TESTIMONY OF

PAUL ROSENZWEIG

SENIOR LEGAL RESEARCH FELLOW
CENTER FOR LEGAL AND JUDICIAL STUDIES

THE HERITAGE FOUNDATION*

214 MASSACHUSETTS AVENUE, NE
WASHINGTON, DC 20002

BEFORE THE UNITED STATES SENTENCING COMMISSION

REGARDING

SENTENCING OF CORPORATE FRAUD AND
WHITE COLLAR CRIMES

25 MARCH 2003

Good morning Judge Murphy and Members of the Commission. Thank you for the opportunity to testify on the proposed amendment regarding corporate fraud and, more generally, about the nature of white-collar crime sentencing.

For the record, I am a Senior Legal Research Fellow in the Center for Legal and Judicial Studies at The Heritage Foundation, a nonpartisan research and educational organization. I am also an Adjunct Professor of Law at George Mason University where I teach Criminal Procedure and an advanced seminar on White Collar and Corporate Crime. I am a graduate of the University of Chicago Law School and a former law clerk to Judge R. Lanier Anderson, III, of the U.S. Court of Appeals for the Eleventh Circuit. For much of the first 15 years of my career I served as a prosecutor in the Department of Justice and elsewhere, prosecuting white-collar offenses. During the two years immediately prior to joining The Heritage Foundation, I was in private practice representing principally white-collar criminal defendants. I have been a Senior Fellow at The Heritage Foundation since April 2002.

The Commission considers today, among other issues, the proposed permanent amendment to the Sentencing Guidelines implementing the directives of the Sarbanes-Oxlely Act of 2002, Pub. L. 107-204. To a large degree the base text of this proposed permanent amendment mirrors the temporary, emergency amendment made by the Commission last December, which took effect in January 2003. The Commission also seeks

comment on various possible "Options" that might be considered as alternatives to the base proposal.

Though it is far too early to have any empirical data for assessing the effect of the temporary amendment, it has already generated substantial commentary. In particular, some commentators, most notably the Department of Justice, think that the temporary amendment did not go far enough in implementing Sarbanes-Oxley and suggest that the provisions of the Guidelines regarding corporate fraud be further strengthened - they therefore advocate both further enhancements of the loss table and, in some instances, a higher base offense level for fraud offenses.

Allow me to take this opportunity today to discuss with you two issues regarding the pending proposal: 1) The conception of "white-collar" crime and how that effects proposals to further modify the fraud loss table and/or the fraud base offense level; and 2) A modification of the director and officer provisions of the Guidelines to take account of the burgeoning legal concept of "managerial liability."

White Collar Crime, Business Fraud, and Regulatory Fraud

The proposal before the Commission would (as did the emergency amendment) add two new levels to the loss table in section 2B1.1 at the top end, providing for even greater penalties for frauds involving more than $200 and $400 million respectively. It would also make permanent various new provisions enhancing penalties when the fraud in question affects a large number of victims, involves a director or officers of a publicly traded company, or substantially endangers the safety and soundness of a financial institution, a public company, or a large private company.

The Department of Justice has suggested that the Commission's amendments do not go far enough. Rather, the Department believes the entire fraud loss table requires adjustment and that, to implement the dictates of Sarbanes-Oxley, the Commission should enhance penalties for *all* frauds, not just those at the top end of the scale. In the Department's view, these revisions are necessary to insure that "all but relatively minor fraud crimes will result in prison time for the wrongdoer." The Commission has asked for comment on this proposal, on specific suggested new loss tables, and on a related proposal to increase the base offense level for certain frauds with enhances statutory maximum penalties.

With all due respect to the Department, I believe that the alternative it urges, embodied in the options proposed for consideration by the Commission, misread Congressional intent in enacting Sarbanes-Oxley.

One can always find snippets of legislative history to support most any interpretation of a Congressional action. Thus, I would not suggest to you that my reading of Congressional intent is without any doubt. Nonetheless, I believe that a full review of the legislative record and, in particular, an understanding of the *context* within which the Sarbanes-Oxley Act arose, provides substantial guidance as to the type of criminality Congress intended to address. In my judgment it is fair to say that in passing Sarbanes-Oxley Congress did *not* have an intent to enhance penalties for all garden-variety common

law frauds - what one might characterize as "street frauds" for want of a better word. Rather, I believe that Congress intended to enhance penalties for a unique subset of frauds - those we identify colloquially as "white collar," "business," or "regulatory" frauds. In assessing the Commission's proposal I therefore believe that the appropriate place to begin is by attempting to define what a white-collar or regulatory crime is.

It is possible to identify certain hallmarks of white-collar, regulatory offenses. The type of offense I have in mind - the one to which I think Sarbanes-Oxley was particularly directed -- is, classically, fraud by any other name. At their core, business frauds are no different in motivation from any common law fraud occurring on the street. Some of the Enron and Tyco allegations, if they are proven true, will fit comfortably into this classical conception of crime.

This sort of white-collar crime has been around for a long while. Many would argue that, viewed through the prism of today, some of the "robber barons" of the turn of the century were white-collar criminals. As A.B. Stickney said to 16 other railroad presidents in the home of J.P. Morgan in 1890, "I have the utmost respect for you gentlemen individually, but as railroad presidents, I wouldn't trust you with my watch out of my sight."

Thus, commentators are right to recognize a fundamental similarity between business frauds and common law frauds insofar as they share similar aspects of intent or *scienter*. But the analogy is not, in my view, complete. It misses important distinctions (distinctions implicit in the passage of Sarbanes-Oxley) between common law frauds and white collar or regulatory frauds. For though both arise from essentially the same *mens rea*- they typically are conducted with the same level of willful intent -- they are accomplished by a far different means or *actus reus* -- that is, they have a different methodology. Business frauds differ in the details of how they are executed, in the sophistication of those who execute them, and in the difficulty that prosecutors have in unraveling them.

Thus, the reason these types of frauds are distinguished as white-collar offenses is because of the means the actors have chosen for committing their criminal offenses. [Another distinguishing aspect of the definition might be the socio-economic status of the perpetrator. I hope that all agree that the socio-economic distinction is (or should be) of no consequence in setting the appropriate sentencing level.] Recognizing the distinction in the method or *modus operandi* of the crime is are vital in capturing Congress' apparent intent -- white collar penalty enhancement should focus on those offenses that are frauds by new and different means - means that we can characterize, loosely, as "regulatory" means.

What then are "regulatory means?" That is, concededly a hard question, not capable of a ready and easy answer. I can, however, sketch some of the parameters of the answer:

First, the subject matter of the offense often involves frauds that arise not because of their inherently deceptive nature, but because the frauds conceal a violation of some underlying substantive statutory scheme that is, itself, a creature of the modern American regulatory state. No statute is required to identify the criminal fraud inherent in the Ponzi schemes that were rampant in the Depression era. By contrast, the "off the books" partnerships at the core of the Enron investigation become criminal not because of something inherently wrongful in that type of corporate organization - rather, they are

wrongful solely because they contravene an existing statutory and regulatory structure. Without the regulatory structure the crime might well not exist.

Second, the means of carrying out the fraud is through the instruments of that same regulatory structure. The structure itself - its reporting requirements and its substantive provisions - is enlisted by the criminal in aid of his act. The structure provides the means of both disseminating his fraud and of concealing it.

I realize that these considerations are by no means easy to apply in all cases. I equally recognize that not all will agree with my conception of a white-collar offense. Nonetheless, the foregoing considerations lead me to conclude that the proposed base amendment under consideration more closely addresses the core concerns, which animated Congressional passage of Sarbanes-Oxley. A broad based, one-size-fits-all increase in the fraud loss tables generally would enhance punishment for both common-law frauds and those business frauds that arise from the violations of regulatory norms. Such a result would be, I believe, a misreading of what Congress has required.

Rather, the Commission should focus on sentencing provisions that distinguish between business frauds and street frauds. The provisions relating to the number of victims and threats to financial institutions go a long way towards making that distinction - common law frauds are less likely to have a large number of victims and are especially unlikely to threaten the stability of large banks and corporations. Admittedly, the "fit" is not perfect - there will be some common law crimes captured by these offense adjustments and some white-collar frauds that are not addressed. But these two factors would appear to be a suitable proxy for the general question - is this a "white collar crime?"

The only alternative I can think of to offer the Commission would be the far more fact intensive alternative of providing a sentencing enhancement if the crime "involved use of regulatory or business expertise" or some such formulation. While such an effort would be more directly, it is an open question whether there is substantial gain in coverage of the sentencing provisions that are worth the significant burden that would be placed on the probation office and the sentencing court if they were required, in each case, to examine the methodology by which the crime was committed and assess whether it arose from an abuse of the regulatory process. Thus, I think the Commission is wise to focus the inquiry on factors (such as the number of victims and the failure of a bank) that are readily ascertainable and provide for ease of implementation.

The Appropriate Quantum of Punishment

Let me next address directly the nuts and bolts question that lurks behind some of the criticism - the question of where to set the penalty levels for fraud. As my comments reflect, unlike the Department of Justice, in general, I think the Commission has identified the right factors to consider in responding to Sarbanes-Oxley. The current level of punishment for fraud is quite significant. In substantially raising the penalties to be imposed for the largest frauds, the Commission has, in my view, responded respectfully to Congressional direction.

That is not, however, the same thing as saying that the quantum of punishment now

imposed is appropriate. That depends, very much, on one's antecedent view of the severity and societal significance of corporate fraud in America. When I testified last year before the United States Senate, I presented some analysis that bears on the question, a portion of which I'd like to share with you, now:

I considered the federal criminal sentences imposed in Fiscal Year 2000, the most recent year for I had a complete data set. Significantly, FY 2000 involved data for sentences imposed prior to the November 2001 fraud guideline revisions, which substantially enhanced the penalties for fraud even before the Sarbanes-Oxley Act was passed.

According to Commission's statistics, in FY 2000 federal courts entered convictions for 58,636 individuals. I examined data regarding the length of imprisonment imposed by category of offense:

Crime Type	**Mean Sentence (in months)**	**Median Sentence (in months)**
Robbery	110.6	77.0
Drugs -- Trafficking	75.3	57.0
Drugs - Possession	18.5	6.0
Manslaughter	26.1	18.0
Larceny	15.6	12.0
Fraud	18.0	12.0
Embezzlement	9.9	5.0
Bribery	16.2	12.0
Tax Offenses	16.6	12.0
Money Laundering	46.3	33.0
Environmental/Wildlife	14.5	9.5
Antitrust	12.7	6.5
Food & Drug	23.1	12.0

The mandatory nature of certain drug offenses is reflected in the data. The disparity in some of these sentences might be read to suggest that white-collar offenses are penalized less stringently, than "street crime" offenses - a reading that would support enhanced penalties for fraud if one believed that the two types of crime ought to be equated.

But there are other aspects of this data that are significant. Insofar as the data are susceptible to analysis, other than serious violent, personal offenses (such as robbery) and offenses relating to drug trafficking (including money laundering) it is noteworthy, I think, that in FY 2000 most offenses were treated relatively similarly, with typical sentences falling in a fairly narrow range of from 1-2 years. Even manslaughter sentences do not vary appreciably from this seeming norm. One might almost suspect that we had reached a general consensus on the subject as a society and identified 1-2 years as the appropriate just punishment for most criminal offenses. In short, it appears that the sentencing guidelines, prior to the November 2001 revisions, reflected a societal agreement as to the equivalence between white-collar fraud, tax evasion, and simple drug possession.

Sarbanes-Oxley plainly calls for some revision to this calculus. As to the appropriate quantum of punishment for true white-collar fraud, I have no crystal ball, nor any

independent moral authority to advise you - that is Congress' job as the representative of the American public.

Clearly, though, we can assess the current state of sentencing: The November 2001 fraud revisions to the Guidelines (as to whose effect no data is yet available) have already substantially modified the rough equivalence I identified in FY 2000 data. With the further revisions adopted as temporary measures last year, I think that in some instances the current sentencing structure might fairly be termed "draconian." One can readily imagine, for example, scenarios where a corporate chief executive has a cumulative offense level in excess of the current level-43 maximum and receives a life sentence - a sentence previously reserved for those convicted of first-degree murder or treason.

Whether this is appropriate is not an easy question to answer, particularly for an academic happily ensconced in the ivory tower of a think tank. I certainly yield to no one in my conviction that corporate offenders ought to be punished no differently then blue collar offenders when they deserve it. But it is fair to wonder whether equating corporate fraud with murder or treason truly captures the "just desert" component of criminal law.

In addition, while the measure of deterrence is for Congress to decide, not this body, one may fairly wonder if the new sentences to be imposed are not somewhat more than is necessary to achieve the other objective of criminal law -- deterrence. I know of no evidence or study suggesting that substantial additional deterrence will be achieved by ever more extended incarceration. Indeed, my own experience is that it is the *fact* of incarceration, not the *length* of incarceration is the primary deterrent. Put another way, in the white-collar arena, what deters is the prospect of being caught not the length of sentence to be imposed.

Thus, I would urge caution on the Commission before it rushes to raise sentence levels further without any empirical data establishing its necessity. Especially in the white-collar area, where rational economic actors understand some of the risks attending criminal activity, such increases may not be required to achieve deterrence ends nor may they be "just."

Some Heretical Thoughts on "Managerial Liability"

Finally, allow me to turn to the proposed amendment to section 2B1.1(b)(13) imposing penalties on directors and officers. In my view, the Commission needs to modify this provision to account for the legal concept of managerial liability.

The Commission should begin by recognizing a variant form of white-collar fraud offense - a type that is quite different than the one we have been discussing thus far. These frauds involve prosecutions not for common frauds but for violations of rules and regulations that are part of a larger statutory structure.

In modern America, as the regulatory state has grown, the number of such criminal offenses has grown apace. They are predicated on violations of the regulations of the Health Care Finance Administration, the Occupational Health and Safety Administration, the Consumer Products Safety Commission and a host of other Federal "alphabet agencies." The growth in this form of white-collar criminal offenses is what Professor John Coffee has

called the “technicalization” of crime. For this category of white-collar offenses, the criminal law is increasingly being used interchangeably with civil remedies.

Three doctrinal developments define this second type of white-collar offense and differentiate it from the classic frauds that are the focus of the Sarbanes-Oxley legislation. First, this type of white-collar offenses involves the criminalization of conduct that, in most instances, is not inherently wrongful in the same way that fraud and bribery are. Rather, we have seen a growth in the category of “public welfare offenses” - a category first created with modest penalties and now increasingly felonized. Second, and of special significance in weighing moral culpability, the statutes involve offenses where the *mens rea* requirement is substantially diminished, if not eliminated. For example, we now punish as strict liability offenses the taking of migratory birds - even if done utterly by accident.

Third, and as relevant to the proposal I advance here, this type of white-collar offense increasingly involves criminal prosecutions of managerial officers for, in effect, vicarious liability. This doctrine known as “managerial liability” or the “responsible corporate officer doctrine” involves the imposition of criminal liability on corporate officers who bear a responsible relationship to some underlying criminal conduct. Unlike traditional criminal law, those “responsible corporate officers can be convicted and imprisoned even though they had no active role in the conduct at issue. Rather, they may be convicted if they merely had, as one Court has said, the “authority to exercise control over the corporation’s activities. There is no requirement that the officer *in fact* exercise[d] such authority.” The use of this doctrine is especially prevalent in many of the regulatory areas such as securities law that are the precise focus of the Sarbanes-Oxley revisions being contemplated by the Commission.

Whatever one may think of the concept of managerial liability as a basis for criminal sanction, none should dispute that there are fundamental differences in criminal culpability between corporate managers who are active participants in criminal activity and those who stand convicted because of their role as officers or managers within a company and whose liability is based solely on their authority to act and their alleged failure to exercise that authority. Yet, the “Role In The Offense” provisions of the Sentencing Guidelines, § 3B1.1, do not attempt to distinguish between these two aspects of a corporate manager’s potential relationship to crimes committed by individuals in an organization. They are drafted solely with the paradigm of an active managerial participant in mind. Section 2B1.1(b)(13) of the emergency amendment adopted by the Commission in response to the Sarbanes-Oxley bill, only serves to enhance this focus - the unstated premise of the amendment is that the corporate officers being punished are those who, in fact, *did* exercise their authority to direct the criminal conduct in question. Yet, the provision, as drafted, has no such limitation. It is quite likely that the penalty enhancements of subsection (b)(13) will be imposed on directors and officers without regard to their actual participation and/or culpability in the underlying criminal offense.

When these sentencing provisions are applied to responsible corporate officers whose criminal liability is premised solely upon their status as corporate officers and their theoretical ability to have avoided the harm in question, the punishment imposed does not fit the crime. The current Guideline provisions enhancing a corporate officer’s punishment based upon his status as an officer thus drain the criminal law of a portion of its moral force.

This is not, of course, the place for an extended discussion of the concept of "managerial liability" or the growth of the regulatory state. Suffice it to say that legal obligations have come increasingly to be imposed by statute rather than through the common law. The Supreme Court first endorsed the trend in 1943, in *United States v. Dotterweich*, 320 U.S. 277 (1943). There the Court addressed a provision of the Food and Drug Act making it a crime to introduce into commerce an adulterated or misbranded drug (that is, one not suitable for consumption or mislabeled). Dotterweich was the President of a pharmaceutical company that had transported certain adulterated drugs in interstate commerce. But it was equally clear that there was "no evidence . . .of any personal guilt" on the part of Dotterweich - there was no proof that "he ever knew of the introduction into commerce of the adulterated drugs in question, much less that he actively participated in their introduction."

As currently employed, the managerial liability doctrine allows the conviction of an officer for because he bore a "responsible relation to the situation even though he may not have participated in it personally." This "responsible relation" doctrine, is difficult to cabin or limit. At its inception the Court said (*United States v. Park*, 421 U.S. 658 (1975)) it could not define or "even indicate by way of illustration" the class of employees who stood in responsible relation to a crime. Rather, it left such definition to "the good sense of prosecutors, the wise guidance of trial judges, and the ultimate judgment of juries." Thus, according to the Court, corporate managers have

> not only a positive duty to seek out and remedy violations when they occur but also, and primarily, a duty to implement measures that will insure that violations will not occur. The requirements of foresight and vigilance imposed on responsible corporate agents are beyond question demanding, and perhaps onerous, but they are no more stringent than the public has a right to expect of those who voluntarily assume positions of authority in business enterprises whose services and products affect the health and well-being of the public that supports them.

In sum those who voluntarily chose to engage in productive economic conduct place themselves at risk of criminal sanction for their "felony failure to supervise." As at least one court has noted, this policy decision to criminalize conduct without reference to whether or not managers have personally acted in a culpable manner may have the effect of dissuading those who work to produce goods and services for society from continuing to do so: "If we are fortunate, sewer plant workers . . . will continue to perform their vitally important work despite our decision. If they knew they risk three years in prison, some might decide that their pay . . . is not enough to risk prison for doing their jobs."

An understanding of this history allows one to critique the current structure of the Sentencing Guidelines as inadequately sensitive to this doctrine. Even if one grants the utilitarian argument in favor of criminal sanctions - that enhanced penalties will modify conduct - it is appropriate to recognize that the utilitarian argument is a *different* argument from the normal ground of criminal law. It flows not from a conception of "just deserts" but from an effort to calibrate the deterrence value of a criminal sanction. And whatever

one may think of how that calibration calculus should be rendered it is, it seems clear, indisputable that: a) deterrence is only one aspect of criminal punishment to be considered; and b) with respect to corporate officers, there is no reason to believe that deterrence will operate with different effect on the two classes of actors - those who are active participants in a crime and those whose conduct is criminalized because of their failure to act. No matter what the value of deterrence, punishment should be greater for those whose acts are deliberate and willful acts in furtherance of a crime than it is for those whose criminality is premised on a failure to act. Traditional concepts of justice require nothing less.

Accordingly, a modification of the Guidelines is in order, perhaps in the form of an Application Note to section 2B1.1(13) along the following lines [as an aside, I would also urge, at the appropriate time, consideration of similar guidance with respect to section 3B1.1]:

> To qualify for an adjustment under this section based upon a defendant's role as an organizer, leader, manager, supervisor, director or officer, the defendant's conduct must have involved actual participation in the crime in question. The defendant must have been a direct participant in the crime or had direct knowledge of the crime. An adjustment under this section is not appropriate if the defendant's conviction resulted solely from conduct involving a failure to act when under a legal duty to do so or where the defendant's conviction otherwise resulted solely from his status as a responsible corporate officer.

In my judgment criminal law in a free society must be carefully crafted to target wrongful conduct, and not be used simply to ameliorate adverse consequences attributable to a failure to act. Criminal sentencing should therefore reflect the distinction between those who act and those who are vicariously responsible for the acts of others, and reserve the more severe condemnation and loss of liberty for those who are direct participants in criminal conduct. The current director/officer provisions of the proposed amendment lack that distinction and ought, therefore, to be revised.

Judge Murphy, thank you for the opportunity to testify before the Commission. I look forward to answering any questions you might have.