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Potential Misuse of Weapons in War on Corporate Malfeasance

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From its proscriptions on audit committees, to enhanced penalties for obstruction of justice, to bolstered protection for whistle-blowers, one of the underlying and unifying attributes of the far-reaching Sarbanes-Oxley Act of 2002[1] is an effort by lawmakers to require corporate managers and employees to partner with federal authorities in the enforcement of federal securities law. This mandate is consistent with long-standing (and recently reaffirmed) Securities and Exchange Commission and Department of Justice practices of rewarding individuals and entities for cooperation with their efforts. The deputization of private corporate actors, however, is not without its risks.

When a constituent of a corporation -- a group of board members, for example, or a cabal of executives allied with a faction of the board -- seizes control of the flow of information to the civil and criminal authorities -- to the exclusion of other corporate decision-makers, corporate cooperation may be a stalking horse for internal struggles for corporate control. But, given the government's emphasis on real-time enforcement and punishment (and public pressure to ferret out swiftly and punish the bad corporate actors), its renewed emphasis on cooperation and its preference for management shake-ups and reorganizations over corporate dissolution, law enforcement officials may find themselves assisting in a corporate-control fight, without assessing carefully the credibility and motives of the parties with whom they have become allied.

In light of this risk, regulators and prosecutors should be wary of the various candidates for the position of Caesar's wife whose offers of cooperation on behalf of a company may mask a covert corporate takeover ploy.

Prosecutorial Goals, Cooperation Strategy

The SEC and the DOJ both have emphasized the importance of cooperation on the part of constituents in a corporation in furthering their efforts to root out improper behavior in a targeted corporation. Both the U.S. Sentencing Commission Guidelines and the prosecutorial offices of the DOJ and the SEC have attempted to structure incentives to encourage insider cooperation. Sarbanes-Oxley contains new incentives for cooperation both through directly legislating corporate/private oversight of the regulatory process and also through fostering such participation through additional protection for whistle-blowers[2] and increased penalties for those who fail helpfully to participate. The United States Attorney's Office in the Southern District of New York has expressed an ongoing preference for target companies to be partners in criminal investigations and expects a high level of cooperation from corporations arguing that they should escape indictment.[3]

The desirability of cooperation by corporate insiders is certainly understandable. Corporate insiders are in a position to discover criminal activity before it becomes apparent to prosecutors. They are able to locate and procure evidence that would be difficult and time-consuming for prosecutors to discover on their own. Given sufficient authority, insiders can ensure that derelictions are not repeated.

The motivations of the insiders who cooperate with enforcement officials are not always so straightforward. Many, to be sure, are simply honest, the classic whistle-blowers, who are simply opposed to corporate crime and report malfeasance at a cost or risk, sometimes high, to themselves. Others are insiders who have their own interests to protect, such as senior management who implicates more junior (and sometimes less-culpable) employees as the miscreants responsible for corporate wrongdoing, a practice known as scapegoating, or higher-ups, in what may be called a corporate Nuremberg defense.

Power Struggles, Prosecution Weapons

In the wake of the recent upsurge in aggressive prosecutorial activities by government regulators, a new variation on the cooperating corporate insiders may be emerging. Cooperation with prosecutors is for them an opportunity to tilt the playing field in a battle for control of vulnerable corporations.

This new opportunity is created from the convergence of two separate, but related, concerns of the government enforcers. Responding to the public outcry for swift retribution against corporate malefactors in the wake of the Enron and similar corporate disasters, the government enforcers committed, in the words of the head of the Corporate Fraud Task Force, to taking swift and certain action to punish the wrongdoers and restore confidence to investors. [4] The enhanced coordination among civil and criminal authorities embodied in the Corporate Fraud Task Force has increased exponentially the pace and volume of investigations and prosecutions of corporate fraud.[5] The SEC has dedicated itself to enhancing its efforts at real-time enforcement,[6] as displayed recently in the SEC's SWAT team approach in filing an enforcement action against HealthSouth Corp. and its chief executive officer, Richard Scrushy, while at the same time filing ex parte petitions for emergency orders freezing all assets of Mr. Scrushy, escrowing any upcoming (but still-undefined) extraordinary payments[7] to HealthSouth's directors, officers, controlling persons and employees, and obtaining expedited discovery.

At the same time, the enforcement community continues to express an understandable reluctance to target corporate entities for criminal prosecution and civil enforcement penalties, in the belief, as President George W. Bush remarked, that [a] few dishonest individuals have hurt the reputations of many good and honest companies and executives.[8] Deputy Attorney General Larry D. Thompson has commented that corporate prosecutions should always be considered, but should be undertaken sparingly.[9]

Given the huge increase in the volume and pace of investigations and prosecutions and an institutional reluctance to prosecute corporate entities, the government enforcers turn to individuals in the upper echelons of corporate management both for partners who can provide swift and effective cooperation and for targets who can be blamed for the corporate wrongdoing. From the point of view of individuals seeking to gain control of a corporation, these twin government needs can offer an opportunity instead of a threat. The logic is plain -- if prosecutors can be persuaded that certain actions by incumbent management, or some of its officers, require investigation, it will be in the corporation's best interests to isolate and eventually dismiss those individuals.

It hardly matters whether in the last analysis the managers are guilty of a crime or not. The impact on investors of a publicly heralded investigation, plus the risk that indeed some wrongdoing may be uncovered, are a strong motivation to the corporation to placate the government by terminating the employment of the suspect individuals or management team. This in turn opens the door for a new group to take power.

In a disturbing undercurrent to the new and improved prosecution of corporate fraud, government enforcers appear to be at least tacitly encouraging corporate control contests as a means of purging the taint of corporate wrongdoing. The SEC expressly has stated that among the factors it considers in determining whether to charge a corporation with wrongdoing is whether the company [is] the same company in which the misconduct occurred ....[10] While the SEC referred in particular to changes in the corporation due to bankruptcy or merger, the same logic applies to other changes in corporate control.

Although the DOJ has not identified changes in management as a criterion in determining whether to prosecute, the DOJ cites as factors in reaching a decision regarding whether to target corporations for prosecution the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents as well as the corporation's remedial actions, including efforts to ... replace responsible management [and] to discipline or terminate wrongdoers.[11] As one commentator suggested, effective corporate cooperation with government enforcers may be nearly impossible without management restructuring.[12]

In light of the new prosecutorial priorities and sotto voce encouragement of management shakeups, there exists a significant risk that when one faction reaches out to prosecutors and causes the corporation to cooperate and provide information to the exclusion of another, it may do so in an effort to consolidate its grip on the reins of power. In this circumstance, the benefits of cooperation are not only felt by the corporation that receives favorable treatment from prosecutors and/or regulators, but also from the cooperating coalition of senior managers, who can both avoid implication in wrongdoing and also, once their adversaries are purged, emerge unchallenged for control of the entity.

It is not easy even for relatively guiltless management to defend against this play. In practice, the party that first gets the ear of the prosecuting agencies gains a considerable advantage, something akin to first mover advantage. The cooperators can monopolize channels of communication with the prosecutors, boxing out their rivals. Indeed, in the

interests of confidentiality the opposing faction may never learn exactly what the government has been told. The race to the prosecutor's office can be as significant as the race to the courthouse.

Unanticipated Consequences

In the past, Congress has been sensitive to issues of corporate control in enacting reform legislation. In passing the Williams Act governing tender offers, for instance, Congress made it clear that it did not want to alter the balance between incumbent management and potential acquirers.[13] Similarly, the Private Securities Litigation Reform Act (PSLRA), while designed to protect corporations from nuisance securities class actions, was crafted not to bar or hinder the pursuit of legitimate claims.[14]

In contrast to these statutes, Sarbanes-Oxley was notoriously rushed through the legislative process, with few hearings and little discussion. It is not surprising, therefore, that its impact may extend beyond the intent of the legislative and executive branches. It is thus left to the enforcement agencies to refine the weapons they have been given to ensure they target only malefactors and do not create victims of friendly fire. There is a great temptation for prosecutors to use the instruments provided them to the fullest extent possible and let the consequences take care of themselves.[15] A full-scale assault by the DOJ or SEC is undoubtedly intimidating. It is not necessarily, though, the most fruitful policy.

Given the current emphasis on real-time enforcement, protection for whistle-blowers and significant encouragement on and rewards for early cooperation, the SEC and the Justice Department would do well to be concerned lest they become unwitting accomplices of corporate factions wresting control for purely selfish motives.

1. Pub. L. No. 107-204, 107th Cong., 2d Sess., 116 Stat. 745 (2002).

2. The Sarbanes-Oxley Act's new whistleblower provisions, included in 806, provide special protection for employees of publicly traded companies who provide evidence of fraud. The act specifies that companies may not discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because that employee assisted in an investigation regarding conduct that the employee reasonably believes to constitute a securities law violation.

3. See, e.g., Audrey Strauss, The Government Proposes Partnership in its Criminal Investigations: Should Your Corporate Client Accept the Proposal, White Collar Crime 1998, at B-57 (Am. Bar. Ass'n 1998).

4. Remarks of Deputy Attorney General Larry D. Thompson to the Citizens' Crime Commission, at *3 (New York, New York July 25, 2002) (available at http://www.usdoj.gov/dag/speech/2002/072502citizenscrimecomm.htm) (Thompson 7/25/02 Remarks').

5. The SEC brought 598 enforcement actions in the last fiscal year. See Securities Exchange Committee Annual Report 2002, at 2, 144. It currently has more than 2,200 investigations under way. See Key Senator Backs SEC's $841.5-Million Budget, The Los Angeles Times, April 9, 2003, part 3, p. 4. The Justice Department is pursuing more than 130 prosecutions. See Top Executives Elusive for Prosecutors, Washington Post, Jan. 24, 2003, p. E1.

6. See Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 (Jan. 24, 2003), at 2.

7. See Stanley S. Arkin and Timothy A. Greensfelder, Business Crime: SEC's Authority to Temporarily Freeze Assets Under Sarbanes-Oxley, The New York Law Journal, Feb. 25, 2003, p. 3, col. 1.

8. Remarks by the president at Corporate Fraud Conference, Washington Hilton Hotel (Washington, D.C. Sept. 26, 2002), at *1 (available at http:// www.whitehouse.gov/news/releases/2002/09/20020926_10.html).

9. Thompson 7/25/02 Remarks, at *2.

10. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Release No. 34-44969, 76 S.E.C. Docket 220, 2001 WL 1301408 (S.E.C. Oct. 23, 2001).

11. Larry D. Thompson, Principles of Federal Prosecution of Business Organizations Memorandum, at *3 (Washington, D.C. Jan. 20, 2003) (available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.html).

12. See Michael Simons, Vicarious Snitching: Crime, Cooperation and Good Corporate Citizenship, 76 St. John's L. Rev. 979, 999-1008 (Fall 2002) (providing examples of corporate cooperation - or a lack thereof - and concluding

that without a change in top management, it can be nearly impossible for a corporation to fully cooperate, because top managers will essentially be cooperating against themselves').

13. Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454. See, e.g., Piper v. Chris-Craft Indus., Inc., 430 US 1, 29 (1977).

14. Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, 109 Stat. 737. See S. Rep. No. 104-98, at 4 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 683 (the PSLRA is intended to ... combat[] abuses, while maintaining the incentive for bringing meritorious actions').

15. For example, violators of the touted CEO and CFO certification requirement for publicly filed financial statements will be subject to fines of up to $1 million and imprisonment of up to 10 years, and even heavier penalties up to $5 million and 20 years in prison for willful violations. Under 807, it is now a crime to defraud anyone or fraudulently to obtain money or property in connection with any security of a public company. A conviction under this section can carry up to a 25-year prison term and a fine. See 18 USC 1348. In addition, the act includes significant federal sentencing guideline enhancements and increased penalties for a variety of previously existing offenses. See, e.g., 903 (increasing prison term from maximum of five years to 20 years for mail and wire fraud); Section 1106 (increasing maximum fine for Exchange Act violations from $1 million to $5 million for individuals and from $2.5 million to $25 million for entities).