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CORPORATE CRIME AND DETERRENCE

Assaf Hamdani & Alon Klement

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This Article sheds new light on the controversial doctrine of corporate criminal liability and other forms of collective sanctions. Critics contend that the use of criminal law to target business entities is undesirable given the disastrous consequences for firms convicted of misconduct, as graphically illustrated by the unraveling of the accounting firm Arthur Andersen. At the same time, the threat of going out of business is commonly perceived as providing firms with powerful incentives to contain misconduct. In this Article, we challenge the conventional view concerning the deterrence value of corporate criminal liability. Specifically, we show that harsh entity-level penalties might discourage monitoring for misconduct and undermine compliance incentives within professional firms. We also identify the conditions under which civil fines might enhance deterrence. Our analysis has implications for entity criminal liability and collective sanctions more generally. We call for greater reliance on purely financial corporate penalties and provide a deterrence-based justification for modifying the existing doctrine for holding firms criminally liable. We also explain why prohibiting law and accounting firms from organizing as limited-liability entities might be unwise.

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INTRODUCTION

The doctrine of corporate criminal liability is notoriously controversial. For decades, scholars have argued that imposing criminal liability on business entities is both ineffective and inconsistent with the fundamental principles of individual culpability and moral condemnation underlying criminal law.[1] It is therefore not surprising that the federal government's post-Enron campaign against corporate crime has reignited debate over the proper use of criminal law to target business entities.[2]

Critics of corporate criminal liability often invoke the disastrous impact of a criminal conviction on firms, employees, suppliers, and other innocent third parties.[3] Consider the case of Arthur Andersen LLP. Formerly one of the "Big Five" accounting firms, Arthur Andersen was convicted in 2002 of obstruction of justice for its destruction of Enron-related documents.[4] The conviction forced the firm to go out of business, thereby making 28,000 employees in the United States lose their jobs.[5] Not surprisingly, Arthur Andersen's tragic fate has sparked calls for sharply limiting the prosecution of business entities.[6]

But while the dramatic consequences of corporate liability occupy a prominent role in the ongoing policy debate, the deterrence effect of these harsh consequences remains largely unexplored by legal academics.[7] This omission is troubling, as the predominant justification for corporate criminal liability is its effectiveness as a necessary tool for combating organizational misconduct.

Commentators typically assume that harsh corporate penalties, including the threat of going out of business, provide firms with powerful incentives to contain wrongdoing.[8] Some find these incentives to be excessive,[9] while others

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1. *See, e.g.*, Brent Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions*, 56 S. CAL. L. REV. 1141, 1183 (1983) (referring to corporate criminal liability jurisprudence as "the blackest hole in the theory of corporate criminal law").

2. *See, e.g.*, Symposium, *Corporate Criminality: Legal, Ethical, and Managerial Implications*, 44 AM. CRIM. L. REV. 1269 (2007); *see also* Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 854 (2007) ("In the past few years, federal prosecutions of organizations have sharply accelerated . . . .").

3. *See, e.g.*, Sara Sun Beale, *Is Corporate Criminal Liability Unique?*, 44 AM. CRIM. L. REV. 1503, 1522 (2007).

4. This conviction was overturned by the Supreme Court in 2005. Arthur Andersen LLP v. United States, 544 U.S. 696 (2005).

5. *See* Elizabeth K. Ainslie, *Indicting Corporations Revisited: Lessons of the Arthur Andersen Prosecution*, 43 AM. CRIM. L. REV. 107, 107 (2006).

6. *See* COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT, at xii (2006) ("[C]riminal enforcement against companies, in light of the experience of Arthur Andersen, should truly be a last resort . . . ."); Ainslie, *supra* note 5, at 110 ("[C]riminal prosecution of business entities should be considered only when it is clear that no civil sanction . . . will suffice to deter the corporate misconduct.").

7. *But see* V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1499-1512 (1996) (considering the extent to which reputational penalties could deter corporate crime).

8. *See, e.g.*, Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1097 (2006) (referring to such penalties as providing "deterrence on a massive scale" (quoting Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't

posit that only the threat of going out of business can effectively deter organizational misconduct. Yet, the prevailing view is that prosecutors should balance the need to deter corporate crime against a conviction's dire consequences for employees and other innocent stakeholders.[10]

In this Article, we show that subjecting business entities to criminal liability carrying severe collateral consequences might, in fact, undermine deterrence. Indeed, purely financial penalties could contain misconduct more effectively than the threat of going out of business. To be sure, severe corporate penalties might produce powerful compliance incentives in some cases. As we shall explain, however, such penalties are likely to fail precisely when entity liability is vital from a deterrence standpoint, i.e., in decentralized organizations where individual wrongdoers are difficult to identify.

Part I begins our analysis by providing necessary background concerning both the doctrine of corporate criminal liability and its collateral consequences. The prevailing respondeat superior doctrine holds entities criminally liable for every offense committed by an agent within the scope of employment.[11] At the same time, a conviction can deal corporate defendants a fatal blow even when courts impose relatively modest penalties. Firms may thus unravel due to a variety of non-criminal sanctions triggered by a conviction, such as delicensing, exclusion from government contracts, and irreparable damage to reputation. Indeed, the most telling evidence of the fatal consequences associated with a conviction is the growing success of prosecutors in compelling companies under investigation to assist them in bringing charges against their own employees and officers.[12]

Components, U.S. Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm)).

9. It is difficult to find an economic justification for corporate sanctions that aim at putting firms out of business, as optimal deterrence requires that penalties equal social harm (discounted by the probability of detection). *See* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 192 (1968). To be sure, an offense may be strictly undesirable from a social perspective, thereby justifying an attempt to secure full deterrence. Yet, legal economists believe that this objective should not dictate the magnitude of firm-level sanctions. *See* Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 322-27 (1996).

10. *See* Garrett, *supra* note 2, at 859 ("The DOJ could seek to impose optimally deterrent fines, but the dire collateral consequences of such an approach make it highly undesirable.").

11. *See* Kathleen F. Brickey, *Andersen's Fall from Grace*, 81 WASH. U. L.Q. 917, 929 (2003) ("Under the respondeat superior rule applicable to federal criminal trials, the acts and intent of agents at any level of an entity's hierarchy—including those at the lower end of the organizational ladder—are imputable to the firm."). For suggestions that imposing liability for misconduct committed by employees against corporate policy or without management's involvement is unfair, see William S. Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability*, 37 AM. CRIM. L. REV. 1285, 1297 (2000).

12. *See* Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 331 (2007) (noting that the threat of indictment induces companies to hand over internal documents and rat out individual employees as targets for

Our analysis then focuses on two distinct channels through which entity liability affects compliance. Part II considers *professional firms*. As the Arthur Andersen case demonstrates, holding a professional firm criminally liable would most likely trigger its demise.[13] Unlike shareholders of a corporation, members of professional firms are both part-owners and potential wrongdoers. This overlap is commonly believed to strengthen compliance incentives. Penalties imposed on professional firms, the argument goes, would not only encourage hierarchical monitoring,[14] but also directly penalize members to the extent of their equity investment,[15] thereby discouraging them from committing misconduct.

We demonstrate, however, that holding professional firms criminally liable might undermine this unique deterrence effect. When a conviction triggers the firm's demise, members decide whether to commit misconduct in a strategic setting: there are many potential wrongdoers within the firm, but liability can be imposed only once before the firm unravels. When other members of the firm are likely to commit misconduct, each member expects to bear her share of the loss associated with the firm's demise regardless of her own actions. The risk of going out of business due to others' wrongdoing thus undercuts the deterrence power of the firm's liability.

Part III considers the second channel—monitoring against misconduct—which applies to all types of business organizations. The threat of going out of business appears to provide firms with powerful monitoring incentives. Most modern firms, however, cannot realistically expect to eliminate wrongdoing even when they implement adequate compliance measures.[16] Under the prevailing entity-liability regime, a firm might unravel even for an isolated violation that took place notwithstanding the firm's compliance effort.

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prosecution).

13. *See also* Julie Creswell, *U.S. Indictment for Big Law Firm in Class Actions*, N.Y. TIMES, May 19, 2006, at A1 (reporting the federal indictment of Milberg Weiss Bershad & Schulman, a leading U.S. class-action law firm, for making illegal payments to clients); Nathan Koppel, *Fatal Vision: How a Bid to Boost Profits Led to a Law Firm's Demise*, WALL ST. J., May 17, 2007, at A1 (describing the demise of a prominent Dallas law firm as a result of an investigation concerning its role in marketing illegal tax shelters).

14. The profit-sharing quality of professional firms might also improve the monitoring incentives among partners. *See, e.g.*, Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 786 (1972) (suggesting that profit-sharing induces monitoring of each employee by every other employee). *But see* Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 J. POL. ECON. 801, 813 (1992) (indicating that "there is little incentive to engage in mutual monitoring, even with profit sharing").

15. Henry Hansmann labels this effect of profit sharing "self monitoring." *See* Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 YALE L.J. 1749, 1762 (1990).

16. *See* Poonam Puri, *Judgment Proofing the Profession*, 15 GEO. J. LEGAL ETHICS 1, 9-10 (2001) (listing rapid growth, globalization, and increased specialization as factors that explain the inability of law firms to monitor their members).

When they cannot eliminate misconduct, firms might respond to the threat of harsh sanctions by *reducing* their monitoring effort. After all, if the firm is about to unravel regardless of its investment in compliance, then why bother? More precisely, the marginal reduction in expected liability might be too low to justify additional monitoring efforts. Entity-level criminal liability can therefore undermine incentives to implement costly compliance measures when such measures merely reduce—but do not eliminate—misconduct.

Our analysis gives rise to several insights concerning corporate liability and collective sanctions.[17] First, as a matter of theory, we demonstrate that harsh penalties could undermine deterrence in group settings. Law and economics scholars recognize that subjecting offenders to severe penalties might fail to produce optimal deterrence.[18] Yet, this Article offers a novel framework to analyze the deterrence effect of harsh penalties imposed on business entities or other groups.

Second, as a matter of enforcement policy, we caution against subjecting firms to harsh sanctions—whether criminal, administrative, or other—that can be imposed only once.

Third, as a matter of criminal law doctrine, we offer a deterrence-based justification for targeting firms only for *pervasive* wrongdoing. While legal economists generally believe that the respondeat superior doctrine provides firms with optimal incentives,[19] our analysis shows that this regime might fail when the defendant entity is unlikely to survive a conviction. A pervasiveness standard, however, can provide both firms and their members with adequate compliance incentives. Interestingly, the federal guidelines for prosecuting business organizations require that prosecutors consider the extent to which wrongdoing is pervasive within the organization.[20] Our analysis thus lends support to this element of the guidelines.

Fourth, our analysis sheds a new light on the debate about unlimited liability for professional firms. Professional firms were traditionally prohibited from incorporating as limited liability entities. In recent years, however, lawmakers have allowed such firms to enjoy the shield of limited liability, by organizing as an LLP, for example.

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17. For a comprehensive analysis of collective sanctions, see Daryl J. Levinson, *Collective Sanctions*, 56 STAN. L. REV. 345 (2003). *See also* Thomas J. Miceli & Kathleen Segerson, *Punishing the Innocent Along with the Guilty: The Economics of Individual Versus Group Punishment*, 36 J. LEGAL STUD. 81 (2007).

18. Economists have shown that, under certain conditions, it may be desirable to lower the sanctions on relatively light offenses in order to enhance the deterrence of more severe ones. *See generally* Dilip Mookherjee & I.P.L. Png, *Marginal Deterrence in Enforcement of Law*, 102 J. POL. ECON. 1039 (1994); Steven Shavell, *A Note on Marginal Deterrence*, 12 INT'L REV. L. & ECON. 345 (1992).

19. *See* sources cited *infra* note 99.

20. *See* Memorandum from Larry D. Thompson, Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys, *supra* note 8.

While critics argue that reinstituting unlimited liability for professional firms is vital for enhancing deterrence,[21] our analysis questions the deterrence value of unlimited liability. Under a regime of unlimited liability, each partner could suffer a severe financial penalty even for wrongdoing by a single, rogue member of the firm. In modern, large professional firms—where members cannot fully eliminate wrongdoing—subjecting members to such potential liability might dilute their incentives to refrain from wrongdoing.

I. RESPONDEAT SUPERIOR AND COLLATERAL CONSEQUENCES

Before turning to analyze the deterrence effect of corporate criminal liability, we would like to set the background by describing the collateral effect of a conviction and the existing regime of corporate criminal liability.

The notion that criminal liability can dramatically affect business entities is widespread among scholars, policymakers, and prosecutors.[22] Subpart A considers the channels through which criminal liability can produce disastrous effects for firms and their employees. We identify three sources for such collateral consequences: criminal law, non-criminal rules and regulations, and market reaction. Subpart B presents the expansive standard governing entity criminal liability. As the remainder of this Article will show, the combination of the existing liability regime with a conviction's collateral consequences can undermine the deterrence effect of corporate criminal liability.

A. *Collateral Consequences*

1. *The "corporate death penalty"*

Courts that convict a corporation for committing misconduct can impose

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21. *See, e.g.*, Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1181 (2003) (arguing that the shift to the LLP organization form deprived members of accounting firms of incentives to monitor their peers); Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 STAN. J.L. BUS. & FIN. 9, 30-31 (2002) ("Reducing this insulation from accountability could give lawyers greater incentives to address collegial misconduct and to establish the internal oversight structures that can check abuses.").

22. *See, e.g.*, Pamela H. Bucy, *Trends in Corporate Criminal Prosecutions*, 44 AM. CRIM. L. REV. 1287, 1288 (2007) ("[T]here is no question that criminal prosecution of a corporation has a tremendous impact on the corporation and its community, employees, customers and lenders."); Kern Griffin, *supra* note 12, at 330 (noting that prosecutors may decide against prosecuting business organizations because they are "justifiably reluctant to cause such extensive economic harm"); Eric Holder, Op-Ed., *Don't Indict WorldCom*, WALL ST. J., July 30, 2002, at A14 ("[T]o ensure that even more innocent Americans are not harmed, prosecutors must not give in to the pressures of the day and feel compelled to indict more corporations simply because they can.").

sanctions that aim at putting the defendant out of business. The Federal Organizational Sentencing Guidelines require courts to impose a fine that would be sufficiently large to divest a corporation of all of its assets "[i]f . . . the court determines that the organization operated primarily for a criminal purpose or primarily by criminal means . . . ."[23] Courts typically impose this so-called corporate death penalty on firms with no legitimate business operations.[24]

Commentators occasionally call for expanding the scope of the corporate death penalty by, for example, revoking the charters of corporations convicted of environmental crimes.[25] Financial penalties, the argument goes, are simply no different than any other cost of doing business. The threat of a firm's demise, in contrast, would compel firms to implement effective measures for containing misconduct.[26]

Finally, firms convicted of crimes could unravel simply because they lack the assets necessary to pay the fines. To be sure, the Organizational Sentencing Guidelines allow courts to depart from the recommended fine range if it would jeopardize the continuing viability of the corporation.[27] Courts, however, are not required to adjust the fines down whenever the fine amount would trigger the firm's demise.[28]

2. *Delicensing, exclusion, and debarment*

A conviction could have fatal consequences for business entities even when the criminal trial ends with a modest penalty for the defendant firm. Indeed, a variety of laws and regulations can effectively put out of business firms convicted of a crime.

Firms in regulated industries could lose their license as a result of a criminal conviction. Consider the Arthur Andersen case. The courts imposed relatively modest penalties on the firm—a $500,000 fine and five years of

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23. U.S. SENTENCING GUIDELINES MANUAL § 8C1.1 (2008).

24. *See* Christopher A. Wray, Note, *Corporate Probation Under the New Organizational Sentencing Guidelines*, 101 YALE L.J. 2017, 2027 (1992).

25. *See, e.g.*, Mitchell F. Crusto, *Green Business: Should We Revoke Corporate Charters for Environmental Violations?*, 63 LA. L. REV. 175, 189-92 (2003) (analyzing recent proposals to revoke the charter of corporations that committed crimes against the environment).

26. *See, e.g.*, Thomas Linzey, *Awakening a Sleeping Giant: Creating a Quasi-Private Cause of Action for Revoking Corporate Charters in Response to Environmental Violations*, 13 PACE ENVTL. L. REV. 219, 221 (1995) ("The power . . . to revoke corporate charters, and thereby end the corporate life, may be the only effective deterrent for corporate polluters.").

27. *See* U.S. SENTENCING GUIDELINES MANUAL § 8C3.3.

28. *See* United States v. Eureka Labs., Inc., 103 F.3d 908, 910, 912 (9th Cir. 1996) (holding that the Sentencing Guidelines do not preclude courts from imposing a fine jeopardizing the firm's continued viability).

probation.[29] Nevertheless, the firm unraveled because SEC rules prohibit any accounting firm convicted of a felony from serving as the auditor of publicly traded corporations.[30] KPMG, another global accounting firm, barely escaped a similar fate when prosecutors decided against bringing charges against the firm for marketing tax shelters.[31]

Likewise, the federal government is authorized to forfeit the franchise of national banks convicted of certain money laundering offenses.[32] Firms in other regulated industries also can lose their licenses as a result of a conviction.[33]

Furthermore, firms convicted for certain offenses—health care fraud, for example—might be excluded from further contracting with the government.[34] A conviction also can cause government agencies to suspend or debar firms from conducting business with the government.[35] Several federal statutes impose *mandatory* debarment or suspension on business entities convicted for violating the statute.[36] These provisions might deal a fatal blow to firms for which government contracts are a key sources of revenue.

3. *Market reaction*

Firms' ability to survive in the marketplace depends on their reputation for honesty and quality of service.[37] Given the market value of reputation, legal scholars have claimed that business entities cannot survive a conviction—not even an indictment.[38] Some further posit that the devastating effect of a

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29. *See* Ainslie, *supra* note 5, at 107.

30. The SEC prohibits any accounting firm convicted of a felony from serving as the auditor of a publicly traded corporation. *See* 17 C.F.R. § 201.102(e)(2) (2008); Stephan Landsman, *Death of an Accountant: The Jury Convicts Arthur Andersen of Obstruction of Justice*, 78 CHI.-KENT L. REV. 1203, 1223-24 (2003).

31. *See* discussion *infra* Part IV.B.

32. *See* 12 U.S.C. § 93(d) (2000).

33. *See* Commodity Exchange Act, 7 U.S.C. § 12a (2000); Federal Deposit Insurance Act, 12 U.S.C. § 1818(a)(2) (2000); Securities Act of 1933, 15 U.S.C. § 77t(b) (2000); Securities Exchange Act of 1934, 15 U.S.C. §§ 78o(b)(4)–(6), 78u(d)–(e) (2000); Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(e)–(f) (2000); Social Security Act, 42 U.S.C. § 1320a-7 (2000).

34. *See* Pamela H. Bucy, *Civil Prosecution of Health Care Fraud*, 30 WAKE FOREST L. REV. 693, 720-37 (1995) (discussing the exclusion remedy for health care fraud under which providers might become ineligible to receive any payment under Medicare or any state health care program).

35. *See* 48 C.F.R. § 9.406-2 (2008) (listing causes for debarment).

36. *See* Andrew T. Schutz, Comment, *Too Little Too Late: An Analysis of the General Service Administration's Proposed Debarment of WorldCom*, 56 ADMIN. L. REV. 1263, 1273 (2004) (discussing mandatory debarment).

37. Khanna, *supra* note 7, at 1499 ("The most powerful sanction that society can impose on a corporation is lost reputation or stigma.").

38. *See, e.g.*, Preet Bharara, *Corporations Cry Uncle and Their Employees Cry Foul: Rethinking Prosecutorial Pressure on Corporate Defendants*, 44 AM. CRIM. L. REV. 53, 73

criminal conviction on corporate reputation is the principal feature that distinguishes criminal from civil liability.[39]

Recent high-profile cases demonstrate the potentially destructive impact of an indictment on firms' reputations. Consider the indictment of Milberg Weiss for bribery and fraud charges.[40] Once a leading class action law firm, the firm has been crippled by its indictment and agreed to pay a $75 million fine to avoid trial.[41] Another prominent law firm has recently unraveled as a result of a government investigation concerning its role in marketing abusive tax shelters.[42]

Unfortunately, there are no empirical studies to support the claim that criminal liability has a distinctively harsh impact on firms' reputations. But the most telling evidence in this context is the behavior of top management.[43] The perception that the reputational consequences of a conviction could exceed even the substantial monetary penalties in any parallel civil litigation can explain why firms under investigation for criminal violations are willing to do almost whatever it takes—including waiving attorney-client privilege, assisting the government's prosecution of their senior officers, and paying millions of dollars in civil fines—to avoid an indictment.[44]

4. *The existing regime*

The previous Subpart reviewed the harsh consequences associated with a firm's criminal conviction. In this Subpart, we outline the conditions under which entities can be held liable. As we will explain, firms can go out of

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(2007) ("[C]orporate defendants, subject as they are to market pressures, may not be able to survive indictment, much less conviction and sentencing."); Pamela H. Bucy, *Organizational Sentencing Guidelines: The Cart Before the Horse*, 71 WASH. U. L.Q. 329, 352 (1993) ("In some instances adverse publicity alone can cause corporate devastation . . . .").

39. *See* Khanna, *supra* note 37, at 1508-09.

40. For a thorough analysis of the indictment and its aftermath, see Bruce H. Kobayashi & Larry E. Ribstein, *The Hypocrisy of the Milberg Indictment: The Need for a Coherent Framework on Paying for Cooperation in Litigation*, 2 J. BUS. & TECH. L. 369, 372-75 (2007).

41. The firm agreed to pay $75 million to settle the criminal charges against it. *See* Jonathan D. Glater, *Big Penalty Set for Law Firm, but Not a Trial*, N.Y. TIMES, June 17, 2008, at A1.

42. *See* Nathan Koppel, *Fatal Vision: How a Bid to Boost Profits Led to a Law Firm's Demise*, WALL ST. J., May 17, 2007, at A1 (describing the demise of Jenkens & Gilchrist).

43. *See* Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 504 (2006) ("Managers and their counsel apparently do not see civil and criminal sanctions as substitutes . . . .").

44. *Id.* at 505-07 (assessing the practice of firms waiving their procedural safeguards to avert an indictment); Kern Griffin, *supra* note 12, at 327 ("Because virtually no company will risk indictment, prosecutors have come to expect compliance with every government demand.").

business for a single violation that took place notwithstanding their compliance effort.

The prevailing respondeat superior doctrine holds an organization criminally liable for every offense committed by an employee within the scope of employment.[45] In other words, an entity can be convicted regardless of the rank of the person committing the offense or her authority within the organization.[46] Firms cannot escape liability by establishing that they have made an extensive effort to monitor against employee misconduct or that the offense was in clear violation of company policy.[47]

The existing regime does not require that the crime benefit the corporation.[48] Moreover, under the so-called collective knowledge doctrine, business organizations can be convicted for a crime although no single individual within the organization was aware of all the information required for the crime to materialize.

To summarize, under the existing regime of enterprise liability, a business entity can unravel even for the misdeeds of a single, low-level rogue employee. As the remainder of this Article explains, the prevailing regime might undermine organizational incentives to prevent misconduct.

II. PROFESSIONAL FIRMS

We begin by assessing the impact of criminal liability on professional firms. In the next Part, we expand our analysis to consider a broader range of business entities.

Wrongdoers in professional firms often are part owners.[49] This profit-sharing quality is commonly viewed as bolstering compliance incentives within professional firms. This Part, however, shows that the severe consequences of entity-level criminal liability might undermine the deterrence effect associated with member ownership. We also demonstrate that the legal system can enhance deterrence by using civil fines or, alternatively, by holding firms criminally liable only for sufficiently pervasive wrongdoing.

45. *See* Brickey, *supra* note 11, at 929 ("Under the respondeat superior rule applicable to federal criminal trials, the acts and intent of agents at any level of an entity's hierarchy—including those at the lower end of the organizational ladder—are imputable to the firm.").

46. Samuel W. Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1662 (2007) ("Under current law, a firm faces criminal liability for virtually any criminal act by an agent.").

47. For suggestions that imposing liability for misconduct committed by employees against corporate policy or without management's involvement is unfair, see Laufer & Strudler, *supra* note 11, at 1297.

48. *See infra* text accompanying notes 85-86.

49. *But see* Note, *Collective Sanctions and Large Law Firm Discipline*, 118 HARV. L. REV. 2336, 2337 (2005) (arguing that the law should provide law firms with incentives to prevent wrongdoing by nonpartners).

We do not argue that criminal liability carrying harsh collateral consequences will always undermine deterrence within professional firms. Rather, our objective in this Part is to demonstrate that there are cases in which purely financial penalties or the pervasiveness standard for criminal liability can bolster compliance among professional firms' members.

Before we proceed, we would like to comment on our terminology. To simplify the discussion, we will refer to the threat of going out of business as representative of the collateral consequences of criminal liability.

A. *Organizational Liability and Member Incentives*

Legal entities do not commit crimes; individuals do. Ideally, the legal system would target only culpable individuals within organizations. But a system of pure personal liability would likely fail to produce adequate deterrence.[50] In the criminal context,[51] the principal challenge confronting prosecutors is to identify individual offenders within large, decentralized organizations,[52] and to gather sufficient evidence to establish their culpability—including the requisite mental state—beyond reasonable doubt.[53]

The conventional justification for entity liability is that holding firms liable would be a cost-effective way to overcome the shortcomings of personal liability.[54] Specifically, holding firms criminally liable would induce them to police their employees and prevent them from committing misconduct.[55]

Like other business entities, professional firms would attempt to minimize their liability exposure by policing their agents. In professional firms, however,

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50. *See, e.g.*, Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CAL. L. REV. 1345 (1982); Reinier Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984).

51. Another common justification for entity-level liability is that wrongdoers might lack the financial resources to pay fines. *See* V.S. Khanna, *Corporate Liability Standards: When Should Corporations Be Held Criminally Liable?*, 37 AM. CRIM. L. REV. 1239, 1243-44 (2000). While it can justify the prevalence of vicarious liability in torts, the assumption that wrongdoers are judgment-proof cannot satisfactorily explain the decision to hold firms *criminally* liable. The government can overcome offenders' limited wealth by subjecting them to imprisonment. Indeed, the government's ability to impose jail sentences explains why personal liability is essential even under a regime of corporate criminal liability. *See* A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 (1993).

52. *See* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 695-96 (1997).

53. *See, e.g.*, Stacey Neumann Vu, *Corporate Criminal Liability: Patchwork Verdicts and the Problem of Locating a Guilty Agent*, 104 COLUM. L. REV. 459 (2004).

54. Subjecting firms to liability also might induce them to adopt an optimal scale of production. *See* Khanna, *supra* note 7, at 1496.

55. While commentators normally agree on the justification for firms' vicarious liability, there is disagreement whether this liability should be criminal or civil. *See, e.g.*, *id.*

wrongdoers are often part owners. This overlap translates into a unique self-enforcing deterrence advantage: imposing a sanction on the firm immediately translates into a personal cost for each member-wrongdoer even when the prosecution cannot establish the wrongdoer's culpability in court.

At first sight, the threat of a firm's demise should supply members with powerful incentives to refrain from wrongdoing. After all, so the argument goes, the firm's collapse will render worthless each member's ownership stake. This Part, however, shows that such a threat might undermine the effect of firms' profit-sharing arrangements on member-compliance incentives.

In order to study the impact of organizational liability on member incentives, we make two simplifying assumptions in this Part. First, we assume that members face no meaningful threat of personal liability for their misconduct.[56] Second, we assume that firms cannot adopt effective measures to police members and prevent them from engaging in misconduct.[57]

Consider a decision by a professional firm's member as to whether to commit misconduct. Under our assumptions, each member would weigh her share of the firm-level expected penalty against her benefit from misconduct. Yet, since a firm can unravel only once, the effective magnitude of the firm-level liability depends on other members' conduct. Simply put, the expected cost of another violation is zero when the firm is going to unravel anyway.

The firm's dissolution turns each member's decision whether to commit misconduct into a *strategic* one—each member's cost-benefit calculus is shaped not only by her own actions, but also by the conduct of her colleagues. The interaction of legal rules and organizational attributes can deepen the strategic nature of members' decisions. Recall that a firm can be held liable even for a single violation by any of its agents. Moreover, members of large professional firms often lack information concerning their peers' behavior. The upshot is that even a small probability that someone within the organization would commit misconduct can undermine the deterrence effect of the firm's liability.

To illustrate, let us use the following example. A law firm has two equal members (attorneys), John and Elizabeth. Each attorney can commit misconduct, say issue legal opinions to facilitate the marketing of illegal tax shelters.[58] At the time of committing misconduct, each attorney does not know

56. When members are held liable for their misconduct, the effect that we identify in this Part is less likely to take place, as each member will bear the cost of committing misconduct regardless of other members' conduct. As explained earlier, however, the difficulty of identifying culpable agents within the firm provides the principal justification for subjecting firms to liability.

57. This assumption is made for simplicity only. In a more realistic setting, this Part's analysis applies to the extent that monitoring is imperfect. We return to this issue when we consider the negligence standard. *See infra* Part IV.B. We also assume that firms cannot turn in wrongdoers after the offense has been committed in order to induce prosecutors to waive a criminal indictment.

58. We discuss such an example below. *See infra* Part IV.B.

whether the other has committed misconduct as well. While committing misconduct would provide the wrongdoer with some personal benefit,[59] it may also lead to the firm's indictment and trigger its demise. The probability of conviction following misconduct is 0.9.[60] The firm total value is 160. Each attorney would thus suffer a loss of 80 upon the firm's demise.

Assume that John's benefit from issuing the questionable tax opinion is 30. At first sight, one could expect the threat of the firm's criminal liability to discourage John from issuing the opinion. After all, John's benefit from committing misconduct is clearly outweighed by his expected loss (i.e., his loss upon the firm's demise discounted by the probability of conviction) of 72.[61]

This conclusion, however, overlooks the strategic environment in which John makes his decision. Specifically, John's action in this example will depend on his beliefs concerning Elizabeth's likelihood of committing misconduct. This likelihood depends on Elizabeth's benefit from committing misconduct, which John, by hypothesis, does not know. Denote this benefit by B_E. The following matrix describes John's situation.

Table 1. The Strategic Decision Under Criminal Liability

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	-72, B_E-72
	Commit	*30*-72, -72	*30*-79.2, B_E-79.2

The left expression in each cell represents John's payoff; the right expression represents Elizabeth's. In the upper left cell, neither attorney commits misconduct. In both the lower left cell and the upper right cell, only one attorney commits an offense. This offender benefits from misconduct, but the law firm is held liable with a probability of 0.9, thereby subjecting each attorney to a loss of 80 (or an expected loss of 72). In the lower right cell, both attorneys commit misconduct, and the probability that the firm will be

59. The analysis assumes that the firm as such does not benefit from wrongdoing. In other words, we assume that corporate crime is to a large extent the byproduct of the so-called agency problem. *See, e.g.*, Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315, 319 (1991) ("The real aim of criminal behavior by organizations is to advance the careers of the responsible corporate actors."). For a critique of this perception of corporate crime, see generally Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571 (2005).

60. We assume for simplicity that the probabilities of conviction for each violation are statistically independent. Relaxing this assumption would not change our qualitative results.

61. John's loss when the firm unravels is 80. The probability that the firm will unravel due to John's misconduct is 0.9. John's expected loss thus equals 0.9 × 80 = 72.

convicted is 0.99.[62] Under these circumstances, the expected liability cost for each attorney is therefore $0.99 \times 80 = 79.2$.

The matrix shows that John's optimal strategy depends on Elizabeth's actions, and vice versa. When Elizabeth acts lawfully, John expects to lose 72 if he issues the illegal tax opinion. Since his benefit from doing so is only 30, he would not engage in wrongdoing.

But if Elizabeth is likely to commit misconduct, the difference between John's expected loss if he commits the offense, 79.2, and his expected loss if he does not commit it, 72, is only 7.2. In this case, John would clearly prefer to issue the opinion, gain 30 with certainty, and increase his expected liability cost by only 7.2. Thus, if he expects Elizabeth to commit misconduct, John will issue the illegal tax opinion notwithstanding the firm's likely demise.

The analysis thus far has focused on John's decision. Elizabeth, however, also has to decide whether to commit misconduct given her uncertainty concerning John's actions. A full model, which we develop in the Appendix, would therefore incorporate both attorneys' incomplete information. As neither attorney knows the other's benefit from wrongdoing, each attorney would act based on her estimate of the other's probability of committing misconduct.

This setup of the game allows us to predict members' actions by finding their threshold benefit, i.e., the benefit from wrongdoing above which each member is expected to commit misconduct given her belief concerning the other's likely actions. An equilibrium of this game is a threshold benefit such that, given the implied probability of offense by one member,[63] the other member's best response is to commit the offense if her benefit is higher than the *same* threshold, and not to commit it if her threshold is lower.[64]

This threshold benefit, which we denote as B^*, is a useful proxy for the impact of organizational liability on deterrence at the individual member level. An increase in B^* implies that members will commit misconduct only if their benefit from wrongdoing is higher. In other words, an increase in B^* represents an increase in the level of deterrence.

The Appendix develops a model that formally studies the impact of various liability regimes on the threshold benefit under the assumption that members' benefits are uniformly distributed between 0 and 100.[65] The Appendix shows that, when the probability of conviction is 0.9, this threshold equals 20.45. Based on the Appendix's model, the following figure describes the threshold B^* as a function of the probability of convicting the firm, p.

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62. This probability equals $0.9 + (1 - 0.9) \times 0.9$.

63. By implied probability we mean the probability that a member will commit misconduct given that she will do so if and only if her benefit is higher than the threshold.

64. We thus restrict attention to symmetric equilibria only.

65. The same analysis can be applied for any other probability distribution of benefits. Note, however, that if the benefit could never exceed 80 (discounting for the probability of detection), the threat of putting the firm out of business would likely deter all members from committing misconduct.

Figure 1. The Effect of Probability of Conviction on Deterrence

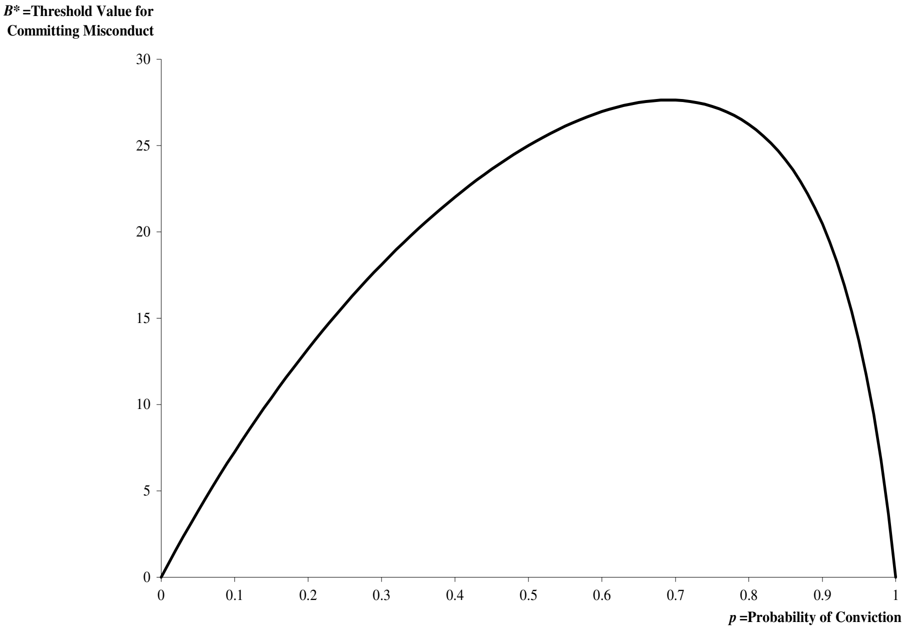


Figure 1 illustrates two somewhat surprising results. First, the maximal level of deterrence that combining criminal liability with the threat of the firm's dissolution can produce in this example is fairly low. Since each attorney would lose 80 upon the firm's unraveling, one could expect members to commit misconduct only when their illicit gain exceeded this amount. Our model, however, shows otherwise. When deterrence is highest, attorneys will commit misconduct whenever their benefit from doing so exceeds 28.[66]

Second, there is a range of probabilities within which *increasing* the probability of detection *reduces* the level of deterrence. Optimal deterrence theory suggests that increasing the probability of detection increases the expected sanction, thereby enhancing deterrence.[67] Our analysis, however, shows that the level of deterrence under the threat of going out of business dramatically decreases as the probability of detection approaches 1.

The intuition underlying this observation follows the logic of marginal deterrence.[68] John's expected sanction equals his share of loss upon the firm's dissolution discounted by the probability of convicting the firm. John's expected loss from committing misconduct thus increases as the firm's

66. It can be verified that at the maximum p=0.69, and that B^*=27.64. The explanation for this result is that the strategic environment significantly reduces the magnitude of the effective penalty facing each member.

67. *See* Becker, *supra* note 9, at 176; A. Mitchell Polinsky & Steven Shavell, *The Optimal Tradeoff Between the Probability and the Magnitude of Fines*, 69 AM. ECON. REV. 880 (1979).

68. *See supra* note 18.

probability of conviction rises. This explains the upward sloping left-hand side of the graph.

Yet, John's misconduct will not affect his expected costs if Elizabeth also commits an offense for which the firm is convicted. Under the assumption that Elizabeth is likely to commit an offense, John's misconduct cannot further increase the magnitude of the sanction imposed on the firm. Rather, it can increase the firm's overall probability of conviction. When Elizabeth is likely to commit misconduct, therefore, committing misconduct increases John's expected costs only in those cases in which Elizabeth is not detected. As the probability of detection increases, John expects his commission of the offense to matter less, as the firm would unravel with higher probability if Elizabeth committed an offense. This explains the downward sloping right-hand side of the graph.

B. *Can Lenient Regimes Enhance Deterrence?*

This Subpart identifies two liability schemes that can discourage members from committing misconduct more effectively than the existing criminal liability regime. We first consider a regime that would impose only a civil fine for each violation. For the purposes of our analysis, a civil fine means a purely financial penalty with no collateral consequences. We then consider a regime that preserves criminal liability, but conditions it on the pervasiveness of wrongdoing within the firm.

1. *Civil fines*

Returning to our example, assume that the fine for each offense is 80 (recall that the probability of detection and conviction is 0.9). The following table describes John's options under the assumption that his benefit from wrongdoing is 30:

Table 2. The Strategic Decision Under Civil Fines of 80

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	-36, B_E-36
	Commit	*30*-36, -36	*30*-72, B_E-72

Reducing the entity-level fine to 80 clearly enhances deterrence in this example: regardless of Elizabeth's likely course of action, John will not commit misconduct. This is because with a fine of 80, the expected liability cost for each attorney contemplating misconduct is 36 even when the other attorney is likely to commit an offense as well.[69] An attorney will thus commit misconduct if and only if her benefit is higher than 36. This threshold is higher than the threshold under the death-penalty regime, i.e., 20.45.

Reducing the fine in this example can enhance marginal deterrence by making each member's expected loss from misconduct independent of the other member's actions. As the previous Subpart showed, criminal liability might lose its deterrent effect when members expect their peers' conduct to trigger the firm's demise. With a civil fine of $80, each member knows that, regardless of others' actions, her own conduct will further increase the firm's liability costs, as it increases both the probability of the firm's conviction and the total value of the sanction. Relatively modest civil penalties can therefore effectively enhance the expected sanction when members lack information concerning their peers' conduct.

2. *The pervasiveness standard*

Consider next a criminal liability regime under which firms are held criminally liable only for sufficiently pervasive wrongdoing. In our example, we take the pervasiveness standard to require that both members commit the offense for the firm to be convicted. As discussed earlier, a criminal conviction leads to the firm's dissolution. John's game matrix under this standard is the following:

Table 3. The Strategic Decision Under the Pervasiveness Standard

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	0, B_E
	Commit	*30*, 0	*30*-72, B_E-72

Under the pervasiveness standard, each attorney knows that the firm cannot be liable unless she commits the offense. In other words, this standard turns each member into a pivotal figure in determining the sanction to be imposed on the firm. The pervasiveness standard thus enhances deterrence when there is a high likelihood that at least one member will commit misconduct. It is not subject to the risk that an isolated case of wrongdoing would trigger the firm's

69. The entity-level fine is 80. Each member's share of the entity-level fine is 40. Since the probability of detection is 0.9, the expected liability cost for each member is 0.9 × 40 = 36.

demise, thereby undermining the deterrence effect of criminal liability on all the remaining members.[70]

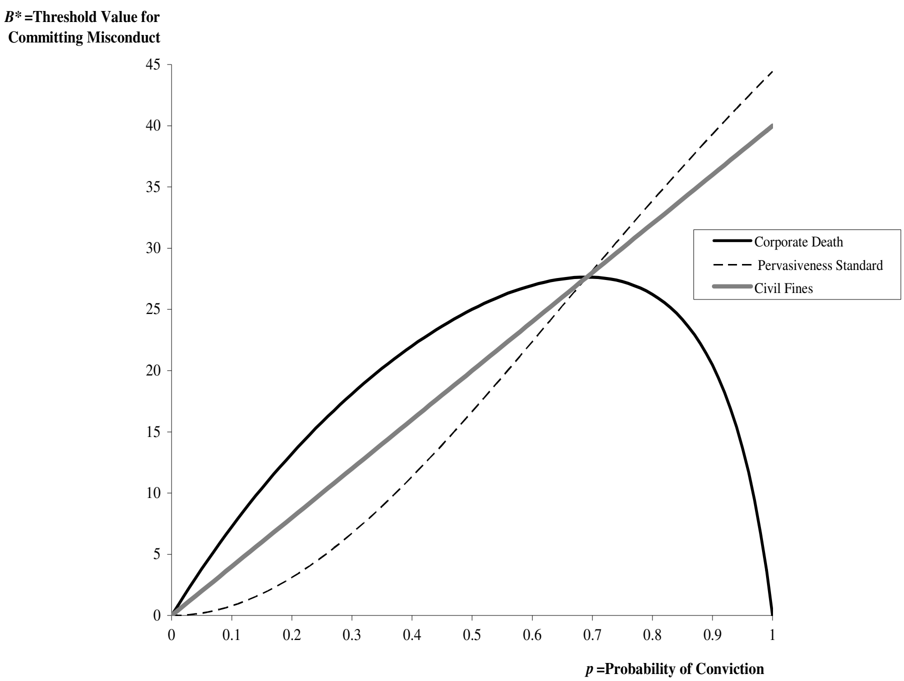
Indeed, the Appendix shows that the threshold B^* under this regime is 39.3, which exceeds the threshold under the existing criminal liability regime, 20.45.

3. *Taking stock*

We do not purport to argue that civil penalties or the pervasiveness standard will *always* outperform the existing regime of criminal liability carrying severe collateral consequences. Nor do we argue that these regimes will optimally deter organizational wrongdoing. Rather, our goal here is to demonstrate that civil penalties or the pervasiveness standard could discourage wrongdoing more effectively than the threat of going out of business under the existing regime of entity liability.

Figure 2 compares the level of deterrence in our example for three regimes: the existing entity-liability regime, a pervasiveness standard of entity liability, and civil penalties. This figure presents the level of deterrence, measured by B^*, as a function of the firm's probability of conviction.

Figure 2. Comparing Deterrence Under Alternative Regimes



70. For similar reasons, the pervasiveness standard may under certain conditions encourage wrongdoing. A member who believes that other members will always refrain from wrongdoing will expect her misconduct to go unpunished under this standard.

This figure shows that the threat of going out of business tends to be powerful when the probability of the firm's conviction following misconduct is relatively small. Once the probability of conviction exceeds a certain threshold, however, the pervasiveness standard or civil fines would contain misconduct more effectively.

For simplicity of exposition, our analysis has thus far focused on a firm with two members. Our framework, however, can be extended to firms with a large number of members. In fact, as an organization increases in size, the threat of going out of business is more likely to reduce criminal liability's deterrence power. In a firm with numerous members, each member is less likely to view her actions as having a pivotal effect on the firm's fate. In other words, as the number of members (and other agents) increases, it becomes more likely that at least one case of wrongdoing will take place. Expecting other members to commit misconduct, members become more likely to commit offenses.

III. MONITORING AGAINST MISCONDUCT

The previous Part focused on the compliance incentives of individual members within professional firms. One might argue, however, that the threat of going out of business can provide the firm itself with powerful incentives to monitor against misconduct by its agents.

Indeed, as we explained earlier, entity liability primarily aims at inducing organizations to monitor against misconduct. In this Part we show that the threat of going out of business might frustrate this goal as well. Again, we do not argue that threatening firms with harsh penalties will *always* distort monitoring incentives. In some cases, the threat of going out of business can compel firms to make an effort—perhaps even an excessive one—to prevent their agents from breaking the law.[71] We do show, however, that corporate liability carrying severe collateral consequences might be inferior from a deterrence perspective to alternative liability regimes. Moreover, while our findings in the previous case were limited to professional firms, our findings in this Part apply to all forms of business organizations.

A. *Firms' Monitoring Incentives*

Firms can adopt a variety of measures to prevent their agents from committing misconduct. They can respond to wrongdoing ex post—by disciplining wrongdoers or reporting them to the authorities. They can also implement internal controls and other ex ante policing measures to detect

71. Deterrence theory predicts that entity liability will produce overdeterrence when the expected sanction exceeds the expected social harm.

agents contemplating wrongdoing or otherwise thwart misconduct.[72] Our analysis focuses on the ex ante measures that firms may take to prevent wrongdoing.[73]

1. *Criminal liability: the existing regime*

Assume that criminal liability will cause the defendant entity to unravel. At first glance, the threat of going out of business appears to be a powerful deterrent. To the extent that the loss associated with a firm's unraveling outweighs monitoring cost, this threat would encourage firms to monitor their agents to prevent them from committing misconduct.

This initial impression, however, may be misleading. The principal drawback of criminal corporate liability in this example is that it imposes the harshest sanction even on firms that made an adequate effort to police their agents. The existing regime holds firms—regardless of their monitoring effort—vicariously liable whenever an employee commits an offense within the scope of employment.[74] Firms, however, often cannot eliminate wrongdoing altogether. A firm may therefore go out of business even for a single violation that took place despite its monitoring effort.

From the firm's perspective, investment in compliance is valuable only to the extent that it reduces expected liability costs. When criminal liability triggers dissolution, however, a decrease in the level of wrongdoing will not necessarily translate into an equal decrease in the firm's expected liability costs.

This Part will use the following stylistic example to compare the deterrence effect of enterprise criminal liability to that of more lenient regimes. A firm has two employees. Without monitoring, each employee will surely commit an offense. Each case of fraud is ultimately detected and leads to the firm's conviction.[75] The firm has only 100 in assets, and a criminal conviction leads it to dissolve.

Assume that the firm can choose between two measures to monitor its employees—*Extensive* and *Moderate*. Extensive monitoring has a 50% success

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72. *See* Arlen & Kraakman, *supra* note 52, at 696 & n.22.

73. The corporate death sanction might also adversely affect ex post measures. For example, a firm that is surely going out of business has no reason to impose private sanctions on culpable individuals.

74. Under the Federal Sentencing Guidelines for Business Organizations, firms' monitoring policies can affect the magnitude of the sanction imposed on the firm. *See* Krawiec, *supra* note 59, at 584 (noting that fines can be "reduc[ed] to as little as one-twentieth or increase[ed] by as much as four hundred percent" based on the presence of an internal compliance program). This mitigation, however, is unavailable when criminal liability triggers the firm's unraveling.

75. To focus on the impact of criminal liability on the incentives of *firms*, we assume in this Part that employees face no meaningful threat of personal liability for their misconduct.

rate in preventing fraud. With Moderate monitoring, the likelihood of preventing each offense is only 20%. The following table describes the probability that the firm's employees commit one, two, or no offenses under each monitoring level:

Table 4. Employee Misconduct and Monitoring

Number of Offenses	Probability with Moderate Monitoring	Probability with Extensive Monitoring
0	0.04	0.25
1	0.32	0.5
2	0.64	0.25

Now consider the firm's expected liability costs under the assumption that the government ultimately detects each offense. With no monitoring, the firm would surely go out of business, i.e., its expected liability cost would be 100 (that is, the total value of its assets). The firm's expected liability cost is 96 with Moderate monitoring,[76] and 75 with Extensive monitoring.[77] The firm's marginal benefit from Extensive monitoring—i.e., the amount it expects to save by moving from Moderate to Extensive monitoring—is therefore 21.

The remainder of this Part shows that the liability schemes that we considered in the previous Part—civil fines and criminal liability under the pervasiveness standard—might contain misconduct more effectively than the current criminal liability regime. For each liability scheme, we demonstrate that the firm's incentive to implement Extensive monitoring may be stronger than under the threat of going out of business.

2. *Civil fines*

Limiting the sanction to civil fines (assuming such fines do not exceed the firm's assets of course) can enhance deterrence because it ensures that firms' liability costs will rise with the number of violations committed by their agents. In other words, a regime of purely financial penalties allows enforcement officials to create a gradual penalty schedule, thus preserving marginal incentives to monitor. Each violation increases the total amount of fines that the

76. With a probability of 0.32, only one offense will take place and the firm will pay a fine of $100. With a probability of 0.64, two offenses will take place. Even if two offenses take place, the effective fine remains $100. The total expected cost under Moderate monitoring is thus $0.32 \times 100 + 0.64 \times 100$.

77. With a probability of 0.5, only one offense will take place and the firm will pay a fine of $100. With a probability of 0.25, two offenses will take place. Again, even if two offenses take place, the effective fine remains $100. The total expected cost under Extensive monitoring is thus $0.5 \times 100 + 0.25 \times 100$.

firm would ultimately have to pay, and, accordingly, each offense that the firm prevents reduces its expected liability costs.

In our example, assume that the fine for each violation is 50. The firm thus faces a fine of 50 if one employee commits fraud, and a fine of 100 if two employees commit fraud. The firm's expected sanction is 80 with Moderate monitoring,[78] and 50 with Extensive monitoring.[79] The firm's benefit from shifting from Moderate to Extensive monitoring is therefore 30. This benefit exceeds the marginal benefit from Extensive monitoring under a fine of 100 for each violation, which was 21.

3. *Criminal liability: pervasiveness*

Consider next a regime under which firms are held criminally liable only when wrongdoing is sufficiently pervasive. In our example, we take the pervasiveness standard to hold firms liable only when at least two employees commit an offense.

Although it allows firms to escape liability for certain offenses (when only one employee commits misconduct), the pervasiveness standard will bolster the firm's monitoring incentives in this example. The firm's expected sanction is 64 with Moderate monitoring,[80] and 25 with Extensive monitoring.[81] The firm's benefit from shifting from Moderate to Extensive monitoring is 39. Therefore, firms for which the cost of increasing monitoring from Moderate to Extensive is between 21 and 39 would not adopt Extensive monitoring under the existing criminal liability regime, but would do so under the pervasiveness standard.

The intuition is as follows. In our example, a firm that increases its monitoring effort will reduce the expected number of offenses below two, but adopting Extensive monitoring cannot reduce the expected number of offenses below one. Under the existing vicarious liability regime for entity liability, however, an investment in monitoring is economically worthwhile for the firm only to the extent that it reduces the expected number of offenses to zero (or below one). In contrast, under the pervasiveness standard, monitoring is valuable if it reduces the expected number of offenses below two.

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78. With a probability of 0.32, only one employee commits fraud, thereby subjecting the firm to a fine of 50. With a probability of 0.64, two employees will commit fraud, thereby subjecting the firm to a total fine of 100.

79. With a probability of 0.5, only one employee commits fraud, thereby subjecting the firm to a sanction of 50. With a probability of 0.25, two employees will commit fraud, thereby subjecting the firm to a total fine of 100.

80. Recall that the probability that two employees will commit fraud under Moderate monitoring is 0.64.

81. The probability that two employees will commit fraud under Extensive monitoring is 0.25.

Another way to understand the deterrence value of the pervasiveness standard is to consider the following perspective: the government's task is to encourage monitoring while using a sanction that can be deployed only once given the collateral consequences of the firm's criminal liability. To achieve this goal, the government needs to target only firms that failed to monitor.[82] The government therefore should impose liability only when the outcome—the number of offenses in this case—is more likely to indicate the firm's failure to monitor rather than a failure of the monitoring measures that the firm did adopt. Because even optimal monitoring may fail to eliminate misconduct, a small number of offenses would often be a poor signal for the firm's monitoring effort. In contrast, a relatively large number of violations credibly signals that the firm did fail to monitor for wrongdoing.[83]

B. *When Will Corporate Criminal Liability Fail?*

We have thus far shown that the collateral consequences that normally follow a business entity's conviction might adversely affect firms' incentives to police their agents, and undermine the deterrence effect of professional firms' profit-sharing arrangements. We have also explained, however, that harsh penalties might sometime be quite effective. Before we turn to explore the policy implications of our analysis, we would like to address an important question. Can one predict the cases in which the threat of going out of business would likely fail to deter organizational misconduct?

This Subpart identifies the conditions under which the existing regime of corporate criminal liability is likely to fail. These conditions vary by offense type, organizational structure, enforcement policy, and the availability of effective compliance measures. For our present purposes, however, it is important to stress that the existing regime undermines the deterrence of exactly those firms for which the need to provide compliance incentives is strongest.

For simplicity, assume that criminal liability would force firms to go out of business. The threat of going out of business can distort monitoring incentives when firms are likely to be convicted notwithstanding their effort to prevent wrongdoing. Likewise, it will undermine deterrence of professional firms' members when each member expects the firm to unravel regardless of her own conduct. Other things equal, therefore, the dissolution threat becomes less effective when: (i) firms are unlikely to eliminate wrongdoing by monitoring; (ii) employees (or members) are prone to commit misconduct; (iii) the probability that the government will detect misconduct is high. We discuss each

82. A negligence standard also is likely to achieve this goal. *See infra* Part IV.B.

83. For some offenses, even a single offense can indicate that the firm did not monitor. We discuss this point below. *See infra* Part III.B.2.

of these conditions below with respect to both professional firms and business organizations more generally.

1. *Monitoring technology*

Firms rely on a variety of internal control mechanisms to prevent their agents from committing misconduct. When the available monitoring devices are relatively ineffective at averting violations, it is likely that at least one violation will take place notwithstanding the firm's compliance measures. This in turn would undermine marginal incentives to monitor, as firms could unravel notwithstanding their investment in policing measures. An ineffective monitoring technology thus increases the likelihood that criminal liability carrying harsh collateral consequences would undermine monitoring incentives.

The effectiveness of the firm's monitoring measures can also affect member incentives in professional firms. When the firm has an effective monitoring scheme in place, members expect the firm to detect and prevent violations. Effective monitoring thus makes members less likely to act under the assumption that the firm will unravel anyway for others' actions. Each member then becomes more pivotal, as her actions are likely to increase substantially the firm's exposure to the risk of dissolution. In other words, a relatively effective system of internal controls reduces the likelihood that members will make decisions in a strategic setting.

2. *Personal gain from wrongdoing*

Firms' success rate in preventing agent misconduct is determined not only by the degree to which monitoring is effective, but also by the extent to which agents are prone to commit offenses to begin with. Individuals, in turn, are more likely to commit misconduct when they derive a *personal* benefit from doing so.[84]

Accordingly, criminal liability carrying severe collateral consequences is more likely to undermine firms' monitoring incentives when agents derive substantial personal benefits from wrongdoing. Likewise, when the personal gains from misconduct are relatively significant, members of professional firms are more likely to expect other members to commit violations that would trigger the firm's demise.

To be sure, the existing federal regime holds organizations criminally liable only for actions that were taken with the intent to benefit the organization.[85] Courts, however, often convict corporations even for offenses that were committed primarily for the benefit of the individual offender.[86]

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84. *See supra* note 59.

85. *See* Alan C. Michaels, *Fastow and Arthur Andersen: Some Reflections on Corporate Criminality, Victim Status, and Retribution*, 1 OHIO ST. J. CRIM. L. 551, 554

3. *Firm size and structure*

An organization's size and structure undoubtedly affect its ability to eliminate agent misconduct. When a firm has numerous agents, it becomes likely that some agents will commit misconduct notwithstanding the firm's policing effort. This description also applies to business organizations with a decentralized structure under which decision making and responsibility are diffuse. This in turn increases the risk that an organization that has adopted adequate policing measures would nevertheless go out of business as a result of a single violation of one of its agents. Thus, a regime under which even a single violation can trigger a firm's demise may turn out to undermine deterrence especially in large organizations.

Firm size also matters for professional firms. A member of a professional firm with a relatively large number of members (perhaps even working at different locations) is unlikely to possess information concerning his colleagues' conduct. In other words, such a member would decide whether to commit misconduct under conditions of uncertainty. Moreover, the increase in the number of members and other employees also increases the probability that at least one of the firm's agents will commit an offense, thereby causing the firm to unravel anyway. Members' expectations that one of the firm's agents would commit misconduct significantly undermine their compliance incentives under the threat of going out of business.

4. *Enforcement policy*

The threat of going out of business is more likely to undermine deterrence when the probability of the firm's conviction following misconduct is high. The previous Part explained the connection between such probability and deterrence in professional firms.[87] In this Part, we explore the link between the probability of conviction and organizations' monitoring incentives.

Other things equal, when the government's probability of detecting each offense is relatively small, detecting even a small number of violations is more likely to indicate the firm's failure to monitor. Conversely, if the probability of government's detection is high, detecting a small number of offenses is less likely to indicate the firm's failure to invest in monitoring.[88] Holding the firm criminally liable would then operate to dilute deterrence instead of enhancing it.

(2004).

86. *See* Buell, *supra* note 46, at 1662 ("[C]ourts have all but read the 'intent to benefit' element out of the law."); *see also* United States v. Potter, 463 F.3d 9, 25 (1st Cir. 2006).

87. *See supra* Part II.B.3.

88. Likewise, when the probability of detection is small, firms can benefit from imperfect monitoring by reducing the probability of a conviction.

Note that the probability of conviction is affected by the legal regime in place. The probability of going out of business as a result of criminal liability is determined by the probability of detection and the probability of the firm's conviction. The intensity of the government's enforcement efforts affects the probability of detecting violations. The likelihood of conviction, in contrast, is largely determined by the applicable liability regime. Under the existing regime—which subjects firms to liability for virtually all offenses committed within the scope of employment—prosecutors have a relatively light burden when trying to convict an organization for its agents' crimes. This makes the probability of conviction roughly equal to the probability that the government would detect a violation.[89]

To summarize, the precise conditions under which the firm's possible dissolution might undermine deterrence vary by offense type, firm attributes, and governmental policy. The analysis in this Part, however, suggests that the threat of going out of business may be an inferior deterrent in those firms for which entity-level criminal liability is important from a deterrence perspective.

One of the primary goals of entity criminal liability is to overcome the difficulty of identifying culpable individuals within firms.[90] The government's task of identifying individual offenders and establishing their culpability in court becomes more challenging when the violation took place within a large organization with diffused decision-making structures.[91] Even professional firms are now large, geographically dispersed organizations with many members and other employees. Arthur Andersen, for example, had 85,000 employees in approximately 390 offices in 85 countries prior to its conviction.[92]

Entity criminal liability is thus vital for combating misconduct within large, decentralized firms. In many cases, however, such firms are virtually incapable of eliminating wrongdoing even when they properly invest in monitoring, policing, or other compliance measures.[93] In these firms, therefore,

89. *See* Garrett, *supra* note 2, at 879 ("[T]he DOJ can readily obtain convictions given broad respondeat superior liability and substantive criminal law."); Gerard E. Lynch, *The Role of Criminal Law in Policing Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 23, 24 (1997) ("[T]here is often no distinction between what the prosecutor would have to prove to establish a crime and what the relevant administrative agency or a private plaintiff would have to prove to show civil liability.").

90. *See supra* text accompanying notes 51-53.

91. *See, e.g.*, Note, *supra* note 49.

92. *See* Ainslie, *supra* note 5, at 109.

93. *See* United States *ex rel*. Porter v. Kroger Grocery & Baking Co., 163 F.2d 168, 177 (7th Cir. 1947) ("As the magnitude of a business increased, with its personal supervision further removed, we apprehend that the difficulties were correspondingly enhanced. Certainly 100% compliance could not be expected in any event; in fact, it would be impossible."). This is also evidenced by the blooming industry of compliance programs that apparently fail to eliminate misconduct. *See generally* Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) (noting that internal compliance mechanisms fail to deter misconduct and merely reduce

trying to bolster deterrence by subjecting the entity to criminal liability carrying severe collateral consequences can ultimately backfire.

IV. IMPLICATIONS: CRIMINAL LAW AND BEYOND

This Part explores the policy implications of our findings. We first put forward several prescriptions concerning the criminal liability of business organizations. In Subpart A, we argue that legal systems should generally abandon entity-level penalties carrying severe collateral consequences. In Subpart B, we explore the conditions under which a firm should be held liable when a conviction is likely to trigger its dissolution. We then explore the implications of our analysis outside criminal law. Subpart C explains why prohibiting professional firms from incorporating as entities with limited liability might undermine deterrence.

A. *The Case for Purely Monetary Penalties*

Finding a business entity criminally liable can trigger a variety of sanctions that aim at—or have the collateral effect of—putting firms out of business. Not surprisingly, these sanctions raise a host of fairness-based objections.[94] After all, a firm's demise can impose undue hardship on innocent parties, such as the firm's employees, suppliers, and even entire communities. This Article, however, offers a novel deterrence rationale for abandoning such penalties—or any other severe penalties that can be deployed only once.[95]

We have shown that purely financial sanctions would contain organizational misconduct more effectively than harsher entity-level sanctions. To be sure, the threat of going out of business might provide firms with powerful compliance incentives in some cases. As we explained in the previous Part, however, harsh entity-level penalties are especially prone to undermine the deterrence of those firms for which the need for corporate liability is strongest.

Given the uncertain impact of sanctions with severe collateral consequences, we believe that lawmakers should generally limit penalties—whether imposed directly in the criminal trial or as a collateral consequence of conviction—to monetary fines that would not trigger firms' demise.[96]

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legal liability and improve market legitimacy).

94. For a comprehensive analysis, see generally Darryl K. Brown, *Third Party Interests in Criminal Law*, 80 TEX. L. REV. 1383 (2002) (assessing the implications of considering the collateral consequences of prosecution and punishment).

95. *See* Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 20-21 (1991) (arguing that dissolving law firms or temporarily shutting their doors for attorney misconduct would be inappropriate and ineffective).

96. *See* Ainslie, *supra* note 5, at 110 ("[M]andatory, automatic and drastic civil sanctions in the wake of criminal convictions are unnecessarily harsh and rigid.").

This prescription has several doctrinal implications. First, lawmakers could significantly cut back on the collateral consequences following a conviction. Second, lawmakers could make sure that debarment, delicensing, and other similar sanctions would apply only when consistent with deterrence, as explained in the next Subpart.[97] Finally, as we explained earlier, there is a widespread belief that the devastating effect of a criminal conviction on corporate reputation is the principal feature that distinguishes criminal from civil liability. To the best of our knowledge, there is no empirical study that proves this belief to be accurate across industries, that is, that shows that the sheer act of convicting an entity for a crime—regardless of any collateral legal consequences—will cause a firm to unravel. Yet, to the extent that the disastrous effects of entity criminal liability are indeed beyond the government's control, lawmakers should narrow down the conditions under which entities could be held criminally liable.

B. *Reforming Entity Criminal Liability*

The goal of eliminating all forms of severe collateral consequences is likely unattainable. For example, the SEC rule disqualifying an accounting firm convicted of a felony from auditing public companies is unlikely to be repealed, and it is equally unlikely that accounting firms will get blanket immunity from criminal liability. In this Subpart, we consider what liability standard should apply when a conviction will trigger the firm's demise.

The respondeat superior doctrine, which governs corporate criminal liability under federal law, holds firms liable whenever their agent commits an offense within the scope of employment. Legal economists, who have been skeptical of any attempt to incorporate notions of individual fault into the entity-liability context,[98] generally believe that this doctrine provides business entities with optimal incentives to prevent misconduct.[99]

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97. The debarment provisions, for example, permit excusing debarment if "the contractor had effective standards of conduct and internal control systems in place at the time of the activity which constitutes cause for debarment or had adopted such procedures prior to any Government investigation of the activity cited as a cause for debarment." 48 C.F.R. § 9.406-1(a)(1) (2008).

98. *See generally* Fischel & Sykes, *supra* note 9 (arguing against criminal prosecution for corporate crimes); V.S. Khanna, *Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea*, 79 B.U. L. REV. 355 (1999) (considering when corporate mens rea is appropriate in prosecution and punishment).

99. *See, e.g.*, Fischel & Sykes, *supra* note 9. Jennifer Arlen has shown that strict corporate liability might produce perverse incentives for firms to adopt measures that could increase the likelihood of detecting offenses. *See* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994). For a comprehensive analysis of modifications that may rectify these distortions, see Arlen & Kraakman, *supra* note 52.

The previous Parts, however, demonstrated that combining the death penalty with respondeat superior might undermine deterrence. So what liability standard should apply when a firm's criminal conviction is likely to trigger its demise?

1. *Top management involvement*

The principal alternative to respondeat superior focuses on the extent to which senior management was involved in wrongdoing.[100] Under the Model Penal Code, for example, entity criminal liability for "mens rea" offenses requires the involvement of an agent with sufficient seniority.[101]

At first blush, top management's involvement appears to alleviate the concern that the threat of going out of business will undermine deterrence. After all, one could argue that senior management's participation is the best evidence for a firm's failure to make a genuine effort to prevent misconduct. Relatedly, such participation is less likely to reflect some coordination failure afflicting members within professional firms.

This liability standard, however, has two principal flaws. First, the involvement of senior officers does not eliminate the concern that the threat of going out of business will undercut deterrence. Even senior officers are agents who need to be monitored by the entity's ultimate owners—shareholders (or members of professional firms). And even senior officers might commit crimes with neither the cooperation nor the knowledge of other members of management. In fact, monitoring senior management by shareholders (or members) might be far more costly than monitoring rank-and-file employees.[102]

Second, this standard distorts organizational incentives for gathering and sharing information.[103] Regardless of the penalty accompanying liability,

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100. Another group of standards focuses on organizational measures of culpability, which can be loosely defined as corporate ethos or corporate culture. These standards of organizational culpability tend to be somewhat indeterminate. *See, e.g.*, Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095 (1991).

101. *See* MODEL PENAL CODE § 2.07(1)(c) (1985); *see also* Commonwealth v. L.A.L. Corp., 511 N.E.2d 599, 602 (Mass. 1987) ("The Commonwealth must prove that the individual for whose conduct it seeks to charge the corporation criminally was placed in a position by the corporation where he had enough power, duty, responsibility and authority to act for and in behalf of the corporation to handle the particular business or operation or project . . . ." (emphasis omitted)). For a survey of states that adopted various formulations of the MPC standard, see RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING §§ 7.025-.036 (2d ed. 1997). Management's involvement also can dramatically affect the magnitude of sanctions under the federal sentencing guidelines. *See* William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1384-86 (1999).

102. *See* Fischel & Sykes, *supra* note 9, at 324-25.

103. *See, e.g.*, Assaf Hamdani, *Mens Rea and the Cost of Ignorance*, 93 VA. L. REV.

holding firms liable only when senior executives are involved would discourage firms from monitoring for violations by rank-and-file employees, and encourage senior officers to distance themselves from any knowledge concerning misconduct.[104]

2. *Negligence*

A well functioning negligence regime could provide firms with optimal incentives to monitor their agents. Under a negligence standard, firms would be liable only when they failed to make an adequate investment in monitoring their employees. Firms that implemented proper monitoring measures would be insulated from liability even when some offenses were committed notwithstanding their compliance effort. Combining harsh entity-level penalties with negligence is therefore unlikely to distort monitoring incentives even when monitoring is not foolproof.[105]

A negligence regime, however, might perform even worse than respondeat superior with respect to professional firms' members. Consider a professional firm that implements an optimal monitoring scheme that leaves some misconduct undetected. Given the limited success of the firm's policing measures, one could expect the firm's profit-sharing arrangements to kick in and discourage members from committing misconduct. Yet, under a negligence standard, the firm will be exempt from liability given its investment in monitoring. Accordingly, members would have no self-enforcing incentive to refrain from wrongdoing.

We should also note the inherent weakness of all negligence regimes: they require courts to possess both the expertise necessary to set the optimal level of monitoring for each firm and sufficient information to determine whether firms did make an adequate investment in monitoring.[106] Courts, however, may find these tasks to be relatively complex in the corporate setting.

3. *Pervasiveness*

Federal guidelines for prosecuting business organizations direct prosecutors to take into account the extent to which wrongdoing is pervasive

415, 446-47 (2007) (explaining how the "responsible corporate officer" doctrine might discourage monitoring by officers).

104. For the general case against making the involvement of top management a factor in setting corporate sanctions, see Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215 (2003).

105. Steve Shavell has shown that negligence standards can be more effective than strict liability in inducing judgment-proof injurers to take care. *See* S. Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 47-48 (1986).

106. Firms' efforts to create the impression that they take the necessary steps to prevent misconduct have been referred to as the problem of cosmetic compliance. *See* Krawiec, *supra* note 93.

within the firm.[107] The guidelines provide that pressing criminal charges against organizations is generally inappropriate in the case of the prototypical rogue employee.[108] The guidelines explain, however, that charging a corporation may be appropriate where the wrongdoing was pervasive and was undertaken by a large number of employees or by all the employees.

Commentators often criticize the guidelines' departure from the strictures of respondeat superior.[109] Our analysis, in contrast, provides a deterrence-based justification for adopting the pervasiveness standard when the collateral consequences of a conviction are likely severe.

The previous Parts used a stylized example of a firm with only two employees. But how many offenses would qualify as sufficiently pervasive in larger firms? Ideally, lawmakers would devise a bright-line rule to determine when wrongdoing is sufficiently pervasive to justify an indictment notwithstanding a conviction's harsh collateral consequences. As it turns out, however, there is no single prescription to determine how many offenses render misconduct sufficiently pervasive.

In order to induce firms to invest optimally in monitoring, the number of violations that qualifies as "pervasive" is one that signals the organization's failure to police its agents. As we showed above,[110] this number is a function of the firm's size, its monitoring capabilities, the government's enforcement policy, and agents' private benefit from wrongdoing.

The pervasiveness standard may also prove elusive with respect to professional firms. In this context, the number of violations that qualifies as "pervasive" is one that prevents each member from expecting the firm to unravel irrespective of his decision whether to commit the offense.

The precise meaning of "pervasiveness" thus varies across firms and offense types. However, the factors that predict whether the threat of going out of business would fail also affect the threshold number of offenses under the pervasiveness standard.[111] The threshold number of offenses is thus likely to increase with the probability of the firm's conviction, the difficulty of uprooting misconduct, organizational structure, and agents' gain from

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107. *See* Memorandum from Paul J. McNulty, Deputy Attorney Gen., to Heads of Dep't Components, U.S. Attorneys 4 (Dec. 2006) [hereinafter McNulty Memorandum], *available at* http://www.usdoj.gov/dag/ speeches/2006/mcnulty_memo.pdf.

108. *See id.* at 6 ("[I]t may not be appropriate to impose liability upon a corporation, particularly one with a compliance program in place, under a strict respondeat superior theory for the single isolated act of a rogue employee.").

109. *See, e.g.*, Laufer, *supra* note 101; Wray & Hur, *supra* note 8, at 1187 (stressing the need for consistency in federal corporate crime enforcement). On the difference between the federal regime of criminal liability and prosecution policy, see Darryl K. Brown, *The Problematic and Faintly Promising Dynamics of Corporate Crime Enforcement*, 1 OHIO ST. J. CRIM. L. 521, 542 (2004) (noting other ways in which prosecution policy and strict respondeat superior differ).

110. *See supra* Part III.B.

111. *See supra* Part III.B.

wrongdoing. In some cases, even a single violation would satisfy the pervasiveness standard.[112] In others, a larger number of detected offenses would be required to justify an indictment.

Given the context-specific nature of the pervasiveness standard, the best practical approach might be to entrust prosecutors and courts with the task of applying it on a case-by-case basis. To be sure, leaving the application of this standard to prosecutorial discretion has the obvious drawbacks associated with any measure that grants the prosecution considerable authority.[113] We take no position here on the proper limits on prosecutorial power. Rather, we highlight one advantage of leaving this standard somewhat open-ended.

The guidelines further require prosecutors to consider the collateral consequences of a criminal conviction, including the possibility of "suspension or debarment from eligibility for government contracts or federal[ly] funded programs such as health care."[114] We believe, however, that the link between collateral consequences and pervasiveness should become more explicit. When the consequences of a criminal conviction are limited to financial penalties, there is little reason to rely on the pervasiveness standard. Prosecutors should be instructed to take pervasiveness into account only when the collateral consequences of a criminal conviction are sufficiently severe.

The difference between the law on the books—under which firms can be held liable for any offense committed within the scope of employment—and the law in action—under which firms are normally indicted only for pervasive wrongdoing—might provide an answer to the following objection. One might argue that our thesis—that is, criminal liability carrying several collateral consequences might undermine deterrence—seems at odds with the common perception that the existing regime of entity liability does provide firms with strong incentives to prevent misconduct. The response to this objection is that one's perception of the existing regime is largely shaped by the law in action, i.e., the federal guidelines for prosecuting business organizations. To the extent that they actually take into account the pervasiveness of wrongdoing within organizations, prosecutors make it significantly unlikely that entity criminal liability would undermine firms' compliance incentives.

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112. As we explained above, the corporate death penalty would not always undermine deterrence. When even a single offense is sufficiently indicative of the firm's failure to monitor, or when the probability of the government's detection is sufficiently low, there is little risk that the putting firms out of business for a single offense would undermine deterrence.

113. *See generally* William S. Laufer, *Corporate Prosecution, Cooperation, and the Trading of Favors*, 87 IOWA L. REV. 643, 647, 650-57 (2002) (questioning "the fairness of trading corporate cooperation for government-granted favors" and discussing "the dark side of guideline incentives"); Geraldine Szott Moohr, *Prosecutorial Power in an Adversarial System: Lessons from Current White Collar Cases and the Inquisitorial Model*, 8 BUFF. CRIM. L. REV. 165 (2004).

114. *See* McNulty Memorandum, *supra* note 107, at 16.

4. *Personal liability*

The apportionment of liability among the firm and its officers is one of the toughest challenges for policymakers and legal scholars alike.[115] We have no intention of resolving this issue here. Rather, we argue that when a criminal conviction would produce severe collateral consequences, prosecutors should make an extra effort to subject culpable individuals within the firm to liability.

As we explained earlier,[116] the goal of entity liability is to rectify the likely failure of personal liability to deter misconduct. But when the collateral consequences of criminal liability are too severe, targeting the entity might undermine rather than enhance deterrence. Personal liability, in contrast, ensures that each actor bears the consequences of her misdeeds.

At first glance, our prescription in this Subpart appears inconsistent with one premise underlying this Article, namely, that subjecting the firm to liability is necessary to overcome the difficulty of establishing individual culpability beyond a reasonable doubt.[117] Indeed, our recommendation would be of little value if it were impossible for the prosecution to identify the culpable individual within the organization.

But identifying such an individual is often a matter of cost, i.e., the extent to which the government is willing to undertake the costly effort to acquire evidence. For example, the prosecutors in charge of the Enron investigation spent considerable resources on gathering sufficient evidence to indict Enron's top management. Their effort included two years of attempts to overcome legal stonewalling by Ken Lay, the company's former chairman, to allow investigators to acquire relevant documents,[118] and a complex "building-block" approach of entering into plea bargains with Enron's executives, where these executives agreed to cooperate with investigators' efforts.[119] More generally, the President's Corporate Fraud Task Force has since 2002 secured the convictions of hundreds of senior officers.[120] Our claim is that, other things

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115. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691 (arguing that management—and not issuers—should be held liable for certain types of securities fraud); Laufer, *supra* note 101, at 1346 ("[T]he evolution of corporate criminal law in the United States . . . is understood best by examining the shifting risks of liability and loss between corporations and their agents . . . ."). For an insightful analysis of the considerations affecting the choice between entity and personal liability, see Kraakman, *supra* note 50.

116. *See supra* Part II.A.

117. *See supra* Part II.A.

118. *See* Kathleen F. Brickey, *Enron's Legacy*, 8 BUFF. CRIM. L. REV. 221, 273-74 (2004).

119. *Id.* at 272.

120. *See* Press Release, Dep't of Justice, Fact Sheet: President's Corporate Fraud Task Force Marks Five Years of Ensuring Corporate Integrity (July 17, 2007), *available at* http://www.usdoj.gov/opa/pr/2007/July/07_odag_507.html (reporting the fraud-related convictions of 214 CEOs and presidents, 53 chief financial officers, and 129 vice presidents).

equal, the investment in gathering evidence against individual wrongdoers becomes more justified when indicting the entity might trigger its dissolution.

5. *The KPMG affair*

We conclude this Subpart by considering the recent investigation against the accounting firm KPMG in light of our analysis. Although it seriously considered pressing charges against the firm for marketing tax shelters, the Department of Justice eventually decided against taking such a step, presumably in light of concerns that the demise of yet another big accounting firm would increase the concentration in the market for auditing services. However, after admitting wrongdoing, the firm had to pay a fine and enter into a deferred prosecution agreement in order to avoid a criminal indictment. In other words, the firm barely escaped criminal liability that would have led to its demise.[121]

Interestingly, KPMG was not the only professional firm allegedly involved in this tax shelter affair. It turns out that Raymond J. Ruble, a partner at the law firm Sidley Austin Brown & Wood LLP, issued numerous legal opinions supporting the legality of the transactions at stake. The government indeed indicted Ruble for his role in marketing these tax shelters.[122]

Under the existing regime of respondeat superior, the government could have indicted not only the partner involved, but also the law firm itself. Indeed, Sidley Austin settled a lawsuit filed by investors in those tax shelters and agreed to pay to the IRS a *civil* penalty of $39.4 million for its role in the tax shelter affair.[123] Unlike in the case of KPMG, however, federal prosecutors did not press charges against (or enter into a deferred prosecution agreement with) the law firm, citing the fact that its tax shelter work had been primarily carried out by one person.[124]

Our analysis sheds a new light on the government's distinction between KPMG and Sidley Austin. The reported evidence shows that a relatively large number of senior KPMG officials participated in the scheme to market the allegedly abusive tax shelter.[125] In other words, wrongdoing was pervasive and not the result of an isolated decision taken by members of the firm in a strategic

121. David Reilly, *Narrow Escape: How a Chastened KPMG Got By Tax-Shelter Crisis*, WALL ST. J., Feb. 15, 2007, at A1.

122. *See* Carrie Johnson, *9 Charged over Tax Shelters in KPMG Case*, WASH. POST, Aug. 30, 2005, at A1.

123. *See* Ben Hallman, *Damage Control: Sidley Agrees to Pay $40 Million for a Rogue Partner's Tax Shelter Schemes. But the Tab Is Still Running*, AM. LAW., Nov. 2005, at 18.

124. *See* Lynnley Browning, *Court Ruling Jeopardizes U.S. Tax Case*, N.Y. TIMES, May 24, 2007, at C1.

125. *See* Buell, *supra* note 43, at 488-89 (reporting KPMG's admission that the conduct involved "dozens of KPMG partners and other personnel").

setting. There was thus little risk that subjecting the firm to criminal liability for its tax-shelter activities would undermine deterrence in future similarly situated firms.

On the other hand, the publicly available evidence indicates that Ruble acted alone, with neither cooperation nor endorsement by his partners. In fact, Ruble was subsequently forced to resign after it turned out that he did not accurately report to his own firm the amount of the fees he received for providing legal opinions to tax shelter clients.[126] Under these circumstances, holding the law firm criminally liable (with the probable outcome of putting it out of business) would have been unwise from a deterrence perspective.

We should stress that we do not argue that firms should face no liability whatsoever for the acts of rogue employees. Rather, we believe that when liability is likely to trigger an entity's demise, convicting the firm for a single employee's misconduct might undermine compliance incentives.

C. *Unlimited Liability of Professional Firms*

The implications of our analysis are not limited to criminal law. Our core insight—that harsh penalties might undermine deterrence in group settings—applies to other cases of collective sanctions, whether civil or criminal. In this Subpart, we use our analysis to shed a new light on the controversy over unlimited liability for professional firms.

For many years, the law required professional firms to organize as general partnerships. Under partnership law, general partners are jointly and severally liable for wrongful acts committed by partners. In recent years, however, there has been a widespread trend among states to allow professional firms to enjoy the benefits of limited liability.[127] This move has always been controversial,[128] and it became even more so in the aftermath of the recent spate of corporate scandals.[129]

Like in the case of the harsh corporate penalties, critics of limited liability for professional firms posit that unlimited liability would bolster deterrence, increase incentives to monitor,[130] and further discourage members from

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126. *See* Lynnley Browning, *Top Tax Shelter Lawyer No Longer at a Big Firm*, N.Y. TIMES, June 30, 2004, at C1.

127. Partners are still liable for their own wrongful acts under all limited liability statutes for professional firms. Some states also hold partners liable for the acts of those whom they supervise and control. *See* Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 BUS. LAW. 85, 94-95 (1995).

128. *See generally* Martin C. McWilliams, Jr., *Who Bears the Costs of Lawyers' Mistakes?—Against Limited Liability*, 36 ARIZ. ST. L.J. 885 (2004); Puri, *supra* note 16.

129. *See* sources cited *supra* note 21.

130. *See, e.g.*, Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1727 (1998) ("A public interest rationale for some form of mandatory vicarious liability is that it increases monitoring beyond what lawyers otherwise would do in the absence of a mandatory rule.").

committing misconduct.[131] Supporters of limited liability contend that it would reduce internal agency costs and allow firms to grow larger.[132] Our analysis, however, shows that holding individual partners liable for the misconduct of their peers might prove counterproductive by diluting deterrence.

Under a regime of unlimited liability, individual partners might lose all their wealth for a single act of misconduct, producing a catastrophic loss.[133] On the one hand, this increase in liability exposure might strengthen partners' incentives to monitor against misconduct.[134] With their personal wealth at risk, partners—whether individually or as a group—would likely increase the investment in monitoring and policing employees and other partners. On the other hand, subjecting individual partners to harsh financial consequences as a result of others' misconduct might undermine deterrence.

Consider first the paradigmatic small professional firms. When partners can cheaply monitor their colleagues, holding them liable for wrongdoing committed by their partners will likely motivate them to effectively police their peers. In this case, therefore, unlimited liability will likely bolster deterrence.

But the effect of unlimited liability might differ with respect to the modern professional firm, with a large number of partners working at different locations. Members of such firms are incapable of monitoring their colleagues to eliminate wrongdoing. Moreover, the liability exposure of members of large firms is greater—both in terms of the likely magnitude of damages and the higher probability of misconduct given the large number of members. A partner might thus face a decision whether to engage in wrongdoing in a strategic setting—when a partner's wealth depends not only on her own decision but also on the acts of others. Under conditions of uncertainty, a partner might estimate that her entire wealth is at a serious risk anyway. In this case, a regime of unlimited liability would undermine deterrence at the level of the individual partner.[135] Indeed, there is evidence that a limited liability organizational form is more likely to be adopted by larger law firms.[136]

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131. For a review of the arguments for unlimited liability of professional firms, see Larry E. Ribstein, *Limited Liability of Professional Firms After Enron*, 29 J. CORP. L. 427, 429 (2004).

132. *See, e.g.*, Ribstein, *supra* note 130, at 1707-08 (asserting that limited liability allows law firms to grow larger).

133. *See, e.g.*, Floyd Norris, *Will Big Four Audit Firms Survive in a World of Unlimited Liability?*, N.Y. TIMES, Sept. 10, 2004, at C1 (reporting a concern that auditor liability would cause audit firms to become insolvent). In theory, partners who are required to bear the cost associated with liability could recover from other partners. However, this is unlikely to provide a meaningful relief. *See* Ribstein, *supra* note 131, at 435.

134. The literature typically depicts unlimited liability as inducing partners to intensify their own monitoring effort rather than increasing the amount that the *firm* expends on monitoring. *See, e.g.*, Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107, 115 ("[U]nlimited liability encourages monitoring of each partner by every other partner.").

135. The problem might be mitigated, but not eliminated, to the extent that the regime of unlimited liability requires each partner to bear only her share of the damages. *See* Henry

V. CONCLUSION

Since Enron imploded in late 2001, the government has increasingly relied on criminal law to combat organizational misconduct. Targeting business organizations, however, can lead them to unravel, thereby subjecting employees, communities, and other innocent parties to harsh collateral consequences.

The dire consequences of entity criminal liability occupy center stage in the decades-old debate concerning corporate criminal liability. Critics contend that these consequences render entity criminal liability unjust. Others, however, believe that the uniquely severe impact of criminal liability turns it into the most effective tool for combating organizational misconduct.

This Article, however, demonstrated that using the threat of going out of business as a deterrent may be unwise. Harsh corporate penalties might distort firms' incentives to monitor for misconduct, and undermine deterrence of professional firms' members. Moreover, more lenient regimes—such as holding firms liable only for pervasive wrongdoing—might bolster compliance incentives within organizations.

Given the uncertainty concerning their ultimate effect, policymakers should generally ensure that entities are not subject to penalties carrying severe collateral consequences. Alternatively, we explored what liability standard should apply when a conviction would inevitably lead a firm to unravel.

The implications of our analysis are not limited to entity criminal liability. Our core insight—that harsh penalties might undermine deterrence in group settings—illuminates other instances of collective sanctions as well. For example, our analysis suggests that prohibiting law and accounting firms from organizing as limited liability entities might undermine rather than enhance the incentives of their members to refrain from wrongdoing.

Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991). Also, the problem could be solved if professional firms could purchase satisfactory liability insurance.

136. *See* John Romley & Eric Talley, *Uncorporated Professionals* (U.S.C. CLEO Res. Paper No. C04-18, U.S.C. Law & Econ. Res. Paper No. 04-22), *available at* http://ssrn.com/abstract=587982.

APPENDIX: MEMBER INCENTIVES IN PROFESSIONAL FIRMS

This Appendix generalizes the example that we discuss in Part I.B.[137]

A. *The Threshold B* Under the Existing Criminal Liability Regime*

Let p be the probability that an offense is detected and triggers a conviction. An attorney's gain from misconduct is his private information, whereas the other only knows that it is drawn from a uniform distribution on [0,100]. Denote this benefit by B_E for Elizabeth and B_J for John.

Table 5. The Professional Firm Misconduct Game: Criminal Liability

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	-80p, B_E-80p
	Commit	B_J-80p, -80p	B_J-80(1-(1-p)^2), B_E-80(1-(1-p)$^{2)}$

We look for a symmetric Bayesian Nash Equilibrium.[138] Denote by B^* the threshold benefit in such equilibrium, so that all attorneys whose benefit exceeds B^* commit misconduct, and all attorneys whose benefit is lower than B^* do not commit it. By hypothesis, an attorney whose benefit is B^* must be indifferent between committing and not committing an offense. Using simple algebra it can be shown that the indifference condition is:

$$B^* - 80p - 80p(1-p)\left(1 - \frac{B^*}{100}\right) = -80p\left(1 - \frac{B^*}{100}\right)$$

Rearranging this condition we get:

$$B^* = \frac{80p(1-p)}{1-0.8p^2}$$

Substituting 0.9 for p, as we do in the example in Part I.A, we get B^*=20.45. The graph in Figure 1 is obtained by finding the threshold B^* for each probability of conviction, p, between 0 and 1.

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137. For a description of the game's setup, see *supra* Part II.A.

138. For a definition of a Bayesian Nash Equilibrium, see DREW FUDENBERG & JEAN TIROLE, GAME THEORY 215 (1991).

B. *The Threshold B* Under Civil Fines*

When the fine for each offense is 80, the game matrix is:

Table 6. The Professional Firm Misconduct Game: Civil Fines

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	$-40p$, B_E-40p
	Commit	B_J-40p, $-40p$	B_J-80p, B_E-80p

Now an attorney would commit the offense if and only if $B>40p$. The threshold is, therefore, $B^*=40p$. If $p=0.9$ then $B^*=36$.

C. *The Threshold B* Under the Pervasiveness Standard*

Under the pervasiveness standard the matrix is the following:

Table 7. The Professional Firm Misconduct Game: Pervasiveness Standard

		Elizabeth	
		Don't Commit	Commit
John	Don't Commit	0, 0	0, B_E
	Commit	B_J, 0	B_J-80p^2, B_E-80p

The indifference condition for each player is then:

$$B^* - 80p^2\left(1 - \frac{B^*}{100}\right) = 0$$

Rearranging, we get:

$$B^* = \frac{80p^2}{1+0.8p^2}$$

Substituting 0.9 for p, as we do in our example in Part I.B, we get $B^*=39.3$.