congress – 2nd Session, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=107&session=2&vote=00192 (last visited March 16, 2008).
[28] 107 P.L. 204, Title I, § 102, 116 Stat. 745 (codified as amended at 15 U.S.C. § 7212 (2006)).
[29] SOX § 201, 107 P.L. 204, Title I, § 102, 116 Stat. 745 (codified as amended at 15 U.S.C. § 78j-1(g) (2006)).

to pass additional regulations, inspect accounting firms, and sanction ones that did not comply. Overall, the entity was charged with enforcing the standards promulgated by the official accounting conference, the FASB.

Other provisions of SOX were even more significant. The law required CEOs and CFOs to certify the accuracy of the audit reports and the resulting financial statements. The statute simultaneously mandated that each public company must establish an audit committee comprised entirely of independent directors.[30] This organ would have exclusive power to determine the scope of the annual audit before it began and implement any changes thereafter. It had the power to review recommendations of accounting treatment by the auditor. The latter also had to report all material written communications between themselves and company management to the committee. The audit committee had final say in all matters under its control. Thus, it could override the objections of the CEO or the CFO while still requiring them to sign off on the committee's preferred version of the financial statements. It is worth reiterating that executives faced criminal punishment for certifying reports that did not fairly present the condition of the issuer.[31] The committee could, and, under some situations, had to hire independent counsel for any issues arising from its work.

A final set of noteworthy provisions addressed disclosure requirements. Auditors had to sign off on financial information before it could be released to investors. A covered company had a responsibility to rapidly report material changes in its economic situation.[32] The statute gave the Securities and Exchange Commission authority to require disclosure of all off-balance sheet transactions and obligations.[33] Crucially, SOX also demanded the companies create large internal compliance systems. These structures were supposed to detect violations of applicable laws early

[30] SOX defined "independent directors" as individuals who did not receive monetary compensation from the company for service in any capacity other than on the audit committee itself. *See* 15 U.S.C. § 78j-1(m)(3)(b) (2006).
[31] *See* SOX § 906, 18 U.S.C. § 1350 (2006).
[32] SOX § 409, 107 P.L. 204, Title IV, § 409, 116 Stat. 745, amended 15 U.S.C. § 78m (2006) to read:

> Real Time Issuer Disclosures. – Each issuer reporting under section 13(a) or 15(d) [of the Securities Exchange Act of 1934] shall disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.

Securities law in general does not favor a duty to correct information already released into the public sphere. Rather, a company is responsible for making correct disclosures at one point in time and then changing to comply with ongoing developments only during future releases. *See, e.g.*, Gallagher v. Abbott Labs., Inc. 269 F.3d 806 (7th Cir. 2001) ("We do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose. . . . Judges have no authority to scoop the political branches and adopt continuous disclosure under the banner of Rule 10b-5. *Especially* not under that banner, for Rule 10b-5 condemns only fraud, and a corporation does not commit fraud by standing on its rights under a periodic-disclosure system."). The opinion went to state that section 13 of Securities Exchange Act requires periodic reports, with emphasis on *periodic*: the regulations 'contemplated that these reports will be snapshots of the corporation's status on or near the filing date, with updates due not when something "material" happens, but on the next prescribed filing date.' 269 F.3d at 809; *compare with* Sec. & Exch. Comm'n v. Manor Nursing Ctrs., Inc., 458 F.2d 1082 (2d Cir. 1972) (holding that under Securities Act § 10(a), the company had a duty to amend a prospectus that had become misleading due to post-registration developments before it could carry on its offering). For a discussion of the relationship between the duty to correct and the duty to update, see generally, Donald C. Langevoort, *Half-truths: Protecting Mistaken Inferences By Investors and Others*, 52 STAN. L. REV. 87 (1999).
[33] SOX § 401(j), 15 U.S.C. § 78m(j) (2006).

on and prevent them from replicating. Executives and auditors both had to certify the adequacy of such compliance measures.[34]

The legal academy has developed a rare consensus the Sarbanes-Oxley Act imposed significant costs on operating a business as a public company in the United States. Several scholars have described the detrimental effects of this legislation in particularly strong terms.[35] This Article will not rehash their ideas. Instead, it will critique SOX compliance requirements as a component of an inefficient, multilayer regulatory regime in Part V. For now, though, the reader should take the statute at face value as the source of numerous new rules that expand federal control over corporate governance.

I.C. Federal Securities Law.

Traditionally, securities laws provided the basis for federal regulation of public companies. The structure rested on two pillars, the Securities Act of 1933 and the Securities Exchange Act of 1934. Roughly speaking, these statutes stood for the principles of registration ('33 Act) and reporting ('34 Act). The first member of the duo outlined a class of instruments called securities[36] and prohibited the sale of these without a prospectus that would describe their key characteristics[37] unless the security would qualify for a specific exception.[38] The statute established the Securities and Exchange Commission, an independent, non-partisan administrative agency, to enforce its provisions.

The 1934 Exchange Act supplemented its predecessor by requiring certain companies to continuously disclose their financial conditions. That is, businesses that either listed their shares on a national exchange,[39] had assets greater than $10 million and a class of securities held by at least 500 people,[40] or filed a '33 Act registration statement had to supplement the information in their prospectus with regular reports. These documents include Form 10K's for annual disclosure (the point of contact for most SOX reporting provisions), 10Q's for more limited quarterly disclosure, and Form 8K's for material developments. The Exchange Act also included rules for soliciting shareholder proxies.[41] The Williams Act later amended several of these provisions to more closely regulate tender offers. Finally, the '34 statute contained sections that required a narrowly defined group of corporate insiders to disgorge profits made from trading company stock during a 6 month period.[42]

Regulatory pronouncements abut federal statutory requirements for corporate conduct stemming from the Securities and Exchange Acts. The SEC gains its rule-making power from several sources. One of the most potent is Section 10(b) of the 1934 Act, the so-called "antifraud provision," which authorizes the Commission to prescribe rules and regulations to prevent the

[34] SOX § 302, 15 U.S.C. § 7262 (2006).
[35] *See* Romano, *supra* note 27.
[36] Securities Act § 2(a)(1), 15 U.S.C. § 77b(a)(1) (2006).
[37] Securities Act § 5, 15 U.S.C. § 77e (2006).
[38] Securities Act § 3, 15 U.S.C. § 77c (2006).
[39] Securities Exchange Act § 12(b), 15 U.S.C. § 78*l*(b) (2006).
[40] Securities Exchange Act § 12(g), 15 U.S.C. § 78*l*(g) (2006); 17 C.F.R. § 240.12g-1 (2008).
[41] Securities Exchange Act § 14(a), 15 U.S.C. § 78n(a) (2006).
[42] Securities Exchange Act § 16, 15 U.S.C. § 78p (2006). Modern insider trading jurisprudence has moved away from Securities Exchange Act § 16 towards the more expansive scope of §10 of the Securities Exchange Act, 15 U.S.C. § 78j (2006), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008). *See* Dirks v. Sec. & Exch. Comm'n, 463 U.S. 646 (1983).

use of manipulative devices or contrivances in connection to the purchase or sale of any security on a national exchange.[43] Additionally, pursuant to Section 12(k) of the Exchange Act, the SEC has the power to "alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization . . . as the Commission determines is necessary in the public interest and for the protection of investors."[44] Sections 6[45] and 19(a)[46] of the Exchange Act grant the SEC power to register national securities exchanges and other self-regulating organizations (SROs)[47] that meet such requirements as the Commission deems necessary.[48] The Williams Act amendments covering tender offers also permit the Commission to promulgate the rules necessary for the protection of investors.[49]

The above sources of authority are only a sample of the many statutory provisions permitting the SEC to set out rules as it sees fit. The aforementioned sections do, however, underpin the regulations that play the most significant roles in shaping the day-to-day activities of a business.

Regulation FD ("Fair Disclosure") provides a good example. It is relatively narrow in scope but powerful, providing that "when an issuer, or person acting on its behalf, discloses material nonpublic information regarding that issuer or its securities" to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it "shall make public disclosure of that information . . . ."[50] A public release via Form 8K and appropriate mass media outlets must follow "promptly" after any accidental disclosure.[51] The regulation was originally motivated by

---

[43] Securities Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2006).

[44] Securities Exchange Act § 12(k)(2), 15 U.S.C. § 78*l*(k)(2) (2006). The Commission recently invoked these powers to first ban "abusive naked short-selling," see Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166 (July 15, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58166.pdf; Amendment to Emergency Order, Exchange Act Release No. 58,190 (July 18, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58190.pdf, and then to implement an unprecedented ban on all short sales. *See* Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,592 (Sept. 18, 2008), *available at* http://www.sec.gov/rules/other/2008/34-58592.pdf. The fact that the SEC could literally cleave the equity markets in half with an administrative order (albeit with overwhelming popular support) highlights its broad regulatory mandate.

[45] 15 U.S.C. § 78f(a) (2006).

[46] 15 U.S.C. § 78s(a) (2006).

[47] SROs are generally governed by Exchange Act § 17, 15 U.S.C. § 78q(d) (2006), with other statutory provisions adding specific oversight and responsibilities as described elsewhere in this Article.

[48] Specifically, the SEC may not register an organization unless it determines that it, *inter alia*, has appropriate disciplinary tools in place and has established "rules of the exchange [that] are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . ." 15 U.S.C. § 78f(b)(5)-(9) (2008). The Commission may also require every national securities exchange or registered SRO to disseminate any reports that are necessary or appropriate to the public interest or the protection of investors. 15 U.S.C. § 78(q) (2008).

[49] *See* Securities Exchange Act § 14(d)(1), 15 U.S.C. § 78n(d)(1) (2006). The Commission has exercised several rules defining unlawful tender offer practices, SEC Rule 14d-1, 17 C.F.R. § 240.14d-1 (2008), and prohibiting certain abusive transactions.

[50] Regulation FD, 17 C.F.R. § 243.100(a) (2008); *see also* Elec. Data Sys. Corp., Exchange Act Release No. 43,154 (Sept. 25, 2007), *available at* http://www.sec.gov/litigation/admin/2007/34-56519.pdf.

[51] 17 C.F.R. § 243.101(e) (2008)

concerns that corporate insiders were tipping certain parties to allow them to make money by anticipating market movements in the stock.[52] Moreover, the SEC wanted to prevent executives from currying favor with sell-side analysts by giving them exclusive peeks at confidential firm information in exchange for favorable grades of the company's shares.[53] Notably, this regulation only applies to communications with market professionals who may reasonably trade on the disclosed information and does not offer grounds for civil liability.[54] Despite the narrow aim at traditional disclosure concerns, Reg FD has profoundly changed the way public companies carry out analyst conference calls and operate in capital markets.[55]

Reg SHO[56] is a second example of powerful SEC regulations that take full advantage of the expansive scope of the authorizing statutes. It was originally used to implement the uptick rule and has recently been supplemented by SEC pronouncements banning "naked" short sales and temporarily suspending their fully-clothed brethren.[57] Similarly, Regulation SX has had an enormous impact on corporate governance by implementing the provisions of the Sarbanes-Oxley Act described in Part I.B above.[58]

Regulation M-A is also quite significant. This document requires any "going-private" transaction[59] to list the purposes, alternatives, reasons and effects of said transactions.[60] Involved parties must disclose the source of funds for the deal,[61] itemize incurred expenses,[62] describe any repayment plan for borrowing,[63] and report any parties that the issuer retained to promote the transaction.[64] Finally, the Regulation asks subject companies to explain whether the transaction is "fair or unfair to unaffiliated security holders"[65] and "state whether or not the Rule 13e-3 transaction was approved by a majority of the directors of the subject company who are not employees of the subject company."[66] Determinations of fairness should revolve among factors such as market prices for the securities (current and historical), enterprise value determinations (based on net book, going concern, and liquidation principles), and outstanding "firm offers" for the company by unaffiliated persons.[67]

---

[52] Final Rule: Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716, 51.716 (Aug. 15, 2000).
[53] "Regulation FD is also designed to address another threat to the integrity of our markets: the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors." 65 Fed. Reg. at 51,716.
[54] *See* 65 Fed. Reg. at 51,718 – 51,719.
[55] *See* Stephen E. Bochner & Samir Bukhari, *The Duty to Update and Disclosure Reform: The Impact of Regulation FD and Current Disclosure Initiatives*, 7 STAN. J. L. BUS. & FIN. 225, 237 (2002).
[56] 17 C.F.R. § 242 (2008).
[57] *See supra* note 43.
[58] 17 C.F.R. § 210 (2008).
[59] Defined in Securities Exchange Act Rule 13e-3, 17 C.F.R. § 240.13e-3 (2008), to cover any transaction that involves the purchase or tender for an equity security by its issuer and has the effect of limiting the class of persons holding said security to 300 or delisting it from a national exchange.
[60] 17 C.F.R. § 229.1013 (2008).
[61] 17 C.F.R. § 229.1007(a) (2008).
[62] Id. at § 229.1007(c)
[63] Id. at § 229.1007(d)(2).
[64] 17 C.F.R. § 229.1009 (2008).
[65] Defined in Rule 13e-3 by exclusion as anyone who is not "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with such issuer." 17 C.F.R. §§ 240.13e-3(a)(1), 13e-3(a)(4) (2008).
[66] 17 C.F.R. § 229.1014(e) (2008).
[67] Instructions to Item 1014, 17 C.F.R. § 229.1014 (2008). The Instructions also provide that 'conclusory statements, such as "The Rule 13e-3 transactions is fair to unaffiliated security holders in relation to net book value, going

While Reg M-A has not gathered as much attention from commentators as S-X, FD, or SHO, it is unique in imposing a federal mandate for fairness certification on transactions. To be clear, the inquiry is not a recent innovation – Delaware courts have long relied on a similar approach to determine whether to invalidate transactions where management violated its duties of care or loyalty. [68] The SEC's version is simply another federal outpost on corporate governance grounds traditionally controlled by the state.[69]

The gradual usurpation of regulatory turf is not the only notable characteristic of Reg M-A. The rule exists as an elaboration of affirmative reporting duties under federal law: subject firms *must* release the required fairness analysis to the public. These disclosures take place in the shadow of the same norms of civil and criminal liability for material misstatements and omissions applicable elsewhere in securities regulation. Reg M-A thus adds a complicating gloss to the state fairness inquiry prototype. That is, even if a finding that management complied with their duties and deserves the deference of the business judgment rule precludes a Delaware court from reaching the fairness inquiry,[70] Reg M-A permits investors to claim in a federal suit that they were mislead by overly optimistic evaluations of the transaction at hand. Moreover, by setting out the factors that should shape a 17 C.F.R. § 229.1014 determination and any administrative scrutiny thereof, the SEC gained power to shape the behavior of managers contemplating any triggering transaction ex ante.

That is, suppose Fund A is considering taking Company B private within the boundaries of Rule 13e-3. Officers of B must then certify that, based on comparisons of enterprise value and available deal options, such a transaction would be fair to unaffiliated shareholders. This is true even where state law in the location of incorporation would permit a streamlined freeze-out conversion. If Fund A found a bargain (a company trading below its projected liquidation value) and secured it by offering half of the expected profit to the shareholders as a premium over the market stock price, Reg M-A still has the power to prevent the purchasers from carrying out this Pareto-beneficial plan. Unless new management can honestly state that outside shareholders will capture a fair share of assets unlocked through liquidation, they would be liable under § 10 of the Securities Exchange Act for making a materially misleading statement in connection with the purchase or sale of a security. The need to avoid this scenario can shape internal prognosis and book-keeping mechanisms by favoring overly conservative analysis.

While this Part shows the breadth of the SEC's power to regulate the activities of public companies, the agency's reach has certain limits. At various points in recent history, courts have successfully curtailed the Commission's domain. For example, in *Business Roundtable v. Securities and Exchange Commission*,[71] the Court of Appeals for the District of Columbia Circuit held that neither the Securities and Exchange Acts nor their subsequent amendments

---

concern value and future prospects of the issuer" will not be considered sufficient disclosure in response to paragraph (b) of this section.' *Id.*

[68] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *See generally* Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557 (2006).

[69] *See, e.g.*, William W. Bratton & Joseph A. McCahery, *Modern Federalism Issues and American Business: The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006); Loewenstein, *supra* note 5, at 353.

[70] *See* Loewenstein, *supra*, at 377 ("[T]he business judgment rule . . . limits the potential liability of a director for breaches of the duty of care. A director is only liable if he or she is grossly negligent, and the rule presumes that the director acted with due care. Thus, a shareholder challenging director conduct bears the burden of proving that the director acted with gross negligence.").

[71] 905 F.2d 406 (1990).

permitted the SEC to prohibit shares with fractional votes when these instruments were approved by the issuer's board of directors. The court felt that such interference in the affairs of a corporation, a creature of state law, was impermissible absent specific legislative authorization. The judges were unable to find any hint of such authorization in the record, declaring instead that "Congress made clear that the power to regulate central information processing was not intended to give the SEC 'either the responsibility or the power to operate as an 'economic czar.'"[72]

Of course, the appeal of limited federal regulation fluctuates with the political climate. The scandals of the dot-com collapse cast a harsh light on the Commission's hands-off strategy under Commissioner Harvey Pitt, with the public clamoring for greater oversight of corporate behavior.[73] Moreover, sweeping legislative products like the Sarbanes-Oxley Act may have eroded legitimate grounds for judicial skepticism over Congress's intended delegation of power to the SEC. Finally, the widespread demand for greater regulation, coupled with unprecedented activity by the Federal Reserve and the Department of Treasury to avert catastrophic market collapse in the fall of 2008 and winter of 2009 further undermined the vitality of rigid deference to state control over corporations. Without these ideological underpinnings, the borders of appropriate action by the SEC have become blurred.

Part II. The Role of Criminal Liability in the Corporate Arena.

II.A. Corporate Criminal Liability for Particularized Violations

The aforementioned statutes and regulations do not have the corporate law arena to themselves. They share it with some sharp-toothed species originating elsewhere in the law. Transplants from Title 18 of the United States Code are particularly prominent. While various agencies can bring civil suits for breaches of duty and criminal prosecutions for intentional violation of securities laws,[74] much of the enforcement measures that shape the legal environment for a business rely on theories of liability that lack any specific historic attachment to the regulation of economic activity.[75]

A proper survey of these tools has to begin with some simple principles. First, for over one hundred years, the common law has viewed corporations as entities capable of criminal conduct.[76] Such culpability generally requires a particular mental state, which, to a lay person,

---

[72] *Id.* at 416.

[73] *See, e.g.*, John McCain, *The Free Market Needs New Rules*, N.Y. TIMES, July 8, 2002, at A19.

[74] *See* Securities Act § 24, 15 U.S.C. § 77x (2006) (providing criminal culpability for all those who "willfully and knowingly" violate the provisions and accompanying rules); Securities Exchange Act § 32, 15 U.S.C. § 78ff (2006) (providing criminal culpability for all those who "willfully and knowingly" violate the provisions and accompanying rules).

[75] Diskant, *supra* note 15, at 137 ("[T]he drive toward entity criminal liability stemmed primarily from the efforts of American prosecutors who creatively and aggressively applied statutory and common law and from the early American courts that allowed them to do so.").

[76] New York Central & Hudson River Railroad v. United States, 212 U.S. 481, 493 (1909) ("'We think that a corporation may be liable criminally for certain offenses of which a specific intent may be a necessary element. There is no more difficulty in imputing to a corporation a specific intent in criminal proceedings than in civil. A corporation cannot be arrested and imprisoned in either civil or criminal proceedings, but its property may be taken either as compensation for a private wrong or as punishment for a public wrong.'"); *see also* United States v. Wise, 370 U.S. 405 (1962) (finding that the Sherman Act definition of "person" applies both to corporations and to individuals acting as corporate agents).

may be difficult to find in a fictional person made up of charters and contracts. American legal thinkers, however, did not see much of a problem here, arguing that

> Applying the principle governing civil liability, we go only a step farther in holding that the act of the agent, while exercising the authority delegated to him to make rates for transportation, may be controlled, in the interest of public policy, by imputing his act to his employer and imposing penalties upon the corporation for which he is acting in the premises.[77]

The same principles applied to inculpate partnerships.[78] Moreover, since the interests of a corporation were those of its shareholders, the law enabled the entity to assert defenses and rationales distinct from its employees.[79] At present, criminal statutes of the United States apply equally to natural persons and corporations, unless otherwise specified.[80]

As previously mentioned, intentional violations of substantive federal regulations for corporate behavior all carry criminal penalties,[81] though specific mental state requirements for guilt vary by statute. Much like elsewhere in criminal law, some of these distinctions have a meaningful impact on the application of the provisions in question, while others don't. For example, while the Securities and Exchange Acts themselves provide culpability for all "willful" contraventions, other applicable laws take a more nuanced approach. Thus, a provision of the Sarbanes-Oxley Act sets out penalties of up to 25 years' imprisonment for knowing execution of schemes or artifices to defraud and use of fraudulent pretenses to obtain money or property in connection with registered securities.[82] By comparison, 18 U.S.C. § 1341,[83] a statute that criminalizes mail fraud imposes punishment on anyone who uses the U.S. Mail or private interstate carriers for the purpose of distributing a security for unlawful use.[84]

It is worth noting that the classification of enforcement measures into criminal and civil categories is somewhat less informative for corporations than it is for individuals. As Justice Day

---

[77] 212 U.S. at 494.

[78] United States v. A&P Trucking Co., 358 U.S. 121, 125 (1958) (holding that Congress has the power to make partnerships criminally liable for violation of statutory safety provisions despite their lack of independent legal identity and that difficulties in attributing mens rea to a partnership are no greater than doing the same to a corporation).

[79] *See* Upjohn Co. v. United States, 449 U.S. 383, 395 (1981) (indicating that a corporation has an interest in asserting a criminal defense that is distinct from the interests of its employees); *see also* John Braithwaite & Brent Fisse, *On the Plausibility of Corporate Crime Control, in* WHITE COLLAR CRIME: CLASSIC AND CONTEMPORARY VIEWS 432-49 (Gilbert Geis et al. eds., 3d ed. 1995) (discussing the ability of corporations to form intentions that are separate from those of their employees).

[80] *See* Rules of Construction Act, 1 U.S.C. § 1 (2006) ("In determining the meaning of any Act of Congress, unless the context indicates otherwise – . . . the words 'person' and 'whoever' include corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals . . . .").

[81] *See supra* note 71.

[82] SOX § 807, 18 U.S.C. § 1348 (2006).

> Whoever knowingly executes, or attempts to execute, a scheme or artifice . . .
> (1) to defraud any person in connection with any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934; or
> (2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a class of securities registered under section 12 of the Securities Exchange Act of 1934 or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934;
> shall be fined under this title, or imprisoned not more than 25 years, or both.

[83] (2006).

[84] 18 U.S.C. § 1341 (2006).

pointed out in *New York Central & Hudson River Railroad*, corporations face largely identical penalties for both kinds of violations (relinquishing property, agreeing to restrict future conduct). Furthermore, the complexity of suspected enterprise misconduct necessitates cooperation between civil and criminal authorities in most investigations.[85] Thus, the decision for who will actually go to court against the accused comes after most of the pertinent information about conduct has been gathered.[86] By contrast, a plaintiff cannot hand off a suit against a natural person to a prosecutor, and the prosecutor cannot usually decide to drop charges against a defendant to permit a civil entity to pursue a less serious violation.

Many white collar criminal prosecutions follow an even more complex pathway. The first hint of wrongdoing will often come from a private party, be it a reporting company following the requirements of SOX, external counsel, or an anonymous tip. Alternatively, a self-regulated, quasi-official entity like the New York Stock Exchange will spot suspicious behavior and initiate an investigation. If one of these bodies determines that serious misconduct took place, they will refer it to the appropriate civil or criminal authorities. One of the interesting consequences of this layered mechanism is that organs of the U.S. government spend a lot less time evaluating weak cases then they would in other legal arenas. This setup is intentional: it permits a small number of people with limited resources to regulate an enormous economy. Later parts of this Article will discuss certain consequences of this approach in more detail. For now, the reader will suffice to keep the peculiar track of many enforcement measures in the corporate arena in mind.

II.B. Obstruction and Alternative Theories of Culpability for Corporate Conduct

The sources of criminal culpability for businesses, their agents, and employees described in the previous subpart fit in well with archetypal criminal law doctrine. Behavior that contravenes norms set out by statute is deemed a violation worthy of sanction. Given some basic legal knowledge, the norms themselves appear fairly intuitive, if somewhat harsh – anything that looks like fraud or intentional misrepresentation is prohibited. To this end, the actus reus element of the criminal offenses is tangible and robust. Likewise, civil liability usually flows out of similar misconduct that lacks the necessary state of mind. Of course, this is a highly idealized description, but its goal is not to provide an exhaustive, brightline definition. Rather, it functions as all labels do, by identifying salient characteristics of a group of items that aid classification of further items.

This subpart will describe frequent sources of criminal liability for corporate actors that look unlike the offenses listed above. All of these stem from a desire to prevent various actors from "obstructing justice." In this respect, the group of statutes may appear isolated. The internal logic of these laws, however, is replicated throughout the realm of corporate regulation. Therefore, a careful consideration of the issues posed by prosecutions under the provisions listed below helps bring into focus similar undercurrents in other parts of the law.

II.B.1. Statutory Variants of Obstruction Offenses.

[85] *See, e.g.*, Samuel W. Buell, *Criminal Procedure within the Firm*, 59 STAN. L. REV. 1613, 1628 (2007) ("The law in this area strains to decisively mark out the boundary between civil and criminal sanctioning.").
[86] *Id.* at 1628.

The oldest, most straightforward provision prohibiting the obstruction of justice is 18 U.S.C. § 1001.[87] The section prohibits knowingly and willfully making material misrepresentations or concealing a material fact in any matter within the jurisdiction of the executive, legislative, or judicial branch of the government of the United States. It thus criminalizes lies to a federal agent in the course of an investigation. Notably, the standards for materiality for misrepresentations that trigger penalties under § 1001 vary significantly from their brethren in the securities arena.[88] Under *Brogan v. United States*,[89] even one-word denials (previously known as "exculpatory no's") qualify for the offense.[90] Some circuits do impose restrictions on the type of falsehoods that underpin a conviction under this section, but these measures usually limit the ability of vague statutory obligations to lay the foundation for a misstatement, instead of redefining materiality outright. [91]

---

[87] 18 U.S.C. § 1001 (2006); *see also* Ch. 321, § 35, 35 Stat. 1095 (1909).

[88] *See* United States v. Irwin, 654 F.2d 671, 676 (10th Cir. 1981) (holding blank response can be false statement where duty to answer exists), *overruled on other grounds by* United States v. Daily, 921 F.2d 994, 1003 (10th Cir. 1990); United States v. Stewart, 433 F.3d 273, 318 (2d Cir. 2006) (holding that the duty to disclose information was a subset of a defendant's § 1001 duty to be truthful); United States v. Kappes, 936 F.2d 227, 231-32 (6th Cir. 1991) (describing § 1001 as a "catch-all" for false representations that impair basic agency functions even if misrepresentations are not prohibited by other statutes); United States v. Austin, 817 F.2d 1352, 1354 (9th Cir. 1987) ("[T]he government is not required to prove that the defendant had a duty under some other statute to disclose . . . ."); Laura Perry & Stephanie Salek, *False Statements and False Claims*, 45 AM. CRIM. L. REV. 465, 471-72 (2008) ('In addition, silence may constitute a false statement under § 1001 when it serves to mislead or when the individual has a duty to speak. . . . The majority of circuits require the duty to disclose be rooted in a "statute, governmental regulation, or form" that is independent of § 1001. The Second and Ninth Circuits view § 1001 as a "catch-all" provision that imposes a general duty to disclose, thereby making the non-disclosure of a material fact an automatic violation.').

By contrast, actionable material misstatements in the securities arena must meet much stricter requirements. *See* Gallagher v. Abbott Labs., Inc., 269 F.3d 806, 808 (7th Cir. 2001) ("We do not have a system of continuous disclosure. Instead firms are entitled to keep silent (about good news as well as bad news) unless positive law creates a duty to disclose."); Berson v. Applied Signal Tech., Inc., 527 F.3d 982, 987 (9th Cir 2008) (remarking that "securities laws don't require firms to disclose all information."); Eisenstadt v. Centel Corp., 113 F.3d 738, 746 (7th Cir. 1997) ("Where puffing is the order of the day, literal truth can be profoundly misleading, as senders and recipients of letters of recommendation well know. Mere sales puffery is not actionable under Rule 10b-5."); San Leandro Emergency Medical Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 811 (2d Cir. 1996).

[89] Brogan v. United States, 522 U.S. 398 (1998); *see also* United States v. Rashid, 383 F.3d 769, 779 (8th Cir. 2004) (holding that the fact that the defendant's false statement did not influence the bank did not make it immaterial under § 1001); United States v. Chen, 324 F.3d 1103, 1104 (9th Cir. 2003) (holding that defendant's false statement that he entered the country only two months prior to filing an asylum application was material because it could have affected an investigation of illegal alien smuggling); *but see* United States v. Gaudin, 515 U.S. 506, 509 (1995) (describing a statement as material if it has "a natural tendency to influence or [is] capable of influencing" an agency); Basic, Inc. v. Levinson, 485 U.S. 224, 248 (1988) ("[P]etitioners may rebut proof of the elements giving rise to the presumption [of reliance], or show that the misrepresentation in fact did not lead to a distortion of price or than an individual plaintiff traded or would have traded despite his knowing the statement was false. . . . Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.").

[90] *See generally* Stuart P. Green, *Uncovering the Cover-Up Crimes*, 42 AM. CRIM. L. REV. 9, 32 n.129 (2005) (explaining that "under this doctrine, a statement that would otherwise have violated *18 U.S.C. § 1001* was exempt from prosecution if it (1) conveyed false information in a situation in which a truthful reply would have incriminated the interrogee, and (2) was limited to simple words of denial (such as 'no, I did not,' 'none,' or 'never') rather than more elaborate fabrications)").

[91] *See, e.g.*, United States v. Whiteside, 285 F.3d 1345, 1346 (11th Cir. 2002) (reversing Medicare fraud convictions because the underlying regulations were too vague to flesh out the "knowingly and willfully" requirement of § 1001 for submitting false documents); U.S v. Anderson, 579 F.2d 455 (7th Cir. 1978) (to convict under § 1001,

A narrower drive to arrive at the same goals as § 1001 can be found in 18 U.S.C. § 1503,[92] an omnibus obstruction provision that requires specific intent for a violation. Criminal liability under § 1503 follows if the defendants: (1) knew of a pending judicial proceeding and (2) corruptly endeavored to obstruct the due administration of justice in that proceeding.[93] The additional qualifiers of the prohibited conduct have led to several streams of litigation to define the statute. In *United States v. Aguilar*,[94] the Supreme Court of the United States adopted the Second Circuit's scope restrictions and held that "[t]he action taken by the accused must be with an intent to influence judicial or grand jury proceedings; it is not enough that there be an intent to influence some ancillary proceeding, such as an investigation independent of the court's or grand jury's authority."[95] That is, "uttering false statements to an investigating agent . . . who might or might not testify before a grand jury is [not] sufficient to make out a violation of the catch-all provision of § 1503."[96] Several circuits have also pared down the reach of the statute to cover only conduct that has a "natural and probable" effect of interfering with justice.[97]

An additional provision of Title 18[98] extends a 1503-type prohibition on interference to administrative and civil proceedings. Furthermore, 18 U.S.C. § 1510 imposes criminal liability for overt bribery and willful disclosure of the contents of subpoenas for financial or insurance institutions when done with the intent to obstruct justice.[99] While the elements of the statute bear a clear relationship to those of §§ 1503 and 1001, this section has not played as important of a role in enforcement of business conduct as its siblings.

Arguably, the most powerful weapon in the obstruction arsenal is § 1512.[100] Traditionally used "where the defendant misled, threatened, or corruptly persuaded *others* to do his dirty work

---

government must prove that the defendant's statements were actually false under all reasonable interpretations of an ambiguous regulation); *see also* Perry & Salek, *supra* note 93, 472-474 (explaining the nuances of materiality requirements under 18 U.S.C. § 1001).

[92] 18 U.S.C. § 1503 (2006).

[93] "*Whoever corruptly*, or by threats or force, or by any threatening letter or communication, endeavors to influence, intimidate, or impede any grand or petit juror, or officer in or of any court of the United States, or officer who may be serving at any examination or other proceeding before any United States magistrate judge or other committing magistrate, in the discharge of his duty, or injures any such grand or petit juror in his person or property on account of any verdict or indictment assented to by him, or on account of his being or having been such juror, or injures any such officer, magistrate judge, or other committing magistrate in his person or property on account of the performance of his official duties, *or corruptly or by threats or force, or by any threatening letter or communication, influences, obstructs, or impedes, or endeavors to influence, obstruct, or impede, the due administration of justice, shall be punished as provided in subsection* (b)." 18 U.S.C. § 1503 (2006) (emphasis added).

[94] 515 U.S. 593 (1995).

[95] *Id.* at 599 (quoting United States v. Brown, 688 F.2d 596, 598 (1982))

[96] 515 U.S. at 598.

[97] *See* United States v. Wood, 6 F.3d 692, 696 (10th Cir. 1993) (adopting the "natural and probable effect" standard for culpability); United States v. Muhammad, 120 F.3d 688, 695 (7th Cir. 1997) (holding that *Aguilar* requires proof of intent to carry out an action that has a "natural and probable effect" of interfering with justice).

[98] 18 U.S.C. § 1505 (2006).

[99] 18 U.S.C. § 1510(a)-(d) (2006).

[100] 18 U.S.C. § 1512(b) (2006) ("Whoever knowingly uses intimidation, threatens or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to . . . hinder, delay, or prevent the communication to a law enforcement officer or judge of the United States of information relating to the commission or possible commission of a Federal offense or a violation of conditions of probation, supervised release, parole, or release pending judicial proceedings; shall be fined under this title or imprisoned not more than 20 years, or both.").

. . . by destroying documents or lying before a grand jury,"[101] it has transformed into a catchall provision with the addition of subsection (c) in 2002.[102] The modification provided for criminal penalties of up to twenty years for anyone who corruptly "alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object's integrity or availability for use in an official proceeding."[103] Unsurprisingly, prosecutors have found appealing both the absence of a nexus requirement from § 1503[104] and the threat of a ten more years of imprisonment than that provided by other obstruction sections.[105]

In the 2005 decision *Arthur Andersen LLP v. United States*,[106] however, the Supreme Court of the United States circumscribed the reach of the statue. The opinion overturned a conviction of the accounting firm for obstruction because it found the trial court jury instructions on the attribution of guilt under § 1512(b) to be invalid. The Court was struck that these instructions permitted the trier of fact to find the defendant guilty even if the defendant "honestly and sincerely believed that its conduct was lawful." [107] The "corruptly" modifier in § 1512(b) and (c) served to protect instances where a person was entitled to withhold information from a proceeding. Accordingly, the statute could not ascribe criminal penalties to "a mother who suggests to her son that he invoke his right against compelled self-incrimination or a wife who persuades her husband not to disclose marital confidences."[108] Attorneys who instructed their clients that they can withhold certain privileged documents from the government fell into the same protected carve-out.[109]

Finally, the Court found that the instructions were infirm because 'they led the jury to believe that it did not have to find *any* nexus between the "persuasion" to destroy documents and any particular proceeding.'[110] While the statute may have suggested otherwise, the Court applied its holding in *Aguilar*[111] broadly to mean that obstruction is impossible without very specific intent: "if the defendant lacks knowledge that his actions are likely to affect the judicial proceeding . . . he lacks the requisite intent to obstruct."[112]

II.B.2. Case Studies in the Role of Obstruction Charges in a Corporate Setting

---

[101] Julie R. O'Sullivan, *The Challenge of Cooperation: The DOJ Risks Killing the Golden Goose through* Computer Associates / Singleton *Theories of Obstruction*, 44 Am. Crim. L. Rev. 1447, 1458 (2007)
[102] *See* Act of July 30, 2002, P.L. 107-204, Title XI, § 1102, 116 Stat. 807 (2002).
[103] 18 U.S.C. § 1512(c) (2006).
[104] Congress explicitly decreed that for the purposes of liability under § 1512,
"(1) an official proceeding need not be pending or about to be instituted at the time of the offense; and
(2) the testimony, or the record, document, or other object need not be admissible in evidence or free of a claim of privilege." 18 U.S.C. § 1512(f) (2006). *See generally* O'Sullivan, *supra* note 106, at 1458-61 (describing the appeal of § 1512(c) and the message that prosecutions thereunder sent to the business community); U.S. v. Veal, 153 F.3d 1233, 1251-52 (11th Cir. 1998) (holding that, under § 1512, "[i]t is irrelevant . . . whether the person who provides false or misleading information that ultimately becomes relevant to a federal investigation *intended* that a federal investigator receive that information; it is relevant only that the federal investigator or judge *received* it.").
[105] *See* Harvey Silverglate, *Making Business A Crime*, WALL ST. J., Apr. 9, 2008, at A14.
[106] 544 U.S. 696 (2005).
[107] *Id.* at 706.
[108] *Id.* at 704 (internal citations omitted).
[109] *Id.* Note that this statement directly invalidates § 1512(f)(2) pursuant to *Upjohn Co. v. United States*, 449 U.S. 383, 395 (1981). *See* supra note 75.
[110] 544 U.S. at 707.
[111] *See supra* note 89, 515 U.S. at 599.
[112] 544 U.S. at 708.

Despite this curtailment, § 1512 has provided grounds for some very interesting theories of liability. In the *Computer Associates* case, the CEO, Sanjay Kumar, implemented a 35-day month to meet Wall Street earnings projections.[113] This approach covered Fiscal Year 2000 and meant that revenue from the first five days of March got booked for February, revenue for the first five days April for March, and so on. The company booked revenue. The scheme shifted a total of $1.899 billion on a revenue stream of $6.776 billion.[114] In 2002, following anonymous allegations, the SEC, FBI, and the U.S. Attorney's Office for the Eastern District of New York began investigations into accounting irregularities at the company.[115] Computer Associates hired Wachtell, Lipton, Rosen & Katz as their counsel and publicly pledged full cooperation with the government.[116]

Despite these assurances, Wachtell was unable to find any of the large number of inculpatory emails exchange by CA executives regarding the matter. It is unclear whether this lapse was due to active impediments from management or a limited authorization from the board, but EDNY, which by then was leading the case, threatened to indict the company unless it produced evidence against Kumar. At this point in time, the board of directors fired Wachtell and brought on Sullivan & Cromwell, whose lead attorney, Robert Giuffra, famously promised a bottle of champagne to the first associate to find records implicating the CEO.[117] A smoking gun surfaced and the prosecutors secured an indictment against Kumar for violating 18 U.SC. § 1512(c)(2). The document charged that Kumar "did not disclose, falsely denied, and otherwise concealed[,] . . . concocted and presented to [Wachtell] an assortment of false justifications" and material misrepresentations with knowledge and intent to obstruct the government investigations.[118] Kumar was also alleged to have lied to FBI officers during the proceedings. The defendant filed a motion to dismiss the charges on the basis that lies to private external counsel lack a sufficient nexus to an official proceeding to give rise to liability under 1512(c)(2).[119] The district court found the indictment's allegations that Kumar made statements he knew to be materially false to the FBI sufficient to uphold the charge and dismissed the motion.[120] Thereafter, Kumar plead guilty to the obstruction and fraud charges and was sentenced to 12 years in prison.[121]

---

[113] Indictment, United States v. Kumar, 2006 U.S. Dist. LEXIS 96141 (E.D.N.Y July 28, 2005) (Cr. No. 04-846), *available at* http://www.usdoj.gov/dag/cftf/chargingdocs/compassocs.pdf [hereinafter Kumar Indictment].

[114] "[T]he practice was wrong but also less than earth-shattering, at least when considered in light of the twelve-year sentence that Kumar received (to be fair, for both the fraud and the obstruction) *and* the possibility that a criminal case would have destroyed the company and the livelihood of its many employees. After all, the deals concluded five days into the next quarter were *real* deals and the revenues were *real;* from a defense perspective, they were simply put in the wrong column." O'Sullivan, *supra* note 106, at 1453.

[115] *Id.* at 1452.

[116] Deferred Prosecution Agreement at ex. C P 6, United States v. Computer Associates Int'l, Inc., Cr. No. 04-837 (S.D.N.Y. Sept. 22, 2004), *available at* http://www.sec.gov/Archives/edgar/ data/356028/000095012304011246/y02481exv10w1.htm).

[117] O'Sullivan, *supra* note 106, at 1454.

[118] *Id.* at 1456.

[119] Memorandum of Law in Support of Defendant Stephen Richards' Motion to Dismiss Counts Six and Seven of the Second Superseding Indictment at 20-25, United States v. Kumar, 2006 U.S. Dist. LEXIS 96141, (E.D.N.Y. Oct. 24, 2005) (No. 04-846).

[120] 'Paragraph 72 recites, in essence, that when interviewed by FBI agents and others at the United States Attorney's Office on November 5, 2003, Sanjay Kumar made materially false statements and representations in an attempt to con-ceal his involvement in the 35-day month practice. Paragraphs 73, 74 and 75 recite with specificity the allegedly false statements made by Kumar and paragraph 76 alleges that Kumar knew and believed at that interview that his statements were false and that he concealed information he knew was material to the Government Investigations and

This outcome provides a worthwhile comparison to that of *United States v. Singleton*. In *Singleton*, the defendant worked as a natural gas trader for El Paso Corporation, which was being investigated by the Commodity Futures Trading Commission (CFTC) and the local U.S. Attorney's Office for misreporting trades to manipulate the natural gas market.[122] El Paso pledged full cooperation to the authorities carrying out these investigations. Accordingly, it retained counsel to conduct an internal investigation into whether any of its employees provided inaccurate natural gas pricing information to trade publications. This conduct would have affected the price and profit points of trades based on an index to be provided by these publications.[123] El Paso turned over all results of the internal investigation to the U.S. Attorney's Office. Thereafter, a grand jury indicted Greg Singleton for § 1512(c)(2) obstruction, in addition to nine counts of conspiracy, wire fraud, and false reporting. The alleged misconduct took place when the defendant "did not disclose, falsely denied, and otherwise concealed that he had provided false information to trade publications" to El Paso's outside counsel while believing that "El Paso's Outside Lawyers would inform government agencies of his statements during the interview."[124]

The defendant moved to dismiss the obstruction indictment for failing to state an offense recognized by law.[125] The district court dismissed the motion, holding that a private party lying to external counsel could provide the requisite causal nexus to obstruction of an official proceeding without defendant's knowledge that false statements would be turned over. The memorandum opinion reasoned that: "The allegations, if proved . . . , could raise the inference that Singleton *expected* and thus arguably intended that his intentionally false statements would be supplied to the Federal government in connection with one or more of these identified official proceedings."[126] At trial, Singleton was acquitted after proving that El Paso's counsel stated that they were not "acting as an arm of the investigative agencies."[127]

As Professor O'Sullivan pointed out, the most important aspect of the *Singleton* indictment was the absence of certain key points. The document made "no reference to a corporate decision (whether communicated to Singleton or not) by El Paso to cooperate with the government *or* waive applicable privileges, including the protections that would shield Singleton's conversations with counsel from discovery. By comparison, *Computer Associates* featured an intentional plan to derail an investigation."[128] Thus, under the theory of *Singleton*, as endorsed by the U.S. District Court for the Southern District of Texas, a material misstatement or omission to private corporate counsel may constitute obstruction solely based on the intent of the

---

would have the effect of obstructing and impeding the Government Investigations. . . . The indictment plainly charges the defendants with conduct that bears a "relationship in time, causation or logic" to an "official proceeding" as that term is used in § 1512(c)(2) and defined in § 1515(a)(1)(C).' United States v. Kumar, 04 CR 846(S-2) (ILG), 2006 U.S. Dist. LEXIS 96142 at *14 (E.D.N.Y. Feb. 21, 2006).

[121] *See* O'Sullivan, *supra* note 106, at 1465; Sentencing Results, United States v. Kumar, Cr. No. 04-846 (ILG) (S.D.N.Y. 2006), *available at* http://www.usdoj.gov/usao/nye/vw/PendingCases/US_v_SANJAY_KUMAR_and_STEPHEN_RICHARDS_Court_events.pdf.

[122] *See* O'Sullivan, *supra* note 106, at 1468; Indictment, United States v. Singleton, No. H-06-080, 2006 WL 3326639 at *10 (S.D. Tex. Mar. 8, 2006) [hereinafter Singleton Indictment].

[123] Singleton Indictment at *2, *3, *10.

[124] *Id.* at *11.

[125] United States v. Singleton, No. H-06-080, 2006 WL 1984467, at *3 (S.D. Tex. July 14, 2006)

[126] *Id.* at *6.

[127] *See* O'Sullivan, *supra* note 106, at 1468.

[128] *Id.* at 1467.

perpetrator. If she believes this information will be turned over to investigators, then 1512(c)(2) imposes liability, regardless of whether the hand-off actually took place. The logic here begins to resemble charges of attempting to carry out a factually impossible crime.[129]

A third useful illustration of the role that obstruction charges play in the corporate setting comes from the recent prosecution of former Broadcom executives for option backdating.[130] According to the SEC,[131] Henry Samueli, the co-founder, Chief Technological Officer, and former Chairman of the Board of Directors, along with three other officers of the California semiconductor manufacturer, systematically changed grant dates listed on option awards to ensure that these instruments immediately yielded economic value. As a result, the awarded stock options were "at the money" – their exercise price exactly matched the price of Broadcom stock on NASDAQ. This process permitted Broadcom to offer individuals significant extra compensation without showing any concomitant expense on their income statement or balance sheet. Over its seven-year duration, the scheme led Broadcom to understate its total compensation expense by $2.2 billion.[132]

To carry out the plan, the defendants used a document claiming to represent the unanimous consent of the company's board of directors.[133] This permitted Samueli and his cohorts to usurp the authority formally allocated to the compensation committee and two independent directors.[134] Predictably, participating individuals discussed their actions over various forms of communication, including email. Overall, the SEC claimed that the conduct constituted numerous violations of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act.[135] Beyond that, the U.S. Attorney's Office named Samueli seventy two times in its indictment of Dr. Henry T. Nicholas, Broadcom's CEO and Samueli's co-conspirator in the conduct.[136]

Samueli himself was never indicted. Instead, he plead guilty to one charge of obstruction of justice under 18 U.S.C. § 1001 for making the knowingly false statement that he was "not involved in the actual granting process" (he later acknowledged selecting suitable grant dates and signing seventeen Unanimous Written Consents to effectuate these decisions).[137] The plea agreement stipulated that Samueli was to serve no jail time, undergo five years' probation, and pay $12 million to the United States Treasury. He had no duty to cooperate with further investigations of his own or his colleagues conduct; in fact, the U.S. Attorney's Office agreed not to prosecute Samueli for any violations unearthed during its investigation into Broadcom's activities. The plea bargain came a year after a similar one from the head of Broadcom's Human

---

[129] *See, e.g.*, People v. Dlugash, 363 N.E. 2d 1155 (N.Y. 1977); State v. Smith, 621 A.2d 493 (N.J. 1993) (holding that despite the actual impossibility of transmitting HIV by spitting, a defendant may be guilty of attempted murder if he believed such a transmission was possible and clearly intended to carry it out). *See generally* Rollin M. Perkins, *Criminal Attempt and Related Problems*, 2 UCLA L. REV. 319 (1955); Kenneth W Simons, *Mistake and Impossibility, Law and Fact, and Culpability: A Speculative Essay*, 81 J. CRIM. L. & CRIMINOLOGY 447, 467-69 (1990).
[130] *See generally* Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802 (2005).
[131] Complaint, Securities & Exchange Commission v. Nicholas (C.D. Cal. 2008) (No. SACV08-539 CJC (RNBx)), available at http://www.sec.gov/litigation/complaints/2008/comp20574.pdf.
[132] *Id.* at 2.
[133] U.S. v. Samueli, 575 F. Supp. 2d 1154, 1161 (C.D. Cal. 2008).
[134] SEC Charges Four Current and Former Broadcom Officers for Backdating Options, Litigation Release No. 20574 (May 14, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20574.htm.
[135] *Id.*
[136] U.S. v. Samueli, 575 F. Supp. 2d at 1159-60.
[137] *Id.* at 1157, 1160.

Resources department, although the latter led to a much longer prison sentence.[138] At the time of this Article, the U.S. District Court for the Central District of California rejected Samueli's plea for excess leniency on the grounds that the prosecution's neglect of its substantive accusations created the impression that justice was for sale.[139] In doing so, Judge Carney appears to have embraced many of the concerns that the remainder of this Article will seek to elucidate.

II.C. The Relationship between Corporate Conduct and Individual Culpability

The careful observer will notice a shift in focus between the discussion of substantive regulations of corporate activity in Part I and the delineation of existing obstruction jurisprudence in the previous section. Both *United States v. Singleton* and *United States v. Kumar* charged individuals with violations of the U.S. Code, though both took place in the midst of ongoing investigations into the misconduct of the companies themselves. The litigation in *Arthur Andersen* was distinct in this respect – there, the prosecutors indicted the entire firm, destroying it even before the initial guilty verdict.

Several scholars have put together comprehensive discussions of the relationship between corporate misdeeds and individual liability.[140] This Article will not attempt to replicate their work or condense their nuanced observations. Rather, for current purposes, a few main points will suffice. First, companies traditionally pay their employees' legal fees. In most situations, managers are not responsible for reimbursing the firm unless a jury finds them guilty of a business-related crime.[141] Moreover, companies often take out liability insurance on behalf of their officers and directors.[142] This symbiotic relationship belies the fact that the primarily responsibility of a corporation is to its shareholders, not its employees. The corporate general counsel represents the former, not the latter, and may often be forced to make decisions that adversely affect the second group. For example, managers usually have to cooperate with their

---

[138] *See id.* at 1162; Amir Efrati, *Ex-Broadcom Officer Pleads Guilty - Samueli Admits False Statement In Backdating Case*, Wall St. J., June 24, 2008, at B2.
[139] U.S. v. Samueli, 575 F. Supp. 2d at 1162-65.
[140] *See, e.g.*, Diskant, *supra* note 15; Melvin Aron Eisenberg, *The Architecture of American Corporate Law: Faciliation and Regulation*, 2 BERKLEY BUS. L. J. 167 (2005); Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers under Delaware Law*, 44 AM. BUS. L.J. 475 (2007); Loewenstein *supra* note 5; Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 NW. U. L. REV. 651 (2002).
[141] *See* Noah D. Stein, Note, *Should the Government Scrutinize an Organization's Payment of Its Employees' Attorneys' Fees?*, 75 FORDHAM L. REV. 3245, 3249 (2007) ("[I]f the organization has promised to advance expenses to employees, then it must make the advances even if it appears likely that an employee's wrongful conduct will make indemnification unavailable to the employee at the end of the case."); *see also* Am. Coll. of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations*, 41 DUQ. L. REV. 307, 332-334 (2003) (noting that the vast majority of states have adopted statutes permitting such treatment of legal fees); Stephen A. Radin, *"Sinners Who Find Religion": Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing*, 25 REV. LITIG. 251, 258-59 (2006) (citing Homestore, Inc. v. Tafeen, 888 A.2d 204, 211 (Del. 2005)). *But see* Peter Margulies, Legal Hazard: Corporate Crime, Advancement of Executives' Defense Costs, and the Federal Courts 24-25 (Aug. 29, 2006) (unpublished research paper), available at http://ssrn.com/abstract=927783 (citing an organized crime example to illustrate a potential danger of advancement in the corporate context); *Caplin & Drysdale, Chartered v. United States*, 491 U.S. 617, 626 (1989) ("A defendant has no Sixth Amendment right to spend another person's money for services rendered by an attorney, even if those funds are the only way that that defendant will be able to retain the attorney of his choice... . The government does not violate the Sixth Amendment if it seizes the ... proceeds [of a crime] and refuses to permit the defendant to use them to pay for his defense.").
[142] *See* Loewenstein, *supra* note 5, at 378.

employer's request for information. Their answers to counsel retained by the corporation fall under the broad rubric of confidential communications with an attorney. The privilege to withhold this data flows to the client, who, in this case, is the business, not the respondent. Thus, a company can choose to release any information that inculpates one of its employees to a government authority or third party against the employee's will.[143]

Enforcement agencies frequently take advantage of this dynamic to get quick results. In fact, for a period of three years, the Department of Justice demanded that companies throw their employees overboard as a condition for lenient treatment.[144] Under the Thompson Memorandum, any entity under investigation had to waive their attorney-client privilege, carry out a detailed internal investigation, and disclose all of its results before it would be considered cooperative.[145] This label resulted in milder prosecutorial tactics: cooperating businesses usually avoided destructive company-wide indictments.[146] Few were sufficiently risk-neutral to aggressively rebut the demands of the government.

To many observers, this pattern of behavior yielded undesirable, if not inequitable, results.[147] An anonymous tip could start a criminal investigation. The U.S. Attorney would approach the firm and offer leniency in exchange for cooperation and indictment in return for any other course of action. The latter would disqualify a company from being traded on a U.S.

---

[143] Hence the *Upjohn / Zar* warning. *See, e.g.*, Sheila Finnegan, *The First 72 Hours of a Government Investigation: A Guide to Identifying Issues and Avoiding Mistakes,* PRACTICING L. INST. CORP L. & PRAC. COURSE HANDBOOK SERIES 901, 930 (Nov. 2006) (describing Zar warning); O'Sullivan, *supr*a note 106, at 1473.

[144] The Thompson Memorandum was promulgated on January 20, 2003; the Department of Justice replaced it with the McNulty Memorandum on December 12, 2006. *See* Ashby Jones, *Thompson Memo Out, McNulty Memo In*, WALL ST. J. ONLINE, Dec. 12, 2006, *available at* http://blogs.wsj.com/law/2006/12/12/thompson-memo-out-mcnulty-memo-in/.

[145]

> General Principle: In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection.

Memorandum from Larry D. Thompson, Deputy Att'y Gen., to Heads of Dep't Components, U.S. Att'ys (Jan. 20. 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (last visited March 16, 2009) [hereinafter Thompson Memo], at Parts VI.A; *see also id.* at Part VI.B. This policy substantially mimics the guidelines set out in the predecessor to the Thompson Memorandum. *See* Memorandum from Eric Holder, Deputy Att'y Gen., to Heads of Dep't Components, U.S. Att'ys (June 16. 1999), *available at* http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html (last visited March 16, 2009) [hereinafter Holder Memo], at Part VI(B). The Memorandum states that the prosecutor may consider the completeness of corporate disclosure of all relevant communications and findings, as well as its waiver of attorney-client privilege in the charging decision. It further states: "Some agencies, such as the SEC and the EPA, as well as the Department's Environmental and Natural Resources Division, have formal voluntary disclosure programs in which self-reporting, coupled with remediation and additional criteria, may qualify the corporation for amnesty or reduced sanctions." Akin to its progeny, the Holder Memo establishes that waiver is not an absolute requirement for lenient treatment. It also notes that "prosecution and economic policies specific to the industry or statute may require prosecution notwithstanding a corporation's willingness to cooperate. For example, the Antitrust Division offers amnesty only to the first corporation to agree to cooperate." *Id.*

[146] *See id.*; Peter Spivack & Sujit Raman, *Regulating the 'New Regulators': Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 167 (2008).

[147] *See, e.g.*, Sarah Helene Duggin, *Internal Corporate Investigations: Legal Ethics, Professionalism and the Employee Interview*, 2003 COLUM. BUS. L. REV. 859, 904 ("The defense bar has repeatedly raised concerns about these policies . . . .").

stock exchange, void key insurance contracts, trigger defaults on loans and bonds, and bar the entity from certain lucrative contracts, guaranteeing its collapse.[148]

Naturally, the company could choose cooperation. Executives would then initiate an internal investigation through either inside or outside counsel. The lawyers would interview low-level employees, who, if they were less than forthcoming, would face a discharge for insubordination and possible prosecution without access to a firm-sponsored attorney. Unsurprisingly, most people on the lower steps of the corporate ladder cooperate fully. The company would then turn over any inculpatory admissions to the government, which would utilize them as building blocks of accusations against individuals further up on the management chart. At some point, the investigators would be satisfied that they nabbed the culprits and would offer the company a final deal. Option One: throw the suspects overboard by providing the prosecution with key witnesses in exchange for a deferred prosecution agreement, a civil fine, or a termination of the investigation. Option Two: face a newly powerful case built on vicarious liability for offenses that are now fully fleshed out.[149]

The incentive structure powering the entire process meant that a company comprised of rational actors would almost always find scapegoats in exchange for its own protection. Moreover, individual participants at all levels were usually powerless to change this outcome – they all faced the traditional prisoner's dilemma pitting uncertainty about the behavior of others against self-interest. In many situations, the scenario took an even more nefarious twist. Since most corporate officers were aware of the standard plotline, they hired personal criminal attorneys at the first sign of an internal investigation or external enforcement interest. The company would pay for these lawyers, who would advise employees on the least dangerous (and revealing) responses to questionnaires or interviews. Predictably, these tactics slowed the investigation; to prevent such roadblocks, a U.S. Attorney would occasionally demand that the company stop advancing legal fees to its employees if it wanted to be seen as cooperative.

Some of the recipients of these tactics alleged that the pressure on a company to withdraw financial support that it contractually promised prior to any finding of guilt violated their Fifth Amendment due process rights and Sixth Amendment rights to counsel. In *U.S. v. Stein*,[150] the Court of Appeals for the Second Circuit eventually agreed. Moreover, soon after the initial district court decision finding for the plaintiffs,[151] Arlen Specter, the U.S. Senator from Pennsylvania, introduced a bill that would provide rigid prosecutorial standards and make behavior underlying the *Stein* complaint illegal.[152] As a result of these developments, the Department of Justice replaced the offending guidelines with a modified version known as the

---

148 *See* 48 C.F.R. § 9.406 (2008); Bucy, *supra* note 15, at 1301-02; Diskant, *supra* note 15, at 142 & n.56.

149 *See generally* Stein, *supra* note 124, at 3267 (""[T]he government regularly flips witnesses to uncover facts in an investigation, using the threat of prosecution to secure cooperation by parties whom they believe to be criminally culpable. Furthermore, prosecutors "ask cooperating drug dealers, bank robbers and gun-toting felons to waive their Fifth Amendment privilege against self-incrimination," and they do so "all the time [even though] the vast majority of [those criminals] do not have access to ... high-priced legal talent.");

150 541 F.3d 130 (2d Cir. 2008).

151 United States v. Stein, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

152 Pedro Ruz Guttierez, *AG Mukasey Hints at Revision of McNulty Memo, Spars with Senators at Hearing*, LEGAL TIMES, July 10, 2008, http://www.law.com/jsp/article.jsp?id=1202422864034; Ashby Jones, *Thomspon Memo Out, McNulty Memo In*, WALL ST. J. ONLINE, Dec. 12, 2006, http://blogs.wsj.com/law/2006/12/12/thompson-memo-out-mcnulty-memo-in/; Pamela A. MacLean, *McNulty Memo on Attorney-Client Privilege Blasted for Lack of Change*, NAT. L. J., Jan. 26, 2007, http://www.law.com/jsp/article.jsp?id=900005553208; Dan Slater, *On McNulty Memo, Specter Fires Back at DOJ*, WALL ST. J. LAW BLOG, July 11, 2008, http://blogs.wsj.com/law/2008/07/11/on-mcnulty-memo-specter-fires-back-at-doj/.

McNulty Memorandum.[153] Unlike its predecessor, the McNulty Memorandum restricted situations where a prosecutor could ask for a waiver of attorney-client privilege only when there is a legitimate need to do so in order to fulfill their law enforcement obligations (mere convenience does not suffice).[154] Before doing so, the U.S. Attorney had to obtain written approval from his superiors.[155] Prosecutors could still accept a company's offer to waive privilege and provide full disclosure of relevant communications in exchange for lenient treatment at their discretion.[156] Moreover, the new document specified that prosecutors should *not* exert pressure on businesses to terminate legal assistance supported by prior contractual obligations.[157]

III. Evaluating the Current Regime

So far, this Article has provided a positive description of the types and sources of rules governing the behavior of public companies in the United States. One group of authorities (general corporate law) applies across a larger set of business entities; a second (the regulation of takeovers and tender offers) kicks in only in a few scenarios; others still (criminal indictments for wire fraud) may never actually take place in the lifespan of a given enterprise. According to scholars and practitioners, however, all of these rules matter a lot. They delineate limits for acceptable behavior by both a company as a whole and its employee constituents. Within this playing field, the laws then ascribe costs to particular actions, both incidental (such as the time it takes to carry out a proxy battle) and expectancy-based (the probability that the absence of a particular point in a MD&A section of a quarterly report will lead to a successful civil suit for damages).

Unlike the natural laws of disciplines like physics, this man-made environment is facially flawed. Some rules appear redundant, others misguided. In a few situations, the mistakes come from incorrect analysis of the impact of a particular regulation, whereas in others, deficiencies arise because no one ever considered the impact of the regulation at all. Of course, observations like this are banal because they apply to every area of human creative endeavor. Criticism becomes interesting only when it provides a new way of evaluating the quality of the field in question or pinpoints a change that, pursuant to some theory, is an ambiguous improvement. The remainder of this Article will attempt to accomplish both of these goals.

III.A. A Theory of Regulation

III.A.1. Rules, Boundaries, and Parameters.

A good place to begin an evaluation of an object is by restating known reasons for that object's existence. In the case at hand, corporate regulation serves to accomplish certain goals. At the most abstract level, it aims to set out limits for what businesses can and cannot do. These boundaries derive from a balance struck by the body politic between aggressive, profit-seeking

[153] Memorandum from Paul J. Holder, Deputy Att'y Gen., to Heads of Dep't Components, U.S. Att'ys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf (last visited March 16, 2009) [hereinafter McNulty Memorandum].
[154] McNulty Memorandum, *supra*, at Part VII.B.2, p. 8.
[155] *Id.*
[156] *Id.* at p. 11.
[157] McNulty Memorandum, *supra* note 148, at Part VII.B.3, p. 11.

action and fear that when unbridled, this motive can overwhelm important objectives like altruism and human dignity.

Specific limits on the actions of a particular enterprise vary with its perceived power. Small sole proprietorships face essentially no restrictions outside of the employment arena, where, despite their size, they wield considerable influence over the lives of community members. Large private companies, whether organized as corporations, limited liability companies, or partnerships, face a different set of rules. These are motivated by the entities' potential to earn significant returns on an investment of societal resources and decision to restrict their use of the public sphere to accomplish these objectives. From the perspective of modern legal theory, the second characteristic means that the aforementioned organizations foreswear access to the most powerful tools of economic success (such as soliciting capital contributions from lay individuals, which can allow a company to gobble up resources and overwhelm competitors). As a result, their capacity to change the public landscape to better suit their profit motive is limited. By contrast, public corporations retain the motivation of their private brethren and desire to utilize every available method of attaining their goals. They operate openly in the public sphere, affecting a much greater number of individuals who do not seek out contact with the venture.

For the most part, the various sources of regulations described in Parts I and II of this Article set out the limits on acceptable corporate behavior. These limits do not have to be purely negative. The duty to disclose material information is an affirmative obligation of a public company. From a purely legal standpoint, it looks quite distinct from a prohibition on looting of corporate resources. As boundary conditions for corporate behavior, however, the two function in a fundamentally similar way. The two rules have limited scope: they specify that as long as a firm satisfies condition X or condition Y, it is free to do as it pleases in every other domain. [158] This quality is both necessary and sufficient to set up a border. By contrast, certain rules, which this Article will label "parameters," leave no room for free decision. Examples of this type include "always do as the Bible says" and "every decision must maximize total social utility."

III.A.2. Why Regulate with Boundaries Instead of Parameters?

There are several reasons why a community would choose to govern business activities through boundaries instead of parameters. The most important one is that a regulator may not be able to identify a universal goal with any confidence. Alternatively, even if she is capable of doing so, she may lack sufficient information to articulate a method by which affected entities should strive for the goal. The truth of either or both of these propositions, however, does not entail that the same regulator could not describe some or even most of the activities that her subjects should avoid.

Despite its abstraction, this rhetoric has a straightforward application to businesses. Members of the American public vociferously disagree on the goals of a public corporation. Some argue that these entities should be dedicated primarily towards generating as much profit

---

[158] It is unclear whether this is entirely correct. The scope of a boundary is the entire domain of an action. Otherwise, it seizes to be a boundary and becomes an obstacle. For example, on a Cartesian x-y plane, a line from (0, 2) to (0, 20) is not a boundary per se. It does not delimit a function in a significant way. If the entire plane is shaded, the total area protected by the line will be 0. By contrast, a line at y = 2, spanning from (0, - ∞) to (0, ∞) will protect an infinitely large area of the plane from shading. Similarly, a circle, defined by y = root of (1 – x^2) will protect an area of 3.1415926 . . . . In a fundamental way, the scope of the latter two functions is global - there is nowhere on the plane where their premise does not hold true – while the scope of the first one is restricted.

as possible; others request that they deploy their resources in a way that benefits the maximum number of citizens; others still ask them to use their size to overcome common-good problems by investing in research and development, but do not object to the companies capturing any surplus resulting from this boost in efficiency. While individual lawmakers, jurists, and regulators hold strong beliefs about the value of the above strategies, no one has yet been able to articulate a universally accepted mission statement for corporations in a capitalist democracy.

Suppose this was not the case because some distinguished body came up with a principle for corporate behavior that garnered global consensus. Even in this idyllic world, in the absence of perfect, complete information, a regulator would still be unable to prescribe a pathway for all existing and future companies to move towards this goal. An instruction to follow this principle would not be sufficient to counteract the destructive attributes of an abstract entity dominated by groupthink and prone to exaggerating individual ambitions. In order to get any meaningful control over the behavior of her subjects that is not rooted in arbitrary, discretionary power, the regulator would have to offer more detailed rules. At this point, she would again encounter an information deficiency. Unless she assumes that she can list all appropriate ways to move towards the goal, she will have to settle for explaining what companies may not do. An arena of free action delimited by specific boundaries thus emerges as a consequence of a desire to regulate corporate conduct with incomplete information.

III.A.3. Second-Order Regulations

In order to craft an informative description of the regulatory arena, one must add a few complications to a model simply demarcated by boundaries. Consider the discussion of rules in the preceding section. Rules aim to achieve certain goals. Limited information available to the rule-making authority should mean that positive prescriptions do not usually make sense because even a conceited regulator will be unlikely to believe that they can articulate the optimal strategy for every business. So, the theory suggests, rational regulators should choose to govern by negative decree.

Some of the rules governing corporate behavior described in Parts I and II clearly fit that description better than others. For example, the duty of loyalty can be neatly characterized as a prohibition on self-interested behavior by officers and directors of a corporation. The SOX requirement that auditors approve internal compliance programs is much harder to squeeze into the boundary box.[159]

[159] The extent that this requirement cannot be recharacterized as a rule but remains a parameter may itself signal a fundamental inefficiency. Part III.A.2 explains that a rational regulator should choose rules as a means of instructing a plethora of firms in getting to some policy destination to deal with her limited information about the specific circumstances facing individual constituents. Unlike most rules, the auditor certification requirement leaves little wiggle room for subject companies. The provision's problem therefore appears to be the presence of a one-size-fits-all approach to regulation where one would expect a broader mission statement ("disclosure of all material risks," "independence of accounting from managerial influence," etc.) coupled with limited prescriptions.

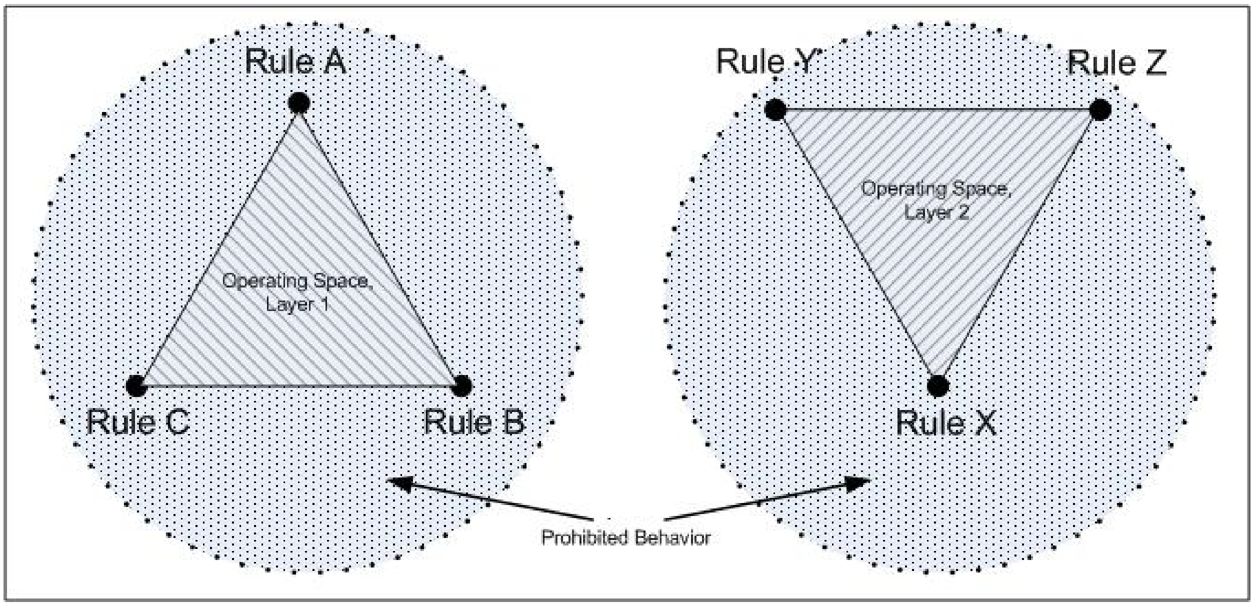

Figure 1

For now, however, suppose the audit requirement can be recharacterized as a negative rule. Even in this case, its superimposition over existing boundaries of corporate conduct may create prima facie inefficiency. Consider a regulatory framework promulgated at time 1 with rules requiring companies to do A, B, and C, but nothing else. This structure demarcates a space for business creativity that observers can visualize as a triangle. Within this sandbox, corporations can do as they please; if they step outside, they by definition engage in prohibited conduct that must be punished.[160] Now, suppose that at time 2, a different rulemaker decrees that while doing A, B, and C, subject entities must also do X, Y, and Z (most pronouncements in the real world take this form because the authorizing body fails to explicitly remove older requirements even if it deems them obsolete). Any preexisting activity that fails to fit into the XYZ space is no longer valid. So long as X, Y, and Z, are all distinct from A, B, and C, the second layer of regulation works as a distinct space (Figure 1). In this system, the cost of a rule is the inverse of its length: challenging regulations are short, lax ones are long. When the requirements of X, Y, and Z are each equally onerous to those of A, B, and C, the two groups

[160] Note that this notion of a fully demarcated arena could not apply to individuals subject to U.S. law. Negative liberties preserved in the constitution and its amendments trump any efforts to "enclose" permissible human behavior by statute or regulation.

should create overlapping equilateral triangles with identical perimeters.

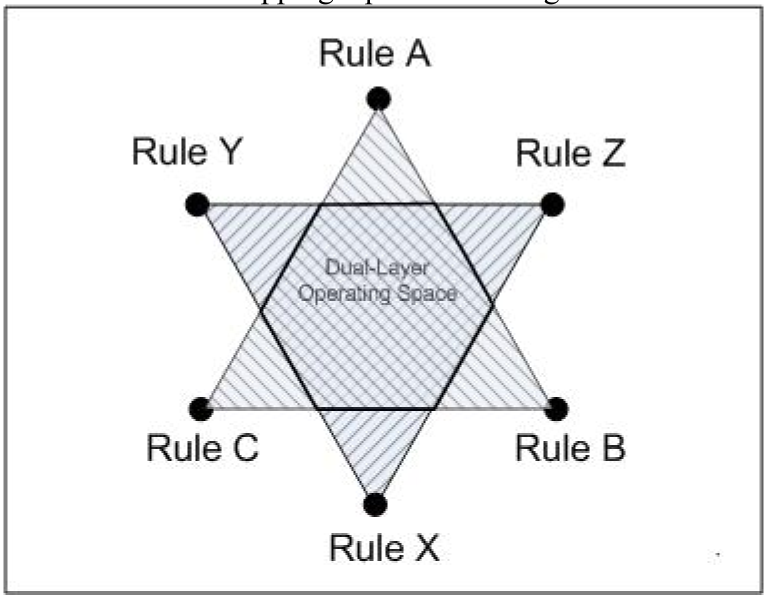

Figure 2

The impact of the superimposition of the second set of rules on corporate behavior is drastic. As illustrated by Figure 2, businesses have much less room to act, with only the shaded interior of the star constituting valid decision space. Recall that the reason for positioning the XYZ vertices between A, B, and C is the distinction between the content of the two sets of regulations. The triangles share a center axis because their motivation – to optimize corporate behavior, broadly – is the same. In the graphical representation, rotating the XYZ closer to ABC would mean that the rules proscribe similar actions; indeed, they become entirely redundant when X, Y, and Z are positioned directly on top of A, B, and C.[161]

By comparison, as shown by Option 1 in Figure 3, one can draw a regular hexagon AXBYCZ that would touch on every policy objective while preserving significant space for companies to operate without interference. A slightly more constricting solution illustrated by Option 2 of Figure 3 would use the outline of the two triangles but delete the internal lines. Policymakers should choose between the two based on their ability to tolerate the risk of an infraction. The narrow approach (Option 1) errs on the side of caution by excluding operating space that is not explicitly endorsed by either set of regulations, while the broader approach

---

[161] This aspect of the model underlines an important point. As mentioned above, when Congress or an agency promulgates a new set of rules for some area, they may amend the previous version of a document dealing with the same general area of activity. The largest constraints on behavior, however, come from the interaction of the new rules with existing, seemingly unrelated provisions. These constraints may be intentional when Congress or a regulator wants to redefine the entirety of the arena of permissible action, but in most cases, they appear accidental and inefficient. It is worth reiterating that cleaning up only those items that the new statute or pronouncement is intended to replace would do little to fix this particular problem. If the older "stumps" are actually similar to new provisions in intent but differ by a matter of degree, old boundaries would run parallel to the new ones. Giving effect to the new legislation would thus mean honoring the freshest line in the sand, be it more or less constricting than the predecessor. Courts and subjects would be expected to have substantial difficulty identifying relevant boundaries only where the prior objectives lie orthogonally to the updates. Part IV of this Article will identify obstruction / compliance as an instance of such hotwire intersections.

(Option 2) allots companies additional freedom to carry out actions that, while not specifically prohibited, may not comply with the internal reasoning of the two individual frameworks.

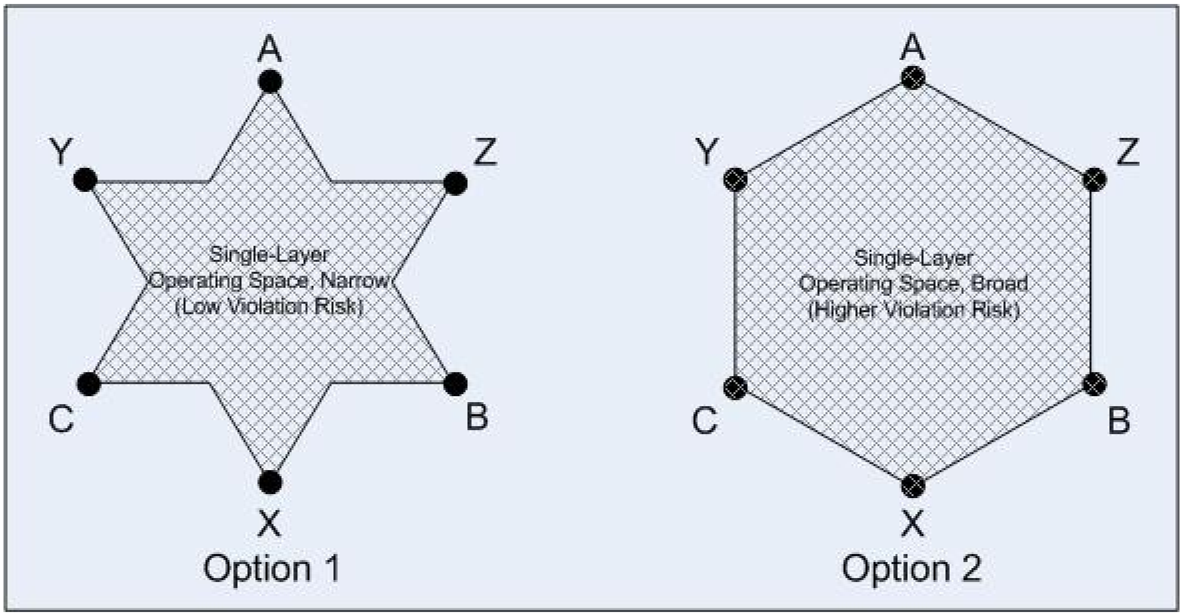

Figure 3

Within the multilayer regulation model, the impact of adding requirements A, B and C varies noticeably across integration methods. As each layer of regulation becomes more complex, the integration-based differences in outcomes increase in scope exponentially. There are many more ways to connect six policy vertices than there are to connect three. Whereas the example given above essentially had three distinct integrated outcomes, a superimposition of a ten-pointed policy initiative over the ABCXYZ landscape would yield hundreds. The choice between these becomes equally difficult to make, even if one knows their precise criteria for evaluating each pattern. If there is uncertainty about the evaluation methodology that attaches to the new pronouncement, the task at hand becomes nearly impossible.

These trends suggest that the body in charge of promulgating a given set of rules should dedicate considerable effort to spelling out their preferred method of integration in the clearest possible terms. Failure to do so will leave later interpreters to playing a game of blindfolded capture-the-flag, with no real way to discern between a myriad of directions. For example, this Article argues that informational asymmetries inherent to the world at large mean that regulators should err on the side of freedom. Therefore, for any given set of objectives, the best method of integration is the one that leaves subject entities with the largest arena in which to operate (Option 1 in Figure 3 below). A reader with a different philosophical orientation may disagree with the assumptions and values feeding into that selection. He may well seek to replace these with his own, but in doing so, he must acknowledge that if Congress had passed his version of the rules, a judge would be much less likely to guess the intended, "best" approach without explicit guidance from the drafters than he would with such information built right in to the regulation.

Furthermore, without the requisite selection criteria, entities responsible for applying the rules may choose a broad reading in one context or a narrow one in another. This asymmetry itself could undermine the objectives of the underlying act without explicitly contravening its prescriptions. Such decisions, whether rendered by a court or an agency, may become very difficult to undo.

Finally, it is worth noting that an adjudicator's decisions on the optimal shape of the regulated arena are independent of their interpretation of the actual statutory commands. The latter process serves only to locate the vertices (A, B, C, X, Y, and Z) on the behavioral plane, whereas the former looks to connect them together into a coherent whole. Clarifying specific commands will not resolve the ambiguity on fit. Instead, at a minimum, the policymakers must specify the extent to which new regulations preempt seemingly unrelated old ones.

III.A.4. Applying the Paradigm to the Real World

Charts and shapes in a legal article prove little. Consider, however, the relationship between obstruction statutes and securities laws. As discussed in Part I, one of the central tenets of the current framework of securities regulation is disclosure of material information. Obstruction charges closely parallel these considerations by punishing individuals who withhold material information from investigators. In both situations, an omission of a key fact can lead to liability. The standard of materiality, however, differs significantly between the two bodies of applicable law.

This divergence leads to peculiar results. A public corporation may submit quarterly reports to the Securities and Exchange Commission that are materially accurate and thereby satisfy all of the requirements of the Securities and Exchange Acts. If, however, the SEC decides to investigate said company for fraud, invites its CEO in for an interview, and the CEO decides to reveal only information contained in Form 10Q, the criminal law may find an obstruction violation.[162]

This result makes little sense. When a person who provides an adequate amount of information in one scenario can be prosecuted on the grounds that this same amount of information is inadequate in a different scenario, the notion of "adequacy" loses meaning. Along with it goes a chunk of the justification for the extant securities regulation regime. If government agents are unable to carry out an investigation without getting information above and beyond that contained in the required quarterly filings, it is not clear how a lay person is supposed to make an informed investing decision on the basis of this same information.

Some might argue that the SEC has a right to more information than private parties because it must carry out its responsibility for enforcing securities laws. On its face, this objection sounds reasonable – the rights of a person suspected of wrongdoing may change from those held by an innocent bystander.[163] The logic of this position, however, does not withstand further scrutiny. Existing securities laws require more than just the disclosure of all information that the issuer deems material. Instead, they impose detailed requirements for the type of data that a company must release to the public and the SEC. These include audits, financial

---

[162] *See, e.g.*, Brogan v. United States, 522 U.S. 398 (1998); *compare with* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (holding that the intent to "deceive, manipulate, or defraud" is required for both private suits and SEC enforcement actions to lie based on a violation of Securities Act § 10(b)); Gallagher v. Abbott Labs., Inc. 269 F.3d 806 (7th Cir. 2001) (holding that there is no duty to update previously accurate quarterly reports with publicly available news of adverse material developments by reasoning that 'a statement may be "corrected" only if it was incorrect when made').

[163] For example, upon indictment or subpoena, a suspect or material witness has to testify about any information that is not privileged. A lay person has no such duty.

statements, certificates for internal compliance programs, a discussion of all risk factors, the name of directors and executives, compensation formulas, etcetera. If the concept of materiality included all of these bits by default, laws and regulations setting out the requirements would be redundant. Since it is common practice to presume that legislation is not duplicative unless clearly proven otherwise, one may conclude that, from the perspective of Congress or the regulators, certain pieces of information are worth disclosing even if they are immaterial. That is, this information would convey more benefit to someone than it costs to disclose and assemble.

So long as the doctrine that a company is required to release all and only material information remains true,[164] the investing public cannot be the intended beneficiary of disclosure requirements' largesse. Thus, to the extent that current regulations force firms to make public data beyond the scope of a bare-bones materiality standard, they must aim to improve the lives of the only other parties with a stake in corporate conduct – the regulators themselves. Of course, criminal statutes frequently have different requirements than civil ones dealing with the same acts. Yet the former almost never punish something when the latter fails to assign liability to it.

In other words, criminal liability ordinarily constitutes a subset of all liability, but the ability of prosecutors to pursue obstruction charges in the absence of substantive securities violations turns this relationship on its head. Ostensibly, the judicial system asks companies to release additional information to make it easier for enforcement agencies to uncover fraud. By doing so, however, criminal law conveys the message that the instructions of its civil sibling should be taken with a grain of salt – by themselves, they can neither provide a defense against later attacks nor offer lay shareholders enough information to detect mismanagement. Yet these instructions carry lofty compliance costs that turn to unnecessary waste when their product becomes useless.[165]

In light of these observations, it is is worthwhile to reconsider the *Samueli* case, introduced in Part II.B.3. Both the SEC and the U.S. Attorney alleged copious instances of fraud, mismanagement, and substantive violations of the Securities and Exchange Acts. Yet to date, the results of the Broadcom investigations have been limited to significant shareholder loss, bad press, and two guilty pleases for obstruction. This outcome does not mesh well with the concept underlying liability for material misstatements and omissions. The reluctance of the prosecutors to press forward with these violations suggests that either the errors were not significant enough to warrant punishment, that the defendants lacked the requisite mens rea for the violation, or worst of all, that substantive regulations of corporate behavior do not actually prohibit stock option backdating. Indeed, the legal status of such activity remains opaque, especially with regard to federal law. Admittedly, the government has certainly made it clear that it frowns on these retroactive grants. Only a foolhardy CEO would engage in this type of behavior in 2009.

---

[164] *Cf.* Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (no private right of action under Securities Act § 12 for material misstatement in private communications underlying a transaction that do not fall into the narrow definition of a prospectus); TSC Industries v. Northway, Inc., 426 U.S. 438 (1976); Blue Chip Stamps v. Manor Drugs Stores, 421 U.S. 723 (1975) (holding that standing under Securities Exchange Act § 10(b) and Rule 10b-5 is limited to actual purchases or sellers of securities); *In re* Trump Casino Sec. Lit., 7 F.3d 357 (3d Cir. 1993) (holding that narrowly tailored, specific cautionary language can turn projections into non-actionable, immaterial statements); Lasker v. N.Y. State & Elec. Gas Corp., 85 F.3d 55 (2d Cir. 1996); *see also* Dura Pharm., Inc. v. Broudo, 544 U.S. 336 (2005); Lentell v. Merrill Lynch, 396 F.3d 161 (2d Cir. 2005).

[165] *See* Deborah Solomon & Cassell Bryan-Low, *Companies Complain About Cost of Corporate Governance Rules*, WALL ST. J., Feb. 10, 2004, at A1 (noting Sarbanes-Oxley compliance costs of between $ 1 and $ 2 million for larger U.S. public companies); *see, e.g.*, *Sarbanes-Oxley Compliance Cost Estimates Soar 62% Since January 2004*, PR NEWSWIRE, Aug. 11, 2004, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY =/www/story/08-11-2004/0002229830&EDATE=.

Yet in light of *Samueli*, even prudent executives must worry the possibility that a contentious exchange with an HR representative in the midst of a legitimate, arms-length negotiation on compensation in economically turbulent times may lead to criminal charges at the hands of a politically motivated prosecutor five years later.

Even a far more comprehensive set of disclosure requirements would improve efficiency if it could satisfy both the investing public and any enforcement agencies. As is, companies spend millions of dollars every year on due diligence associated with reporting standards. They then spend at least as much for internal investigations that examine substantially the same records, albeit with a different standard of accuracy. Indeed, it is difficult to believe that an internal investigation thorough enough to satisfy enforcement bodies would fail to uncover any information that the firm compiles through the reporting process. Put another way, the data listed in offering memoranda and 10Ks is just a subset of the minimum required for full implementation of the current regime. It would be sensible to unify the mandate for the two to eliminate duplicative discovery costs.

III.B. A Methodology for Testing Regulation Through the Multilayer Paradigm

The preceding section set out a general theory of regulation. The purpose of this exercise was to articulate a set of subject-neutral principles that guide policymakers who promulgate rules of conduct. These assumptions can be used to test the value of an entire system of regulation at once, identify its weaknesses, and suggest improvements, all without scrutinizing its individual components. The Section then applied this technique to securities regulation. It singled out the varying standards of materiality contained in obstruction and disclosure jurisprudence as a cause for significant inefficiency for actors who usually have to comply with both bodies of law. Such overlaps between sets of conflicting substantive rules are characteristic of the flaws of second- (and third- through nth-) order regulation. This section will further explore the impact of multilayered rules on real enterprises. It will also address several complex obstacles standing in the way of expanding the first-order paradigm.

III.B.1. Peeling Onions – Identifying Layers of Regulation in the Real World

Many objections can be leveled against this Article's claim that adding overlapping layers of regulation always has an overadditive effect on compliance costs when compared to merely adding identical objectives to a flat regulatory framework. The most important is probably the degree of abstraction involved in making the point. Even readers who accept the soundness of the logic may worry about its applicability to the real world. The distinction between first-order and second-order rules may work on a graph, but how would it hold up in Washington, DC?

Identifying separate layers of corporate law is indeed difficult, but it is important to understand what the process does *not* entail. The proposed evaluation of the regulatory regime does not require the construction of a hierarchy of rules. Though such schemes exist (e.g., the federalism doctrine or administrative law), they are too rough of a tool for the task. While the objectives contained in state law are unlikely to be part of the same "layer" as those in its federal counterpart, they may fall into any number of lesser included target subsets. The source of authority does not help further pare the latter, whereas a strict focus on federal regulation gives the problem a more manageable scope.

The issue then is how one can sort the objectives of, say, the '34 Act, SOX, and the Obama Stimulus Plan into some coherent whole. It is not productive to merely say that the current framework consists of several (dozen) layers of overlapping objectives and should be flattened, since one needs a vision of what its single-layer equivalent would look like. The last goal may not be particularly susceptible to explanation by imagery, but certain functional conclusions make it tangible / less opaque. For example, a flat system of rules would permit a company to avoid wasting time and money to comply with parallel requests to do largely the same thing.

Moreover, a flat system would allow a rational, well-informed entity to plan a single, comprehensive compliance strategy that balances the cost of following each rule with the punishment for violating it. Public companies, with their armies of inside and external counsel, quality monitors, and compliance experts, are usually actors of this sort. They should be able to commit a constant amount of money and staff to an autonomous compliance unit that would produce all necessary reports and check for internal violations. In the case of a government investigation, this unit should be able to produce all necessary documentation and identify the locus of the problem quickly.[166] Its members could then advise executives (in the presence of their own, personal criminal attorneys) on what information the latter need to provide in order for the investigation to reach a particular conclusion. In some situations, this advice would include a decision that no violation occurred and the firm should vigorously contest any charges within the bounds of the judicial system. In others, given the information already available to this compliance unit, turning over likely culprits and admitting responsibility may be most prudent.

The key feature of this arrangement and others like it is that the firm anticipates its informational needs ex ante, plans a process to get this information, and holds the depth of inquiry steady across a slate of unanticipated events. Obviously, this is an idealized vision – some developments would require further investigation or review of existing records. Nonetheless, the nature of the task that a company faces would fundamentally change. Donald Rumsfeld's terminology sheds much light on the transformation.[167] Previously, notice of official concern about possible misconduct cast the enterprise into a search for unknown unknowns – the response was to find data that may or may not have existed describing violations that may or may not have occurred. If an internal investigation did not reveal evidence of misconduct, one could not determine whether parties were innocent or the investigation itself deficient. *Computer Associates* presented an example of just this kind of dynamic. By contrast, under a single-layer disclosure requirement, accusations would lead the firm to examine a known quantity of material information. If this set of information did not contain evidence of a violation, one could reasonably conclude that such evidence did not exist. The violation may have still occurred, but it would have been undocumented and as impervious to investigation as any other cold case.

---

[166] This would be like setting up a library that keeps constant track of key publications. Then, users could search the library catalog when they need certain information and feel fairly confident that whatever is there does not exist. By contrast, the current approach is akin to going to a bookstore or Amazon and trying to buy all relevant books the week before a paper is due. The selection that exists is not cataloged appropriately, nor is it a cross-section of important publications across time. Instead, it is just a set of pieces that exists.

[167] Hillary Profita, *Known Knowns, Known Unknowns And Unknown Unknowns: A Retrospective*, CBS NEWS, Nov. 9, 2006, http://www.cbsnews.com/blogs/2006/11/09/publiceye/entry2165872.shtml; Hart Seely, *The Poetry of D.H. Rumsfeld*, SLATE.COM, Apr. 2, 2003, http://www.slate.com/id/2081042/; *see also* Richard J. Herring, Essay, *The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis*, 26 YALE J. ON REG. (forthcoming 2009).

III.B.2. Other Tell-Tale Signs of Flat Regulatory Structures

Flat regulatory structures carry other operational attributes. For example, they rely on consistent terminology within their own boundaries. This operational vocabulary should be unique to the greatest extent permitted by natural language. If reasonably distinct from other areas of law, this set of key terms will serve to delineate a regulatory arena that focuses primarily on certain objectives peculiar to its subject. Practices prevalent in other fields will not unintentionally muddle the internal logic of such an arena because their elements will be largely distinct. Thus, the federal standard for good decision-making by corporate officers would have to rely on concepts unlike those of the states.

While such an approach may seem to strew confusion, difficulty in formulating a new terminology to describe a matter already covered by an existing set of rules would probably deter those who care to reinvent the wheel. On the other hand, if an issue has not been dealt with, the relevant vocabulary would be up for grabs. Finally, in case a regulatory authority decides to promulgate rules governing a space controlled by someone else, the distinct standards would offer a clear choice to adjudicators evaluating the merits of one or the other. As such, courts would be forced to guess the meaning of ambiguous, overlapping measures to a much lesser extent than in the status quo.

Part IV. Evaluating the Compliance Regime through the Multilayer Paradigm

IV.A. Compliance Requirements Generally as Second-Order Regulation

Recall the discussion of the interaction between substantive disclosure requirements and current compliance practice in Part III.A. The dynamic provides the starkest example of inefficiencies of a dual-layer regulatory regime and merits further exploration. It is worth noting that compliance is not a term of art. It does not appear in the Sarbanes-Oxley Act itself, and it is not defined by any relevant regulations. Instead, compliance is a broad notion that spans several distinct but related processes that operate within a public corporation.

IV.A.1. Damage Control

First, compliance includes activities that companies undertake to mitigate harm from substantive violations by their employees or agents. Crucially, these procedures attempt to fix any problems created by a known act of misconduct only after this misconduct has been discovered by management, a regulator, or some other enforcing agency. Compliance in this context includes reviewing transaction records and account ledgers for inaccuracies; identifying any gaps in the documentary record created by the perpetrator to hide his activities; finding and disciplining any individuals who participated in the misconduct; reviewing and repairing financial statements and Exchange Act reports for any inaccuracies stemming from a known instance of misconduct; and issuing press releases or media updates necessary to communicate the remedial process. All these activities are fundamentally retrospective – they seek to return the company to the state in which it would have found itself but for the misconduct.[168]

[168] Removing and / or disciplining any individuals who participated in the misconduct contains both retrospective and prospective elements. The activity looks backwards to the extent that it seeks to punish deviation from company rules of conduct. It looks forward in aiming to prevent future violations of a similar sort by removing or debilitating

IV.A.2. *Internal Controls – Prevention and Record-Keeping*

Second, compliance involves the implementation of the managerial and data-collection apparati required by SOX §§ 302, 404, and associated regulations.[169] As discussed in Part I.B, SOX § 302 requires officers of a reporting company to establish and certify the quality of internal controls over financial reporting that are supposed to ensure that material information about the issuer gets to the correct individuals.[170] Section 404 then elaborates on this command.[171] Regulatory guidance for auditors explains that to satisfy the statute, an appropriate compliance program would include robust devices designed to identify any fraudulent transactions, such as controls over significant managerial estimates or internal transfers.[172] SEC Releases that provide managerial instructions on the matter generally concur with the accounting rules. The Commission, however, emphasizes record-keeping, both for actual screening of decisions that carry a significant risk of generating a material misstatement and for documentation proving that the compliance system works overall.[173]

---

the most likely perpetrators. This blend, however, is characteristic of most punitive sanctions, including those in the criminal law. When examined with the rest of the mitigation steps, the employee penalties look primarily retroactive, especially when contrasted with the other types of compliance activity.

[169] *See* Part I.B, *supra*; 15 U.S.C. §§ 7241(a)(4)(B), 7262 (2006); Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (Aug. 14, 2003), *available at* http://www.sec.gov/rules/final/33-8238.html, [hereinafter Release No. 34-47,986].

[170] 15 U.S.C. §§ 7241(a)(4)(B) (2006) ("the signing officers . . . are responsible for establishing and maintaining internal controls").

[171] 15 U.S.C. § 7262 (2006).

[172] *See, e.g.*, PUB. CO. ACCOUNTING OVERSIGHT BOARD, AUDITING STANDARD NO. 5 – AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS AND RELATED INDEPENDENCE RULE AND CONFORMING AMENDMENTS, Release 2007-005 at 7, A1-9 (Par. 14, 15) (2007), *available at* http://www.pcaobus.org/Rules/Docket_021/2007-05-24_Release_No_2007-005.pdf.

[173] Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 55,929, 77 Fed. Reg. 35,324, at 35,337-35,348 (June 27, 2007); Release No. 34-47,986, *supra* note 164. Release No. 34-47,986 defines "internal Control over financial reporting" as:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors,50 management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

Id.

In practice, internal control systems store most copies of employee electronic communications, automatically check certain allocations, and flag suspect transactions for review.[174] In addition to the automated functions, compliance policies of this sort may feature complex managerial rules and employee regulations.[175] Both the SEC and PCAOB favor a mix of human and computerized controls, and a heterogeneous approach makes sense in light of technological constraints (machines are far inferior to people when it comes to identifying distressed or lying workers). Accordingly, these systems may involve layers of supervision for certain departments, often by parallel bodies. Anonymous tipping systems set up to encourage and protect whistleblowers would also logically fall into this category of enterprise behavior. These may include mandatory up-the-ladder reporting requirements akin to those targeting attorneys in Section 307 of SOX.[176] Overall, the focus of the second type of compliance behaviors is proactive – they ferret out irregularities and try to prevent fraud before it happens. By doing so, the programs shape the overall information environment of the enterprise by collecting and organizing key data. They thus lay the foundation for the third type of compliance behavior.

IV.A.3. Internal Investigations.

Even with the two types of systems described above firmly in place, firms often have to undertake emergency action to deal with tips about potential misconduct that come from either concerned regulators or private whistleblowers. The corporate response usually takes the shape of an extensive internal investigation where either a high-level manager or outside counsel review records, interview employees, and compile a report detailing their findings. Both statutory and practical concerns motivate this behavior.[177] Pursuant to SOX § 301, the Board is obligated to follow up on the receipt of any allegations of material misconduct.[178] Practically, even with the advent of the McNulty Memorandum, internal investigations are a key element of cooperative behavior with the government.[179] Failure to undertake them or turn over results to the government often threatens the firm with dissolution through indictment, or, at best, severe monetary penalties.[180]

IV.B. Contextualizing the Impact of Compliance Practices

While the three types of compliance are each reasonable responses to different kinds of pressure in their own right, they interact to form several noxious effects. Internal Control systems usually maintain permanent records of most workplace communications and decisions.[181] At the

---

[174] *See, e.g.*, Andrew R. Lee, Keep or Toss? Document Retention Policies in the Digital Era, 55 LA Bar J. 240, 246-47 (Dec. 07 / Jan. 08).
[175] *Id.*
[176] See SOX § 305, 17 U.S.C. § 7245 (2006); 17 C.F.R. § 205 (2008).
[177] *See* Lee, *supra* note 173.
[178] 15 U.S.C. § 78j-1(m)(4) (2006).
[179] See O'Sullivan, *supra* note 112.
[180] *See id.*
[181] *See, e.g.*, Zubulake v. UBS Warburg, LLC, 220 F.R.D. 212 (S.D.N.Y. 2003); Lee, *supra* note 173, at 241-242; Fran Howarth, *Emails That Come Back to Haunt: Deleted? May Be Not …*, THE REGISTER, Apr. 26, 2004, http://www.theregister.co.uk/2004/04/26/email_data_retention/; Jesselyn Radack, *I Learned the Hard Way that E-Mails Are Forever: They Never Really "Disappear,"* DAILYKOS.COM, Apr. 12, 2007, at http://www.dailykos.com/story/2007/4/12/54612/8770; Press Release, United States Attorney's Office, Eastern

same time, such systems set up channels for anonymous complaints and encourage employees to report suspicious behavior. They often supplement the latter prong with an up-the-ladder provision that requires managers in receipt of complaints to forward them on to ostensibly less partial higher ups. Meanwhile, pragmatic managers and competent legal advisors understand that failure to investigate an allegation in good faith could prove extremely damaging if later uncovered by the authorities; indeed, beyond merely suggesting that a company is not cooperating, it can lead to obstruction charges against the firm and its executives.

The existence of compliance systems generates further troublesome path-dependent corporate behavior. In a sufficiently complex enterprise, employees routinely have to make complicated decisions based on imperfect or incomplete information. This context means that frequently, a good choice is not obviously correct and a bad choice is not obviously wrong. Many options may seem equally worthwhile. The Business Judgment Rule discussed in Part I.A insulates the behavior of managers and directors from excessive ex post scrutiny by shareholders for this very reason. Problematically, compliance systems may do quite the opposite, exaggerating errors and even creating illusory violations.

IV.B.I. A Reasonable Example of a Difficult Decision

Consider Adam, a worker who has to make a difficult decision about the percentage of a loan portfolio that will become uncollectible and must be written off. Suppose further that this "bad loan share" is a crucial metric for comparing the company to its competitors and that Adam gets a bonus every year that varies in proportion to it. Adam, however, works closely on managing the portfolio with Barbara, a member of the tax planning office tasked with minimizing taxable corporate income. From Barbara's perspective, larger bad loan estimates create legitimate amortization deductions if they are accurate and improve free cash flow for the company. Of course, Barbara recognizes that excess deductions may lead to future tax liabilities. Since the company is under continuous IRS audit, however, the danger from overstating these is relatively small. As long as the deductions do not venture into the clearly abusive territory, the company will simply have to reimburse the Service for the challenged item.

After a volatile Q4 2008, Adam and Barbara both attempt to value their loan portfolio. Adam is reasonably optimistic and believes the company's customers have weathered the worst of the financial storm. They cut inefficient side business, trimmed their workforce, and decreased their debt-to-equity ratios. In his experience, these steps mean that the proportion of borrowers defaulting on their loan should decrease compared to previous year. Barbara, on the other hand, sees these same decisions as symptoms of an increasingly severe economic contraction that will drastically reduce the debtors' revenue and free cash flow. These developments would make it difficult for companies to pay back existing obligations at the very time when future profits and the concomitant incentive to stay in business begin to diminish. Barbara believes that the company should prudently recognize the incoming storm and attempt to minimize tax expenditures. Unfortunately, the staff economists at work have been too busy dealing with internal viability forecasts to provide detailed advice to the managers.

With all of the above facts in mind, Adam proposes a 5% loan write-off. Barbara responds that 20% is the more reasonable amount. Following a series of increasingly heated

---

District of New York, Two Senior Managers of Bear Stearns Hedge Funds Indicted on Conspiracy and Fraud Charges (June 19, 2008), *available a*t http://www.usdoj.gov/usao/nye/pr/2008/2008jun19.html (referencing email communications between the individuals and their colleagues from several prior years).

phone calls and email exchanges, Adam takes a deep breath and acknowledges that Barbara's figure is probably more accurate – she has been working at the company longer and has a master's degree in finance. Moreover, the resounding messages of impending doom in the media make any optimistic projections seem at best naïve, and at worst misguided; after all, seemingly healthy companies are falling apart like decks of cards for increasingly complex reasons. Adam's calculations support his estimate, but he figures some implicit, outdated assumption in his model drives the currently erroneous conclusion. The two settle on 15% as the projected amortization of the loan portfolio.

IV.B.II. How Compliance Systems Turn the Business Judgment Rule Inside Out

The above behavior is innocuous; indeed, both Adam and Barbara appear to be model employees: thoughtful, diligent, dedicated, willing to change their minds. Unfortunately, the compliance regime distorts these characteristics into far more nefarious traits. If neither Barbara nor Adam was exactly correct and total defaults rose to 20%, records of their discussion collected by the ICFR system would look like an intentional disregard of the correct estimate. Certainly, some of Adam's concerns will also be reflected in the correspondence trail, but so would the parameters of his decision – a contingent bonus and ongoing pressure to outperform competitors in the short term. Moreover, from the perspective of future observers, the two employees may have disregarded instructions in the company manual to report material disputes to their respective supervisors. Both would probably argue that, in a time of rolling layoffs, they feared bothering their boss with mundane matters that could be interpreted as incompetence, but the transgression may be enough to initiate a firm-wide investigation into similar practices as an insurance policy against future prosecutions.

An alarming twist arises out of the result of this investigation. Even if management uncovers no wrongdoing at all, they will compile a report detailing what appear to be a set of reasonable disagreements on hard questions. The company will then store this document indefinitely. If at some point in the future a young, politically-motivated U.S. Attorney decides to examine possible fraud at an enterprise teetering on the brink of collapse after receiving billions of dollars in federal aid and wiping out as much in shareholder value, management will be put to an uncomfortable decision. They could either withhold prior reports identifying and exculpating instances of suspicious behavior from the prosecutor and risk an obstruction charge a la *Computer Associates*, or turn the documents over and play into to the previously unfounded charges.

As illustrated above, the combination of obstruction of justice statutes with practical and legal compliance requirements essentially turns the traditional Business Judgment Rule inside out by encouraging enforcement agents to second-guess managerial decisions. In this environment, an employee who changes his mind under adverse circumstances lays the foundation for a crime even in the absence of any guilty mens rea. Rather, a system that accumulates an ongoing record of these actions without simultaneously tracking the entirety of the circumstances creates a fertile ground for politically-minded prosecutions later on. Routine deviations from industry practices that do not receive an official reprimand begin to look like low-level fraud, or, more likely, a managerial dereliction of duty. Mistakes that do set off the hair trigger for some degree of internal investigation but lead to an exculpatory conclusion are far worse – they create the image of an intentional cover-up by executives who allegedly looked the other way when things were going awry on the shop floor.

IV.B.III. Enforcement Raids and Fishing Expeditions

Since multiple parties are aware of the existence of a mass of potentially damaging information within corporate records, the extant compliance posture encourages fishing expeditions. Disgruntled employees can handicap the careers of their superiors or competitors at nearly zero cost by anonymously alleging misconduct by these individuals. Within most robust internal controls systems, these tips trigger internal investigations that can be ruinous for workers and very costly for the enterprise, both from a monetary and a reputational perspective. Indeed, if these internal investigations yield nothing of note, as would be expected from a wild goose chase, they can still put the company in peril at a later, official confrontation by suggesting that the managers did not look hard enough. Worse yet is the possibility that the executives uncover some behavior that looks suspicious and happens to roughly match the anonymous allegations, but, unbeknownst to organizers is actually innocuous. In this situation, the company is likely to discipline productive employees for being more successful at their jobs than the lazy, disgruntled ones, all because of an overwhelming desire to preserve an innocent, scrupulous image for any potential conversation with government officials in the future.

In fact, inserting a government official in place of the anonymous private tipster who sends out false alarms to carry out private vendettas yields an even grimmer outcome. If an agency voices concern over potential violations within a firm and asks the target to carry out an internal investigation and turn over the results, the costs to the enterprise remain somewhat constant. The company has to pay for outside counsel, managers have to focus their work on looking for ethereal culprits, transaction costs for the business generally go up. Shareholders take an additional hit due to reputational consequences that are likely to depress the stock price. In one area, however, the firm bears a lot more damage. Here, if the allegations happen to match a record of actual behavior, the costs to the target will not be capped at merely firing a good worker while potentially holding on to a bad one. Instead, the coincidence will start in motion a much harsher legal process, since now the enforcement authority will have evidence to match its theory of guilt.

Curiously, a company would fare better in such a situation if the prosecutor initially embarked on the fishing expedition with the express motive to boost his status, rather than due to a misguided suspicion of genuine violations. The former would likely have a better strategic understanding of the internal dynamics the company faces within the compliance regime. He would be unlikely to assume that the match in question by itself signifies the presence of genuinely harmful conduct. As such, he would extract political rents from the firm only up to the point where the damage his actions cause to the entity (by destroying jobs, eroding the local tax base, and hurting shareholders) begin to outweigh the benefit to his reputation for being tough on crime. By contrast, the righteous but paranoid government investigator would be less likely to look at the newly conforming data skeptically. His goals would be to genuinely clean house in the target company. Since, by hypothesis, no real violation occurred (recall that the matching conduct is innocent but suspicious), the prosecutor would lack a natural endpoint to his demand. After all, the individuals he is likely to blame are no more culpable than their officemates. Moreover, any company-wide program that he requests to prevent future violations would by definition constitute deadweight loss on society – these safety measures would be no better at preventing a nonexistent violation from taking place than the previous ones.

IV.C. The Specific Harms of the Compliance Regime

Of course, U.S. Attorneys or SEC lawyers can go on fishing expeditions in the absence of internal control systems. Likewise, frustrated employees can attempt to sabotage their supervisors' careers without using tipping hotlines established by the company – an unsigned letter slipped under the CFO's door would do as much. As previously mentioned, however, the compliance regime generally acts as a catalyst that amplifies properties of the original substance almost beyond recognition.

If a private party makes a complaint in the absence of an anonymous whistleblower system, two things can happen. First, the recipient can take heed of the allegations and check them in good faith. If he finds nothing, he would be under no responsibility to save the results of his investigation for posterity.[182] If misconduct did take place, the officer can punish the perpetrator, document the behavior, and move on. In the second state of the world, the recipient of the allegations would ignore them, again in good faith – perhaps because he knows that the harsh economic climate has caused widespread employee discontent or because he has recently carried out a comprehensive survey of the operations in question. In the absence of an internal controls system that requires up-the-ladder reporting and documents the overwhelming majority of corporate communications, the decision to do nothing based on the allegations would benefit from the veil of the Business Judgment Rule. Once the above mechanisms are in place, however, failure to take action begins to look like obstruction from the viewpoint of future investigators.

With respect to government authorities, the impact of the compliance-obstruction mix is even more potent. Human beings maintain a relatively steady accuracy rate in a given task across time, with each person carrying their own intrinsic rate of error.[183] Training improves the performance for most individuals; time pressure and fatigue worsens it.[184] While empirical work on these findings has focused primarily on elementary tasks, its lessons should naturally apply to the office environment. That is, for any given position and degree of experience, employees will make mistakes with some constant frequency x (that is, x times out of 100, they will fail to perform their assigned job correctly). Sometimes the errors will be involuntary; other times they will be malicious. The point, however, is that, for present purposes, one can expect to have a steady flow of both types of results.

When a company implements a new, more comprehensive system of internal controls and records, it should generally document a greater number of infractions than management previously detected.[185] At the same time, unless the firm is generally committed to

---

[182] *See* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) ("a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.").

[183] *See, e.g.*, David E. Kieras & David E. Meyer, The Role of Cognitive Task Analysis in the Application of Predictive Models of Human Perfomance, *in* COGNITIVE TASK ANALYSIS 237-60 (J. M. Schraagen, S. F. Chipman, & V. L. Shalin, eds., 2000); David E. Meyer & David E. Kieras, *A Computational Theory of Executive Cognitive Processes and Multiple-Task Performance: Part 1, Basic Mechanisms*, 104 PSYCHOL. REV. 3 (1997); Joshua S. Rubinstein, David E. Meyer & Jeffrey E. Evans, *Executive Control of Cognitive Processes in Task Switching*, 27 J. OF EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 763 (2001).

[184] *See* Kieras & Meyer, *supra*.

[185] Conceivably, employees can begin to concentrate harder on their work when they know their performance is being monitored more accurately, thereby decreasing the rate of errors. Such behavior seems unlikely, however, unless the increased probability of detection also entails an increased probability of punishment. A robust compliance system guarantees the former, but not the latter. It will record a lot more information, thereby capturing evidence of faulty performance, but any interpretation of this data stream will still have to be made by human beings.

revolutionizing its culture, supervisors are unlikely to pursue a significantly greater number of the violations than before. Managerial resources (number of available people and their time) are fixed in the short term and the firm is unlikely to want to contribute an increased share of these to discipline. This is especially so when the stated purpose of most compliance systems is to decrease the amount of time spent on remedying non-material infractions by efficiently identifying those instances of conduct that deserve attention. Intuitively, this latter type of behavior must fall or stay the same, not go up; its share of total infractions should also stay constant. However, the gross number of detected employee violations should go up due to greater systemic sensitivity as a whole. In turn, this means that rational managers will intentionally ignore or unintentionally avoid knowledge of a larger *number* of mistakes by their teams.

All the transgressions will remain on the record, however. Indeed, with the aid of the first two types of compliance apparati, they will multiply. Some of the items the new system detects will actually merit internal investigations, which are as prone to errors as any other processes. The review of employee misconduct will thus lead to the creation of more instances of misconduct simply because the review itself constitutes work that would not have existed otherwise.[186] As pointed out above, both accidental and intentional infractions are the unavoidable product of the combination of human fallibility and work.

The easily accessible, searchable records of all these violations generate fodder for unscrupulous enforcement officials. Before the advent of comprehensive compliance systems, government investigators could allege misconduct and force a company to turn over some finite amount of data. Alternatively, the authorities could request that the target carry out an internal investigation and return the results. In either case, investigators received a limited amount of material from which they could build conforming evidence in fishing expeditions. The proliferation of internal control systems with up-the-ladder requirements, anonymous tip hotlines, and obligatory "key point" review has increased this amount of raw material by an order of magnitude while simultaneously making it easier to search. As argued above, these changes have actually generated a greater gross number of violations. Any one of these can provide fuel for a damaging prosecution. Enforcement officials rarely seem to care and almost never measure the rate of violations within an enterprise,[187] focusing instead on their absolute number. By doing so, they essentially create a secondary tax on compliance, further raising the efficiency costs of the current system.

Conclusion

To be clear, the above consequences stem neither from the existence of compliance programs broadly, internal control systems particularly, or even obstruction statutes alone. Political turbulence and alternating business cycles catalyze the mix into its present form. The latter ingredients, however, are ever-present in the status quo. A regulatory system looking to

[186] It is reasonable to assume that firms will staff their most competent workers on internal review matters. While the intrinsic error rate of these individuals is likely to be significantly lower than that of the average employee, they will still make some mistakes.

[187] *See* Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 YALE J. ON REG. 1 (2008); *cf.* Macey & O'Hara, *supra* note 27, at 109. *See generally* Theodore Eisenberg & Jonathan R. Macey, *Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients,* 1 J. EMPIRICAL LEGAL STUD. 263 (2004) (showing that the rate of financial restatement by Arthur Andresen clients did not differ significantly from the rate of restatement for clients of the other Big 5 accounting firms).

optimize economic performance while honoring retributive justice concerns must take them into account.

Arguably, eliminating prosecutorial discretion would also go a long way in reducing the efficiency costs of the compliance regime. If enforcement agents who brought charges of obstruction had to commit to litigating them before a judge, they would be less likely to allege such violations for political gain or due to earnest but paranoid desires for corporate discipline. Moreover, if the number of bench trials for obstruction skyrocketed, one could reasonably expect the standards of disclosure and good faith behavior for reporting companies to converge, simply because good jurists would recognize that both issues examine the same general set of enterprise behavior.

Prosecutorial discretion is not going anywhere any time soon, however, at least not in the United States and especially not at the federal level. Efficiency-minded policymakers thus need to find a different solution to excessive corporate compliance costs. A systematic eradication of multi-layer regulations offers one alternative. In a structure of flat rules, firms would have a lot more freedom to optimize their performance while still operating within the constraints of social morality. The next best approach would be to explicitly encourage judges and other adjudicators to interpret overlapping regulatory decrees as specific objectives, not general principles, thereby preserving maximal room for unfettered corporate creativity. At a minimum, Congress and administrative agencies need to clearly spell out their preferred criteria for integration to end the secondary efficiency toll that currently comes from uncertainty. This change would permit interpreters to use a more restrictive method of interpretation as a default while honoring the regulator's intent to preserve freedom of action in cases that feature the appropriate instruction.

If either the first or the second recommendation came into fruition, companies would no longer face the threat of dissolution for assuming a defense posture in response to allegations. Rather, they would be able to confidently point to the required periodic reports and auditor memoranda as fulfilling their disclosure obligation to the government. That is, potential defendants would be able to legitimately argue that the authorities are not entitled to any information beyond that which the companies already put forward into the public sphere to build their case. Of course, even a perfectly flat regulatory structure would not immunize individual perpetrators within the firm, who would still face the choice between cooperating with the government for reduced sentences and gambling on a criminal trial. Moreover, the substantive aspect of obstruction violations would remain: enterprises would not be entitled to knowingly destroy records or affirmatively interfere with officials' efforts to construct a case out of publicly available information. Given the above dynamics, politically minded enforcement agents would be far less likely to attempt fishing raids on large enterprises, since they would have far fewer chances to get a fortuitous match.

There is no shortage of calls for regulatory reform at this time. Pundits from both sides of the political spectrum have proposed a variety of new constraints on the behavior of corporations and their employees in an effort to tame "runaway greed and excess speculation." While many of these ideas are the worst examples of reactionary populism, some doubtless have merit. Yet when evaluating their worth, policymakers must consider their impact in the context of the existing regulatory regime as a whole. This Article seeks to establish a new paradigm for such examination (multilayer regulation) and point towards one direction where close scrutiny may be particularly important (the interaction of obstruction and compliance regimes).