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ORGANIZATIONAL LIABILITY

*James Fanto**

This Article focuses on the role of organizational liability and the corporate monitor in addressing corruption in publicly traded business firms. The major disagreements with respect to organizational liability involve belief and theory. The belief issue concerns whether one thinks that groups, organizations, and larger social bodies or institutions significantly determine a scandal or corruption in a business firm. My sense is that many people believe that these social factors are unimportant background or, at best, secondary causes. If one accepts (as I do) that a scandal is determined by group, organizational, and institutional factors, as well as by individuals, there should be a theory that draws a relationship between these causes in a coherent way. Indeed, the need for a comprehensive theory linking these numerous factors is suggested by research findings that, in a given situation, there is often no single factor, whether individual, group, or organizational, that entirely explains the corruption in an organization because it is caused by multiple factors, with certain ones being more important than others in any given situation.¹ Moreover, if one accepts that multiple causes determine organizational corruption, it is difficult then to make policy suggestions for remedying the problems without a coherent theory.

Social psychology and organizational research offer theoretical frameworks that attempt to reconcile the different causal factors.²

* Professor, Brooklyn Law School. I would like to thank my colleague, Professor Miriam Baer, for inviting me to participate on the panel and my co-panelists, Professors Henning and Orland. © All rights reserved.

¹ See generally YOAV VARDI & ELY WEITZ, MISBEHAVIOR IN ORGANIZATIONS: THEORY, RESEARCH, AND MANAGEMENT 23 (2004).

² One useful collection of articles with various theoretical frameworks is the July issue of 33 ACAD. MGMT. REV. (2008).

One particularly useful framework distinguishes between “organizations of corrupt individuals” and a “corrupt organization.”³ The former case involves “bottom up” corruption where rogue individuals in a corporation focus on their own personal benefit at the detriment of organizational goals. Their perspective and practices can also adversely affect an organization, or at least parts of it. For example, one thinks of a police department where there are rogue officers. Generally, individuals or “bad apples” are the cause of such corruption although group, organizational, and cultural issues may be implicated as well, as others imitate the individuals’ conduct in the organization.⁴ A corrupt organization, by contrast, is generally characterized by “top down” misconduct orchestrated by senior executives of a firm who act primarily for the firm’s own goals (e.g., to enhance profitability) and who establish models of thinking and conduct for others in the organization, but whose activities end up being harmful to third parties (e.g., shareholders, communities) and ultimately to the overall organization.⁵ Many examples of this kind of corrupt organization come to mind, for this is the typical scenario of a corporate or financial scandal: Enron with the single-minded focus of its top management on maximizing shareholder value, even if the executives perverted the ways to achieve it;⁶ and a contemporary example is Goldman Sachs, with its culture of trading for the firm’s benefit at the expense of its service to clients.⁷

A corrupt organization requires a different method of reform than does an organization of corrupt individuals. While reform in

³ See generally Jonathan Pinto et al., *Corrupt Organizations or Organizations of Corrupt Individuals? Two Types of Organization-Level Corruption*, 33 ACAD. MGMT. REV. 685 (2008).

⁴ See *id.* at 688–89.

⁵ See *id.* at 689–90.

⁶ See generally BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003).

⁷ See generally Complaint, Sec. & Exch. Comm’n v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010). The SEC and Goldman have just entered into a settlement. Consent of Defendant Goldman, Sachs & Co., Sec. & Exch. Comm’n v. Goldman Sachs & Co., No. 10-CV-3229 (BSJ) (S.D.N.Y. July 14, 2010).

the former case centers on removing the “bad apples” from the firm, the latter demands significant organizational reform beyond expelling the executives who pushed the firm down the road of corruption. Even if the senior executives in a public firm are removed, the perverse organizational mindset and practices may remain, for they have become ingrained in the culture of the firm. Depending upon the extent of the corruption, there must be an extensive “top-to-bottom” reform of the affected (one might say “infected”) firm’s ways of doing business. In the worst case, the organization must be disbanded because it is irretrievably corrupt and beyond reform. Drexel Burnham Lambert in the financial sector,⁸ and Arthur Andersen in the accounting industry are prime examples.⁹ Ending the existence of a corrupt organization, however, can be problematic, for it can result in the dispersion of individuals from the organization, which means that the corrupt mindset and practices propagate throughout the industry as the individuals take positions at other firms.¹⁰ Again, Goldman Sachs, which has “alums” throughout the financial world, including in financial regulation, is an example of a firm that spreads its questionable practices through its alumni.¹¹

Moreover, there are broad social and cultural factors that reinforce the individual, group, and organizational mindsets that lead to corruption within business firms. If these factors are not addressed, reforming the organization will not adequately remedy the undesirable conduct.¹² For example, there are numerous social causes for the misconduct in Enron and in the financial

⁸ This was Michael Milken’s junk bond investment bank. For a contrasting view of the firm’s demise, see generally DANIEL FISCHER, *PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION* (1995).

⁹ Arthur Andersen, one remembers, collapsed when it was indicted in connection with its auditing of Enron.

¹⁰ See John M. Darley, *Social Organization for the Production of Evil*, 3 *PSYCHOL. INQUIRY* 199, 208–11 (1992).

¹¹ For example, two Goldman Sachs alums include Robert Rubin, the former Treasury Secretary and Chairman of Citigroup, and Jon Corzine, the former New Jersey Governor.

¹² On these issues, see generally Vilmos F. Misangyi et al., *Ending Corruption: The Interplay Among Institutional Logics, Resources, and Institutional Entrepreneurs*, 33 *ACAD. MGMT. REV.* 750 (2008).

conglomerates that were at the heart of the financial crisis, including the academic and professional training received by their executives in business schools and in their professional careers. More simply put, their training was based upon a specific view of human beings (i.e., self-interested profit maximizers), and this view then became a self-fulfilling reality when individuals began to act in accordance with the theory and expected everyone else to do the same.¹³ Thus, remedying business corruption requires a transformation of the basis of business training, which goes beyond the reform of specific business organizations. Significantly, the issue of organizational corruption is complex and a simple solution, such as the expulsion or incarceration of a few individuals, does not accomplish meaningful reform of a corrupt firm.

Organizational liability, whether criminal or “quasi criminal” in the form of an enforcement action brought by a government agency such as the Securities and Exchange Commission (“SEC”), is one way in which a corrupt business organization can be reformed. The major problem with organizational liability, whether in the criminal or civil enforcement context, is that it has not been used in a sustained, thoughtful way to reform corrupt organizations. Rather, it has served as a tool for making an organization a part of the prosecutorial process against corrupt (and even not so corrupt) individuals in the firm.¹⁴ The

¹³ See, e.g., Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGMT. LEARNING & EDUC. 75, 76-77 (2005); Dennis A. Gioia, *Business Education’s Role in the Crisis of Corporate Confidence*, 16 ACAD. MGMT. EXECUTIVE 142, 143 (2002).

¹⁴ See James A. Fanto, *Recognizing the “Bad Barrel” in Public Business Firms: Social and Organizational Factors in Misconduct by Senior Decision-Makers*, 57 BUFFALO L. REV. 1, 54-61 (2009) [hereinafter *Bad Barrel*]. A well-known example of the use of organizational prosecution to reach individuals is the prosecution of executives of the accounting firm KPMG in the Southern District of New York. In several thoughtful opinions, Judge Kaplan found that prosecutors coerced KPMG not to provide assistance and defense to the accused employees. For a description of this jurisprudence and related developments, see JAMES A. FANTO, *DIRECTORS’ AND OFFICERS’ LIABILITY* § 7.6 (2d ed. 2009). See also John Hasnas, *The Centenary of a Mistake: One Hundred Years of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1329 (2009) (arguing that corporate liability is un-American in that it gives prosecutors too much

prosecutorial and enforcement situation concerning business organizations today is heavily weighted against the accused employees when they are alleged to be involved in a criminal violation or a serious civil infraction. Under pressure from prosecutors and enforcement personnel, an accused firm will identify individuals to be sacrificed as scapegoats for the benefit of the organization. The organization can then undertake reforms, even if they lack substance, and argue to the outside world that the problem has been addressed because the “bad apples” have been expelled. The use of organizational liability thus reflects the belief that corruption in a firm is due to the “bad apples,” and not to a perverse firm culture or business practices that in fact transcend individuals.

It is not the place here to explore in detail the reasons for this use.¹⁵ Suffice it to say here that there are interrelated individual, group, organizational, and institutional reasons for this prosecutorial and enforcement emphasis on prosecuting individuals. For example, prosecutors have limited time horizons in office and for career reasons want the kind of visible results that come from putting away the “bad guys.” Organizations, like offices of U.S. attorneys and the SEC Enforcement Division, have institutional practices and are part of a legal system that focuses on individual liability. Moreover, prosecutors and enforcement staff are driven by the U.S. ideological tenet that outcomes are due primarily to individuals.

That being said, the question arises whether organizational liability could be altered to affect real reform of a corrupt business firm. This question raises the issue of the role of the corporate monitor, which is a standard part of the deferred or the no prosecution agreement. In practice, the corporate monitor is often a former prosecutor or judge who is appointed for a limited term to

discretion in the prosecution of individuals in firms). *But see generally* Sara Sun Beale, *A Response to the Critics of Corporate Criminal Liability*, 46 AM. CRIM. L. REV. 1481 (2009) (arguing that these abuses do not characterize just corporate criminal liability, but criminal prosecution more generally. For example, prosecutors are given too much discretion, the crimes are overly broad and not always aimed at reprehensible conduct, and innocent third parties are often punished.).

¹⁵ For an in-depth discussion on this topic, see *Bad Barrel*, *supra* note 14.

ensure that the business firm reforms itself in line with the commitments it made in the agreement. The monitor is, therefore, an outsider to the firm and even to the firm's business and has a defined, restricted role, except in unusual cases.¹⁶ The firm's commitments in an agreement are often of a highly legal or technical nature. The firm, for example, might commit to enhancing its compliance system, increasing compliance and ethics training for employees, incorporating more oversight into transaction approvals, and hiring outside auditors or other parties to help it develop compliance or other systems.¹⁷ The goal of the corporate monitor is to see that these commitments are fulfilled, which has a "check the box" aspect about his or her tasks.¹⁸

This kind of a corporate monitor is likely to be useful, or at worse only to be a minor expense, in a situation where a scandal involved only corrupt individuals and a partial corruption of the organization. The "bad apples" will be removed, and the monitor's supervision of the organization's reforms will help the firm put itself back on the lawful path and, as discussed below, will send a signal to outsiders about its rehabilitation. Again, given the dynamics of organizational prosecution, this kind of monitor with a compliance orientation is applied in all cases of corruption because of the underlying assumption that they primarily involve corrupt individuals.

However, this monitor will generally be of little value in a corrupt organization, where the organizational beliefs and ways of conduct (in short, its culture) have been altered and corrupted.

¹⁶ One unusual case was Richard Breeden's appointment as a monitor of WorldCom by Judge Rakoff. Mr. Breeden was involved in a wholesale reform of the firm. *See generally* RICHARD C. BREEDEN, RESTORING TRUST, REPORT TO THE HON. JED S. RAKOFF, THE UNITED STATES DISTRICT COURT OF THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC. (2003).

¹⁷ *See* U.S. DEP'T JUSTICE, ATTY'S OFF., PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS § 9-28.1300 (2008).

¹⁸ For the Department of Justice's discussion of the selection and tasks of the monitor, see generally Memorandum from Craig S. Morford, Acting Deputy Atty Gen., U.S. Atty's Off., to Heads of Dep't Components, U.S. Atty's, *Selection of Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations* (Mar. 7, 2008), available at <http://www.justice.gov/dag/morford-useofmonitorsmemo-03072008.pdf>.

Since, in other words, corruption has taken root in the organization, meaningful reform would require an in-depth transformation of the firm. To be effective in these circumstances a monitor should have a more open-ended mandate, significant resources (including advice from firm insiders), adequate incentives, and the competence to understand how to change ingrained organizational views and practices. As an alternative, a traditional compliance-oriented monitor could prove effective in a corrupt organization scenario, but only if he or she assisted new executives who were themselves motivated to alter significantly the organization.

In an earlier article, I examined how federal prosecutors and the SEC could reorient their deferred or no prosecution agreements to use a corporate monitor in order to accomplish more significant organizational reform, in circumstances where such reform was needed.¹⁹ I concluded that the SEC was better situated than federal prosecutors for this task, since it has jurisdiction over public companies that are part of the market system that it regulates.²⁰ More simply, the SEC has an institutional interest in more significant organizational and industry-wide reform with respect to companies under its regulatory jurisdiction and is not as susceptible to pressures for prosecutorial results. Accordingly, it could design a mandate for a corporate monitor that would be more extensive than what has been typical, and federal prosecutors could give it their support. The monitor could continue to be a prominent lawyer, judge, or other professional, whose stature is useful when the monitor must deal with executives who might be inclined to continue past practices.

On the issue of competence to accomplish meaningful reform, I argued that social psychologists and organizational theorists should be enlisted as consultants by corporate monitors in order to bring their knowledge of group, organizational, and institutional causes of misconduct to the reform of companies.²¹ Although they are not

¹⁹ See *Bad Barrel*, *supra* note 14, at 73–76.

²⁰ This jurisdiction comes from the fact that public companies are reporting companies under the Securities and Exchange Act of 1934, which means they are companies whose securities are traded in organized markets. See generally Securities Exchange Act, 15 U.S.C.A. § 781 (West 2010).

²¹ See *Bad Barrel*, *supra* note 14, at 76–79.

likely to be the right persons for the position of corporate monitor (i.e., not having the adequate “stature” to deal with senior executives), they would be ideal for the consultant role, similar to accountants, finance specialists, and outside lawyers who are brought in for their expertise. Moreover, enlisting social psychologists and organizational theorists would not only bring their expertise to reform efforts, but their participation would also reinforce the view that organizational corruption is not only due to individual factors; in other words, it would ensure that group, organization, and institutional factors are adequately recognized. In addition, their involvement would counter the current bias—held by academics and practitioners alike—concerning problems in business organizations, which tends to view them as just matters of financial reform and finance.

It should also be recognized that a corporate monitor can help a firm in its rehabilitation, which is a social process, whether the corruption in the firm was widespread or limited. Organizational theorists who study firm rehabilitation point out that it passes through several stages: (i) discovery and identification of the facts of the scandal; (ii) offering an adequate explanation for it; (iii) undergoing punishment; and (iv) rehabilitation proper, which includes internal changes and an explanation of the reform to external parties.²² By the time a corporate monitor is installed, the firm has generally disclosed the facts and reasons for the scandal, offered a suitable explanation, and accepted its punishment. Clearly, a major role for the monitor in the rehabilitation of the organization is to affect the necessary internal changes to the firm and to make it clear to outsiders that the changes adequately address the corruption and that the firm is truly reformed. Without rehabilitation, a firm may continue to be punished “informally,” as customers, regulators, and the media deem the official punishment to be too light and the internal reforms to be inadequate. Thus, while the monitor is engaged in substantive reforms, he or she also has a symbolic or signaling function to internal and external constituencies.²³

²² See Michael D. Pfarrer et al., *After the Fall: Reintegrating the Corrupt Organization*, 33 ACAD. MGMT. REV. 730, 735–40 (2008).

²³ The monitor thus becomes a symbol for those in the organization who

Finally, the responsibility of a government organization for a corporate problem suggests that the government organization can be reformed as well. For example, there may well be group, organizational, and cultural issues at the Board of Governors of the Federal Reserve System and the U.S. Treasury Department, which, during the financial crisis, led these agencies to engage in unethical and unprincipled transgressions: saving certain financial institutions, but not others; strong-arming Bank of America into purchasing Merrill Lynch; and supporting the payment of counterparties of American International Group.²⁴ It would appear that, for reasons of sovereign immunity and other doctrines, organizational liability with its corporate monitor is not possible here, whether criminal or civil, and the question arises how reform of these agencies can be achieved, except through the political process and Congressional oversight. There are, however, Inspectors General and oversight boards, which provide outside perspectives and reform suggestions to the agencies, and they have sparked reforms within the SEC and watched over the actions of the Treasury.²⁵ My suggestion for corporate monitors to enlist the

wish to reform it and who are undertaking the necessary cultural changes. They can then act under the authority of the monitor and use his or her power. *See generally* Peter Henning, *Corporate Criminal Liability and the Potential for Rehabilitation*, 46 AM. CRIM. L. REV. 1417 (2009) (arguing that criminal prosecution through the use of deferred prosecution agreements actually works as a useful tool in reforming the organization by expressing a social message to it that spurs its reform and overcomes the firm's reluctance to change its culture).

²⁴ In an opinion rejecting a settlement between the SEC and Bank of America, Judge Rakoff expressed his own concerns about the conduct of the SEC in its investigation of Bank of America's disclosure violations regarding the Merrill Lynch merger. *See generally* Sec. & Exch. Comm'n v. Bank of America, Nos. 09-CV-6829 (JSR), 10-CV-0215 (JSR), 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010).

²⁵ For example, the SEC Inspector General investigated the SEC's inadequate regulation of investment bank holding companies and mishandling of inspections of Bernie Madoff. *See* OFFICE OF AUDITS, U.S. SEC. & EXCH. COMM'N OFFICE OF INSPECTOR GEN., REVIEW AND ANALYSIS OF OCIE EXAMINATIONS OF BERNARD L. MADOFF INVESTMENT SECURITIES, LLC (2009). For the Treasury, there is a Congressional Oversight Panel reviewing its actions during the financial crisis, see CONG. OVERSIGHT PANEL, <http://cop.senate.gov> (last visited Oct. 13, 2010), and a Special Inspector General of the Troubled

help of social psychologists and organizational theorists could equally apply to these officials and reviewing boards. With this expert aid, Inspectors General and oversight boards could make reform proposals for these agencies that would be more effective in addressing their organizational and institutional defects.

Asset Relief Program, see OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLE ASSET RELIEF PROGRAM, <http://www.sigtar.gov> (last visited Oct. 13, 2010).