# THE LOCUS OF CORPORATE SCIENTER

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## I. INTRODUCTION

Consider the following scenario: A corporation issues an earnings report containing various misrepresentations regarding its financial status. These fraudulent misrepresentations cause injury to the current shareholders of the corporation and intimate a much larger, systematic fraud conceived at the core of the corporation's "numbers driven" culture. After the fraud is discovered, the corporation's stock price plummets, setting off the legal equivalent of a five-alarm fire; both criminal prosecutors and the civil plaintiffs' bar comb through the wreckage for a responsible party. The chief executive officer of the corporation is indicted, convicted, and sentenced to twenty-

five years in prison for her part in the fraud, and her personal wealth is disgorged for the benefit of injured shareholders. On the civil side, a class action suit proceeds against a number of defendants, including the issuer corporation, pursuant to Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.[1] The defense attorneys representing the corporation seek dismissal of the suit on the grounds that the *corporation* did not possess the requisite scienter for a finding of liability.[2]

Such a hypothetical scenario raises the question of where corporate scienter resides. Does it reside in the mind of the jailed CEO? In the mind of the chief financial officer who prepared the report but received a reduced prison sentence in exchange for his testimony at the CEO's trial? In the minds of the regional sales managers, some of whom falsified numbers included in the fraudulent report? In the minds of the hundreds of rank and file employees who bought into the aggressive culture of meeting Wall Street's financial performance targets at any and all costs? Like the mythical multiheaded monster, Hydra, a corporation has many minds.

A corporation, by definition, is a "body formed and authorized by law to act as a single person although constituted by one or more persons and legally endowed by various rights and duties."[3] From a jurisprudential

[1] Codified at 15 U.S.C. § 78j(b) (2000) and 17 C.F.R. 240.10b-5 (2000), respectively. The Supreme Court has stated that "[t]he scope of Rule 10 . . . is coextensive with the coverage of § 10(b) . . . therefore [the Court] use[s] §10(b) to refer to both the statutory provision and the Rule." SEC v. Zandford, 535 U.S. 813, 816 n.1 (2002) (citing United States v. O'Hagan, 521 U.S. 642, 651 (1997)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976). This Article follows the Court's lead.

[2] The term "scienter," as applied to conduct necessary to give rise to an action for civil damages under the Securities Exchange Act of 1934 and Rule 10b-5, refers to a mental state embracing an intent to deceive, manipulate, or defraud. *Ernst & Ernst*, 425 U.S. at 185. In this Article, the terms "intent," "mens rea," and "scienter" will be used interchangeably to refer to the same concept of a "guilty state of mind" as applied in different legal contexts.

[3] WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 292 (1991).

standpoint, this seemingly straightforward dictionary definition is a paradoxical Gordian Knot[4] with which courts and commentators have struggled for centuries.[5] It is in the realm of offenses requiring specific intent that this theoretical struggle is played out most dramatically.[6]

"Intent" is defined by Black's Law Dictionary as "[a] *state of mind* in which a *person* seeks to accomplish a given result through a course of action" or "[a] *state of mind* existing at the time a *person* commits an offense and may be shown by act, circumstances and inferences deducible therefrom."[7] In the many formulations of the definition of intent, there is one commonality: the inevitable mention of a "person" in whom it resides. One might suppose that this "person" cannot be anything but a *natural* person—a human being with the necessary mental capacity to chart out a given path in furtherance of a criminal or tortious end. Nonetheless, many criminal and civil offenses require proof of a *corporation's* intent in order to find it culpable of wrongdoing. So, how can a corporation—which is only a "person" by an act of legal anthropomorphization—come to possess a unitary, discrete, and demonstrable state of mind?

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[4] The Gordian Knot is a metaphor for an apparently insoluble problem requiring a bold and unconventional solution ("cutting the Gordian knot"). *See generally* ROBERT GRAVES, THE GREEK MYTHS (Penguin Books 1992) (1955).

[5] *See generally* KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY: A TREATISE ON THE CRIMINAL LIABILITY OF CORPORATIONS, THEIR OFFICERS AND AGENTS § 2:02 (2d ed. 1992) (discussing the historical development of corporations).

[6] *See, e.g.,* Presbyterian & Reformed Pub. Co. v. Comm'r, 743 F.2d 148, 155 (3d Cir. 1984) ("The difficulties inherent in any legal standard predicated upon the subjective intent of an actor are further compounded when that actor is a corporate entity."); EEOC v. Univ. of Tex. Health Science Ctr., 710 F.2d 1091, 1096 (5th Cir. 1983) ("[P]roving up the collective intent of a giant state institution as we have here is particularly difficult and uncertain.").

[7] BLACK'S LAW DICTIONARY 810 (6th ed. 1990) (emphasis added).

Given the epistemological conundrum of ascribing liability to a lifeless entity,[8] three questions inevitably arise: (1) How does one properly attribute an "act" to a corporation; (2) How does one properly ascribe intent to a corporation; and (3) Must the imputed corporate action and the imputed corporate intent intersect in one individual actor? This Article addresses the latter two questions and attempts to furnish a workable solution to them in the context of civil securities fraud cases.

Over the years, the criminal law has had to develop a series of responses to the problem of corporate mens rea to enable it to realize the goals of punishment, retribution, and deterrence. For almost a century, the civil agency doctrine of respondeat superior, the first and most traditionally accepted of these approaches, has served as the linchpin of corporate criminal liability.[9] Respondeat superior renders a corporation criminally liable for the acts of any of its agents if an agent (1) committed a crime, (2) within the scope of his employment, and (3) with intent to benefit the corporation.[10]

Yet, well-established agency principles like respondeat superior do not apply neatly to corporations in certain

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[8] Assessing the optimal degree to which corporations should be held civilly or criminally liable, if at all, is beyond the scope of this article. For purposes of this Article, it is assumed that corporate liability is both socially desirable and acceptable. For more on this question, see Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319 (1996); Lawrence Friedman, *In Defense of Corporate Criminal Liability*, 23 HARV. J.L. & PUB. POL'Y 833 (2000); V.S. Khanna, *Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea*, 79 B.U. L. REV. 355, 359 (1999) [hereinafter Khanna, *Faulty Notion*]; V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1479-81 (1996) (discussing obstacles to the general acceptance of corporate criminal liability concept) [hereinafter Khanna, *Corporate Criminal Liability*].

[9] *See* N.Y. Cent. & Hudson River R.R. v. United States, 212 U.S. 481 (1909).

[10] *See* W. PAGE KEETON, PROSSER AND KEETON ON TORTS 499-508 (5th ed. 1984). For a discussion on the requirements of corporate liability under the respondeat superior approach, see Note, *Corporate Crime: Regulating Corporate Behavior through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247-1251 (1979) [hereinafter Note, *Corporate Crime*].

critical circumstances. One such instance arises when the act and the intent do not coincide in a single corporate actor. Given that many corporations are large decentralized groups of individuals, often with collectivized decisionmaking structures and a multitude of actors participating in a single corporate act, criminal law has been forced to find alternatives to respondeat superior for proving or imputing knowledge and intent in the context of corporate crime. One of these alternatives, known as "collective knowledge" or "collective scienter," aggregates the states of mind of several agents within a corporation to prove the knowledge of a corporate defendant.

The concept of collective scienter has recently, with some controversy, entered the domain of Section 10(b) claims.[11] Though not always explicitly recognized as such, some courts have presumed collective scienter, allowing for an ultimate finding of corporate liability under Section 10(b) even where no one culpable actor possesses the necessary intent. Other courts have rejected such a view. Utilizing a comparative and interactive approach, we aim to analyze corporate scienter in the area of 10(b) litigation and, ultimately, to formulate a rule that will simplify the concept of corporate intent in securities fraud cases.

In Part II, we present two recent Section 10(b) cases that are contradictory in both their logic and assumptions. While one case presupposes the notion of collective scienter in a corporation, the other expressly rejects the idea that liability may attach to the corporation when one unknowing corporate actor speaks for the corporation while another corporate actor has guilty knowledge of the misrepresentations. In Part III, we indulge an in-depth analysis of five tenets of criminal law regarding the corporate form, corporate liability, and the efficacy of agency principles in the pursuit of corporate justice. In no area of law has the concept of collective knowledge been so discussed and undergone such evolution. Consequently, it is a natural

[11] *See generally* Craig L. Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934,* 1989 BYU L. REV. 1227 (1989).

source of enlightenment for judges, scholars, and practitioners of civil securities law, where corporate defendants are as common as natural person defendants. In Part IV, we attempt to glean some insight into collective action and intent principles in securities fraud cases by analyzing and applying criminal law principles. We then propose a rule for attributing a corporate agent's intent to a corporation, one that is largely inspired by traditional criminal law principles. After discussing and testing the application of our rule in a range of real world scenarios, we conclude in Part V that a legal reconceptualization of corporate action and thought is both necessary and possible.

## II. APPLES AND TIRES

Though few courts explicitly refer to the doctrine of corporate scienter by name, in effect, their decisions either apply the doctrine or they do not. Two recent high profile cases illustrate the divergent treatment of corporate scienter by courts. Each case involves a well-known, publicly traded company and assesses corporate scienter in the context of a securities fraud suit. While the underlying fact scenarios of the cases differ only slightly, the reasoning and decisions on the issue of corporate liability under Section 10(b) are diametrically opposed. In the first case, the Sixth Circuit had little difficulty permitting a suit to proceed against Bridgestone and Firestone based on a silent corporate officer's alleged scienter. In the other case, the Ninth Circuit summarily dismissed a suit against Apple Computer based on statements by its officers that were allegedly known by others in the corporation to be false. This Section reviews the facts and rationales of these two opinions, which, standing in relatively stark counterpoise, set the stage for our discussion of corporate scienter in Section 10(b) cases.

## A. Apple Computer

In a fairly simple, straightforward, and representative case,[12] the Ninth Circuit in *Hawaii Structural Iron Workers Pension Trust Fund v. Apple Computer, Inc.*[13] recently affirmed the district court's dismissal of a class action securities fraud suit against Apple Computer and its CEO, Steven Jobs.[14] In an unpublished decision, the Ninth Circuit flatly rejected any type of collective scienter theory and affirmed the district court's brief analysis:

> It is not enough to establish fraud on the part of a corporation that one corporate officer makes a false statement that another officer knows to be false. A defendant corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter, i.e., knows the statement is false, or is at least deliberately reckless as to its falsity, at the time that he or she makes the statement.[15]

The plaintiffs in *Apple Computer* alleged that corporate officers made misrepresentations to bolster the company's stock price during the technology stock tumble of 2000.[16] On appeal, four different statements or sets of statements were at issue. The Ninth Circuit deemed one statement nonactionable "puffery,"[17] but treated the remaining three as

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[12] For other similar cases, see, *e.g.*, Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 383-84 (5th Cir. 2004); Adams v. Kinder-Morgan, Inc., 340 F.3d 1083 (10th Cir. 2003); Suez Equity Investors, L.P. v. Toronto Dominion Bank, 250 F.3d 87 (2d Cir. 2001).

[13] No. 03-16614, 2005 U.S. App. LEXIS 5511 (9th Cir. Apr. 4, 2005). The lower court case, *In re* Apple Computer, Inc. Secs. Litig., 243 F. Supp. 2d 1012 (N.D. Cal. 2002), will be referred to herein as *In re Apple*.

[14] *Apple Computer*, 2005 U.S. App. LEXIS 5511, at *22.

[15] *In re Apple*, 243 F. Supp. 2d at 1023.

[16] *Id.* at 1016.

[17] This was a set of statements by CEO Steven Jobs about the Power Mac and its new dual processor capability. *Apple Computer*, 2005 U.S. App. LEXIS 5511, at **17-20.

potentially actionable false statements. The three statements were: (1) revenue projections made by Apple CFO Fred Anderson in a July 18, 2000 conference call with analysts;[18] (2) statements made by Apple Controller Peter Oppenheimer during that same conference call regarding the success of Apple's reorganization of its K-12 educational sales force;[19] and (3) statements made at a sales conference by Apple CEO and codefendant, Steven Jobs, regarding the commercial viability and success of a new Apple product, the G4 Cube.[20]

Consistent with the view that Section 10(b) liability attaches only when a misstatement coincides with scienter in the same individual, thus making any corporate liability only vicarious, the Ninth Circuit parsed the plaintiffs' allegations statement by statement, separately assessing the scienter of each speaker.[21] As for Anderson's scienter in making fourth quarter 2000 revenue projections, the court gave short shrift to the allegation that Anderson had a duty as CFO to know Apple's "correct financial condition."[22] The court noted that this allegation alone might permit a reasonable inference of negligence—if Anderson's statements were false[23]—but it did not reach the level of scienter required for liability under the Private Securities Litigation Reform Act ("PLSRA").[24]

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[18] *Id.* at *8.

[19] *Id.* at **9-10. Apparently neither Anderson nor Oppenheimer was a defendant in the case.

[20] *Id.* at **12-14.

[21] Because the statements regarding the Power Mac and its new dual processor were considered to be "puffery," the court did not address Jobs's scienter or lack thereof in making the statements. *Id.* at **18-20.

[22] *Id.* at *9.

[23] On that question, in a separate section of the opinion, the court later noted that Anderson's revenue projections overstated the company's actual performance by less than 10%. *Apple Computer*, 2005 U.S. App. LEXIS 5511 at **20-21. The court found that the projections were immaterial as a matter of law, which could have served as a sufficient independent basis for dismissing the suit as to Anderson's alleged misstatements.

[24] *Id.* at *9. Section 21D of the PSLRA, Pub. L. No. 104-67, 109 Stat. 737 (1995) ("PSLRA"), requires plaintiffs seeking recovery under Section

Similarly, the court pointed out that the plaintiffs had failed to allege any specific facts showing that Oppenheimer knew that his statements about the K-12 sales force reorganization were false when made.[25]

Finally, in addressing Jobs's statements touting the new "Cube" computer and projecting the sale of 800,000 units in its first year, the Ninth Circuit panel entered the arena of collective scienter.[26] The court acknowledged plaintiffs' allegations that other Apple employees, including company engineers, senior managers, and executives, were aware that there were production problems with the Cube that threatened its commercial viability. Nonetheless, the court did not find that the plaintiffs had pled the allegations with sufficient particularity to attribute the necessary scienter to Jobs and, through him, to the company.[27] The *Apple Computer* court then referred, without further analysis, to a single inapposite prior case for the proposition that the Ninth Circuit previously had rejected the doctrine of collective scienter.[28]

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10(b) to plead particular facts that give rise to a strong inference of scienter. Securities Exchange Act of 1934, 15 U.S.C. § 78u-4(b) (2000).

[25] *Apple Computer*, 2005 U.S. App. LEXIS 5511, at *8, *11.

[26] Regarding Jobs's personal knowledge of substantial production difficulties with the Cube, the court considered and rejected plaintiffs' allegations that Jobs had access to and in fact knew about the problems. The appellate court agreed with the district court that the plaintiffs did not plead the allegations with sufficient particularity as to date, time, and content of memos and conversations. *Id.* at **14-16.

[27] *Id.* at *17.

[28] *Id.* (citing Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424, 1435-36 (9th Cir. 1995) (holding that a collective scienter theory would not alter the outcome of insurance indemnity suit)). In fact, the court in *Nordstrom* recognized that "[t]heoretically, collective scienter could be a basis for liability." *Nordstrom*, 54 F.3d at 1435. In connection with this proposition, the Nordstrom opinion quotes *In re Warner Communications Securities Litigation*, 618 F. Supp. 735, 752 (S.D.N.Y. 1985), for the proposition that a collective scienter theory "would require a showing that 'one or more members of top management knew of material information . . . but failed to stop the issuance of misleading statements . . . or that Warner management had recklessly failed to set up a procedure that insured the dissemination of correct information.'" *Id.* at 752. The

## B. Bridgestone

The Sixth Circuit's recent decision in *City of Monroe Employees Retirement System v. Bridgestone Corp.*[29] embraces a different line of reasoning than that employed by the Ninth Circuit. Though the opinion does not expressly invoke collective scienter theory, a review of the facts, reasoning, and ruling reveals that, unlike the Ninth Circuit in *Apple Computer*, the Sixth Circuit squarely embraces the possibility of liability for a corporation when one actor speaks and another has knowledge that those statements are false.

The *Bridgestone* case arose out of the well-publicized Firestone ATX tire/Ford Explorer product defect debacle.[30] Shareholders brought a class action suit under Section 10(b) against the Japanese company, Bridgestone, its wholly owned U.S. subsidiary, Firestone, and two corporate officers. The suit contended that the defendants made misrepresentations that concealed their knowledge about the potential for thousands of successful tort suits alleging that ATX tires caused injurious and fatal rollover accidents.[31] The district court granted the defendants' motions to dismiss claims against Bridgestone's President and CEO, Yoichiro Kaizaki, for lack of personal jurisdiction and against the remaining defendants for failure to allege adequately the scienter necessary for Section 10(b) claims.[32]

On appeal, the Sixth Circuit's approach to liability for these statements—specifically the sufficiency of the plaintiffs' scienter allegations—was completely different than that of the Ninth Circuit in *Apple Computer*. The Sixth Circuit apparently was unconvinced that to establish Section

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*Nordstrom* panel merely found on the state of the record before it, that plaintiffs did not make a sufficient evidentiary showing. 54 F.3d at 1436. It did not expressly accept or reject collective scienter as a theory.

[29] 387 F.3d 468 (6th Cir. 2004), *amended by* 399 F.3d 651 (6th Cir. 2005), *cert. denied*, 126 S. Ct. 423 (2005).

[30] 399 F.3d at 661-663.

[31] *Id.* at 658, 663-64.

[32] *Id.* at 664.

10(b) liability, scienter and a misstatement must reside in the same natural person, which theory incorporates the premise that a corporation acts only through its agents, and therefore, that corporate liability can only be vicarious. Taking that view, the court first tested the various alleged misrepresentations for their falsity, or tendency to mislead, and materiality, treating them all as general corporate statements.[33] As had the trial court, the Sixth Circuit panel rejected a number of these statements as general optimism or opinion.[34] However, the court found two statements to be potentially actionable; these statements ultimately served as the basis for the court's reversal of the lower court's Rule 12(b)(6)[35] dismissal of the claims against the two corporate defendants and the remaining individual defendant, Masatoshi Ono, Executive Vice President of Bridgestone and CEO of Firestone.

The first statement that the court considered involved a Firestone press release, issued in response to public outcry for a recall of tires on August 1, 2000. The press release announced: "[W]e continually monitor the performance of all our tire lines, and the objective data clearly reinforces our belief that these are high quality, safe tires."[36] For ease of reference, the court called this the "Objective Data" statement.[37] The second statement involved two written

[33] Indeed, the individual who made one of the alleged misstatements was not a named defendant, and the court made a point of not identifying her in its opinion. *Id.* at 662 n.9.

[34] *Id.* at 671.

[35] FED. R. CIV. P. 12(b)(6).

[36] City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 672-75 (6th Cir. 2005). A little over a week later, the company announced a formal recall of 6.5 million ATX tires. *Id.* at 662.

[37] *Id.* at 671. In addressing the falsity of the statement, the court viewed the context in which the statement was made and found that "a reasonable juror could infer that the 'objective data' representation was a direct response to the lawsuits, or to the public challenges to the safety of Firestone's tires, or to both" and that "a reasonable juror could conclude that the statement, without some qualification or accompanying disclosure of the numerous pieces of evidence that tended to cut the other way, was a misrepresentation." *Id.* at 672.

representations made in financial statements incorporated in Bridgestone's 1999 Annual Report to shareholders, which the court denominated the "No Impairment" representation and the "No Loss" representation.[38] Both of these statements related to Bridgestone's failure, from an accounting perspective, to note in its financial statements that the defective tires gave rise to potentially enormous contingent liability.[39]

Having established that these statements could serve as actionable misrepresentations, the court next considered whether either Bridgestone or Firestone had the requisite scienter to support a Section 10(b) claim. In addressing this issue, the court relied heavily on *Helwig v. Vencor, Inc.*[40] and the nine factors that the Sixth Circuit had previously identified as bearing on scienter in securities fraud actions.[41] These include:

> (1) insider trading at a suspicious time or in an unusual amount;
> (2) divergence between internal reports and external statements on the same subject;
> (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information;
> (4) evidence of bribery by a top company official;
> (5) existence of an ancillary lawsuit charging fraud by a company and the company's quick settlement of that suit;
> (6) disregard of the most current factual information before making statements;
> (7) disclosure of accounting information in such a way that its negative implications could only be

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[38] *Id.* at 674.

[39] *Id.*

[40] 251 F.3d 540 (6th Cir. 2001).

[41] The Sixth Circuit explicitly declined to frame the scienter inquiry under familiar Second or Third Circuit precedents, but rather called for an analysis of motive and opportunity or conscious misbehavior. City of Monroe Employees Ret. Sys v. Bridgestone Corp., 399 F.3d 651, 684 n.6 (6th Cir. 2005).

> understood by someone with a high degree of sophistication;
> (8) the personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and
> (9) the self-interested motivation of defendants in the form of saving their salaries or jobs.[42]

Regarding Firestone and its Objective Data statement, the Court pointed to allegations supporting at least five of the *Helwig* factors, specifically factors two, three, six, seven, and nine.[43] The first four of these allegations relate specifically to Firestone and the circumstances surrounding its corporate misstatement. The last factor relates only to conduct of individual corporate agents of Firestone. It is clear then that the Sixth Circuit's framework for analyzing scienter contemplates corporate liability separate and apart from the conduct of the individual defendants who might create vicarious liability for the corporate defendant.

Equally important for purposes of this discussion, the *Bridgestone* court also pointed to alleged facts demonstrating that a scenario analogous to *Helwig* factor number five, the existence of an ancillary fraud suit against the company and quick settlement thereof, was present.[44] The discussion of this factor focused on Firestone's confidential settlements of multiple claims relating to the ATX tire defects. Though the court recognized that these were "not, strictly speaking . . . based on fraud per se," it found that the "animating idea" behind this particular *Helwig* factor to be that:

> [A] company engaging in such practices is, all things being equal, more likely than not aware of the improper nature of the practice being alleged, or at least of the perception of the given problem, which puts it on notice and, is fair to say, generates a duty

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[42] *Helwig*, 251 F.3d at 552 (citing Greebel v. FTP Software, Inc., 194 F.3d 185, 196 (1st Cir. 1996)) (collecting cases).

[43] *Bridgestone*, 399 F.3d at 684-85.

[44] *Id.* at 685.

> to inquire. These settlements are thus appropriate to weigh in our scienter analysis . . . .[45]

Notably, this factor by definition applies only to a corporate defendant, which reinforces the court's presupposition that corporations may have the requisite mental state to be held liable as primary violators of Section 10(b) without imputing scienter from a particular individual corporate agent.

The Sixth Circuit found that the existence of these six *Helwig* factors was sufficient to establish a strong inference of scienter against Firestone. Next, the court discussed whether Bridgestone possessed the requisite scienter. The fraud allegations against Bridgestone were based on two representations made in a 1999 Annual Report to shareholders. The first of these, the "No Impairment" statement, represented that "no impairment of Bridgestone's corporate assets was substantially certain to occur through problems arising from customers' or regulators' actions."[46] The second, the "No Loss" statement, represented that "there were no actual, material losses connected to the lawsuits and responses to the regulatory scrutiny of the ATX tires."[47] In assessing Bridgestone's scienter in connection with these misrepresentations, the court focused primarily on the divergence between internally known information and the disclosures made to shareholders. Referring to the fifty consumer lawsuits already filed against the parent and its subsidiary by 1999, the red flags set out in internal corporate memoranda, and Firestone's prior history with a massive tread separation recall problem, the court found that Bridgestone was "at least reckless" as to the falsity of the "No Impairment" representation.[48]

As for Bridgestone's "No Loss" statement, the court found that the company's public statement diverged from internal

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[45] *Id.*

[46] *Id.* at 686.

[47] City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 686 (6th Cir. 2005).

[48] *Id.*

information documenting the mounting "lawsuits, claims settlements, and informal complaints that led to investigations by governmental authorities in Arizona, Venezuela, and Saudi Arabia. Furthermore, the court pointed to knowledge of the existence of secret settlements with State Farm, under which Firestone reimbursed the insurer for accidents allegedly caused by ATX tire failures."[49] Because plaintiffs alleged that defendant Ono was present at the quarterly meetings during which these matters were discussed, his scienter was directly attributable to the corporation.[50] The court also pointed to two facts that should have alerted Bridgestone to the fact it was "taking heavy losses via claims settlement resulting from alleged problems with the ATX tires."[51] First, there was the heightened possibility of defects from Firestone's Decatur, Illinois plant, where the company had employed around-the-clock replacement employees during a strike. Second, one particular ATX tire model was generating a disproportionate number of claims (more than 50%) relative to its production quantity (10% of Firestone's total production output).[52] These facts, together with the quarterly meetings discussing the widespread tire defect problems, gave rise to a strong

[49] *Id.* at 688.

[50] Apart from examining the corporations' liability for the misstatements, the court discussed the possibility of individual liability for the executive, Ono. The difficulty with the plaintiffs' claim against Ono was that he had not personally made any of the statements. The court also found that the corporate statements could not be attributed to him. Thus, despite the fact that he was alleged to know of the falsity of the statements, Ono did not utter any falsities nor were any of the statements attributable to him. On that basis, the Sixth Circuit affirmed the dismissal against him. *Id.* at 690. It is noteworthy that given the court's findings with respect to his scienter, Ono would likely still be held secondarily liable under § 20(a). This possibility was not, however, a subject of the Sixth Circuit's opinion.

[51] *Id.* at 688-89.

[52] *Id.* at 689.

inference of "at least recklessness" as to Bridgestone's "No Loss" statement.[53]

## C. The Dialectic Revealed

These cases expose a fundamental difference in the approaches that courts take when faced with the question of a corporation's intent. The Ninth Circuit, along with other courts, presuppose that corporations can only be vicariously liable for their agents' statements and scienter.[54] This stance does not contemplate the aggregation of scienter and apparently assumes that an issuer corporation that makes misstatements to the market cannot have guilty knowledge or intent separate and apart from its multiple agents. It is noteworthy that in *Apple Computer*, the court acknowledged plaintiffs' allegations of scienter on the part of other corporate executives and employees, but then focused only on whether that guilty knowledge was conveyed to Steve Jobs, the person who actually made the alleged misrepresentations.[55] As the plaintiffs could not plead sufficiently the details of the meetings during which Jobs purportedly had been advised of the facts that rendered his statements false, the Ninth Circuit held that the scienter allegations regarding Jobs's misstatements were

[53] City of Monroe Employees Ret. Sys. v. Bridgestone Corp., 399 F.3d 651, 689 (6th Cir. 2005).

[54] This is not entirely surprising, given that less than thirty years ago the Ninth Circuit—among others—did not recognize the application of agency principles in securities fraud cases at all. *See, e.g.*, Christoffel v. E. F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978); Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir. 1975), *cert. denied*, 423 U.S. 1025 (1975); *see also* Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981). For purposes of this Article, if the use of respondeat superior to establish a corporation's vicarious responsibility for securities fraud is at one end of the spectrum, the Sixth Circuit's and Second Circuit's use of collective knowledge concepts, which move beyond respondeat superior by not requiring imputation, are at the other. By failing to go beyond the use of respondeat superior when it comes to questions of corporate scienter, the Ninth Circuit has not strayed far from its roots.

[55] In re Apple Computer, No. 03-16614, 2005 U.S. App. LEXIS 5511, at *12-16 (9th Cir. Apr. 4, 2005).

inadequate.[56] Furthermore, and critical to its ultimate disposition, the court failed to attribute the other employees' knowledge directly to the company, which, coupled with Jobs's misrepresentations, could have exposed the corporation to liability in a court willing to aggregate.

On the other hand, the Sixth Circuit in *Bridgestone* and some other courts simply presume the possibility of collective scienter. These courts view the corporation as a separate entity and, perhaps more importantly, as a legal "person" with scienter apart from any individual speaker or writer.[57] The conflict between these opposing schools of thought must be resolved in order to delineate the legal standards applicable to corporate defendants. The next Section analyzes traditional criminal law principles in an effort to move toward a better rule for the attribution of corporate scienter.

## III. CRIMINAL LAW

> Now, there is no distinction in essence between the civil and the criminal liability of corporations, based upon the element of intent or wrongful purpose. Each is merely an imputation to the corporation of the mental condition of its agents.
> – Judge Learned Hand[58]

Although corporations do not possess the nature or qualities of human beings, criminal law, as encouraged by societal impetus, has always sought to hold corporations to the same standards that apply to individuals. Professor Mueller has noted that corporate criminal liability grew in an awkward and unorganized manner in response to societal

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[56] *Id.* at *15-17.

[57] *See, e.g.*, Chill v. General Electric Co., 101 F.3d 263 (2d Cir. 1996) (discussing scienter of defendant financial services firm in a 10(b) case); *In re* Oxford Health Plans, Inc. Sec. Litig., 51 F. Supp. 2d 290, 294-95 (S.D.N.Y. 1999) (discussing scienter of defendant accounting firm in a § 10(b) case).

[58] United States v. Nearing, 252 F. 223, 231 (S.D.N.Y. 1918).

urgency, rather than on firm intellectual footing.[59] Regardless, the notion of corporate criminal liability ultimately achieved legitimacy alongside other long-established criminal doctrines.

The logical starting point for a discussion of corporations and their states of mind is the landmark decision in *New York Central & Hudson River Railroad Co. v. United States*.[60] In that case, the Court reasoned that if, according to agency principles, a corporation would have *civil* responsibility for injuries caused by its agents, the Court would be justified in going "only a step farther" and holding the corporation *criminally* liable for "the act of the agent [done] while exercising the authority delegated to him."[61] Hence, the Supreme Court affirmed the viability, applicability, and necessity of the use of traditional agency principles such as respondeat superior to hold corporations criminally liable.

In this seminal case, a lower court found the railroad company and its employee liable for giving rebates to certain customers in violation of the Elkins Act.[62] On appeal to the Supreme Court, the corporation argued that it was unconstitutional to impose vicarious criminal liability on a corporation for the acts of its agents. The defendants contended that "punish[ing] the corporation is in reality [punishing] the innocent stockholders [and depriving] them of their property without opportunity to be heard." The Court rejected this argument and upheld the constitutionality of the Act.[63] Drawing upon entrenched civil

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[59] Gerhard O.W. Mueller, *Mens Rea and the Corporation—A Study of the Model Penal Code Position on Corporate Criminal Liability*, 19 U. PITT. L. REV. 21 (1957); *see also* John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981); Fischel & Sykes, *supra* note 8, at 320 (noting that "the doctrine of corporate criminal liability developed . . . without any theoretical justification").

[60] 212 U.S. 481 (1909).

[61] *Id.* at 494.

[62] Act of Feb. 19, 1903, ch. 708, 32 Stat. 847 (repealed 1978).

[63] *New York Central*, 212 U.S. at 494.

principles of tort doctrine and agency law, the Court reasoned that a corporation could be held vicariously liable for the criminal acts of its agents when those acts were committed within the scope of the agent's employment and for the benefit of the corporation. Moreover, the Court articulated that there was:

> no valid objection in law, and every reason in public policy, why the corporation which profits by the transaction, and can only act through its agents and officers, shall be held punishable by fine because of the knowledge and intent of its agents to whom it has intrusted [sic] authority to act . . . .[64]

To hold otherwise, thought the Court, would allow the law to "shut its eyes to the fact that the great majority of business transactions in modern times are conducted through [corporations]," and to grant them immunity from all punishment "would virtually take away the only means of effectually controlling" them.[65]

## A. Justifying the Comparison: Corporate Criminal Versus Civil Liability

*New York Central* demonstrates that concepts of corporate liability, though developed and tested in the context of criminal law, can provide great insight into other areas of law where corporate intent figures prominently. The analogy of criminal charges to civil suits under Section 10(b) is compelling for a number of reasons.[66] First, a majority of corporate criminal violations are similar in subject matter and motive to those in Section 10(b) cases. As the Ninth

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[64] *Id.* at 495-96.

[65] *Id.* at 496.

[66] Not all criminal law tenets are similar, applicable to, or even desirable in the securities fraud context. We do not advocate the criminalization of securities fraud beyond its present stature nor do we claim that substantively or procedurally the two areas are or should be more related.

Circuit stated in *United States v. Hilton Hotels Corp.*,[67] most corporate crimes are commercial violations, "usually motivated by a desire to enhance profits,"[68] and "are a likely consequence of the pressure to maximize profits that is commonly imposed by corporate owners upon managing agents and in turn, upon lesser employees."[69] The same is true for civil suits under Section 10(b). In sum, though the forces causing or enabling misbehavior in the corporate setting are different than those at the individual level, those same forces are often at work in both the criminal context and in Section 10(b) cases.

Second, both Section 10(b) and the criminal law have strong deterrent components. Traditional tort law, by contrast, strives to allocate responsibility for past harms; tort law does not seek to prevent all harms but to induce the actor to take the optimal level of care. The nature of Section 10(b) claims is such that their secondary goal (after providing reparations for harms) is, like criminal law, complete deterrence.[70] Section 10(b) demonstrates an interest in deterrence in that the corporation, not the individual actors, is the most socially effective repository of liability.[71] The corporation, as the party with the most control over its agents, is encouraged to prevent future misconduct because it faces "personal" liability. Although corporations act through their individual agents, imposing liability solely on individual actors could leave injured shareholders undercompensated due to limitations on

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[67] 467 F.2d 1000 (9th Cir. 1972). Although this case involved criminal violations of the Sherman Act, there are significant similarities between the Ninth Circuit's characterization of corporate wrongdoing in this context and in the civil securities fraud context.

[68] *Id.* at 1006.

[69] *Id.*

[70] Judge Easterbrook has opined that "[t]he optimal amount of fraud is zero." Ackerman v. Schwartz, 947 F.2d 841, 847 (7th Cir. 1991).

[71] *See generally* Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law,* 101 YALE L.J. 1795 (1992).

individual personal wealth.[72] By punishing the corporation, Section 10(b) jurisprudence functions similarly to the criminal law: both aim to provide an incentive for corporate officers to police internally and to prevent future wrongdoing and, simultaneously, create a moral stigma surrounding the corporation's reprehensible conduct.[73]

Lastly, intent, or mens rea, plays a central role in criminal law, whereas civil law tends to emphasize objective reasonableness. In this regard, Section 10(b) cases are more like criminal cases than their traditional tort siblings. In Section 10(b) cases, unlike the ubiquitous tort of negligence, the concept of intent (and its imputation or lack thereof) is dispositive in civil cases against corporate defendants. Congress made this purpose clear when it enacted the PSLRA,[74] which posits scienter as the primary *sine qua non* of Section 10(b) liability. Indeed, the PSLRA's heightened pleading standard for scienter provides a sharp scalpel with which judges can dispose of suits that are not well documented at the pleading stage, regardless of the number of "babies thrown out with the bath water."[75] We now turn to five important lessons from criminal law that may shed innovative light on corporate scienter in Section 10(b) cases.

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[72] ROBERT C. CLARK, CORPORATE LAW § 8.11, at 344 (1986). *Contra* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 692-93 (1992) (arguing that, although widely accepted, vicarious liability does not serve the goals of optimal deterrence or optimal risk spreading in fraud-on-the-market cases).

[73] Some have argued that there is little value in secondary market litigation against corporations, which serves only as a very expensive (considering the transaction costs of litigation) method of redistributing wealth between different classes of dispersed, innocent, and primarily diversified shareholders. *See, e.g.*, John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo*, 60 BUS. LAW. 533 (2005).

[74] *See* PSLRA, Pub. L. No. 104-67, § 21(d), 109 Stat. 737 (1995).

[75] *See* Ann Morales Olazábal, *The Search for "Middle Ground": Towards a Harmonized Interpretation of the Private Securities Litigation Reform Act's New Pleading Standard*, 6 STAN. J.L. BUS. & FIN. 153 (2001).

## B. The Criminal Law Experience

### 1. The Elusiveness of Corporate Wrongdoing

#### a. Theoretical Struggles with Corporate Personhood

In creating the legal fiction of the corporation, the law authorizes a group of actors to operate as one.[76] Further compounding the corporate paradox, the fiction of a corporation is endowed with the capacity to act both legally and illegally, to do right as well as wrong. This naturally raises a critical question: How do "human" laws apply to a nonhuman entity whose conduct is the inevitable result of the thoughts and actions of a collection of individuals?

##### i. The Inherent Tension: Nominalism v. Realism

The philosophical strife underlying the law's apparent cognitive dissonance is between "nominalist" and "realist" theories of corporate personality.[77] As its title implies, nominalism views the "corporation" as a mere name or designation for the group of human actors within it, just as we would say a school is to fish or a pack is to wolves. To a nominalist, corporations are "nothing more than collectivities of individuals."[78] Accordingly,

> [s]peaking of corporate conduct or corporate fault is seen as a shorthand way of referring to the conduct and culpability of the individual members of the collectivity. The "corporation" is simply a name for

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[76] The very etymology of the word "corporation" brings to light its fictitious beginnings; the word is derived from the Latin "corporatus," past participle of "corporare," meaning "to make into a body."

[77] Eric Colvin, *Corporate Personality and Criminal Liability*, 6 CRIM. L.F. 1, 2 (1995).

[78] *Id.* at 1.

> the collectivity and the idea that the corporation itself can act and be blameworthy is a fiction.[79]

Realists, on the other hand, maintain that a corporation can develop a unique existence and culture independent from its individual employees and agents. As such, a corporation can take action, know, and intend the consequences of its action, and ultimately can be held responsible for this autonomous behavior. In other words, "corporations can act and be at fault in ways that are different from the ways in which their members can act and be at fault."[80]

Our legal system is replete with examples of the realist sensibility. Consider, for example, the concept of legislative intent.[81] Although there is no question that each participant in the process of enacting a law possessed his or her own nuanced view of the legislation at issue, the group acts as a unified whole with a purpose and intent that belongs singularly to the collective.[82] It would be misleading to characterize legislative intent as merely an aggregation of the intentions of the individual members of Congress or as purely a fiction.[83] Instead, we simply accept legislative intent as collective in nature. Implicit realism also informs the ways in which we discuss jury verdicts and en banc

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[79] *Id.* at 1-2.

[80] *Id.* at 2.

[81] Courts have acknowledged the intellectual exercise and suspension of disbelief inherent in attributing intent to the legislature. *See* Runnebaum v. NationsBank, 123 F.3d 156, 169 (4th Cir. 1997) ("Even if we believed that the collective intent of a 535-member body is ascertainable by reference to legislative history (which we doubt), we find it unfathomable that the statements of one Senator and three Congressmen could serve as the expression of that collective intent. We choose instead to adhere to 'the strong presumption that Congress expresses its intent through the language it chooses.' INS v. Cardoza-Fonseca, 480 U.S. 421, 432 n.12 (1987)"); Markman v. Westview Instruments, Inc., 52 F.3d 967, 987 (Fed. Cir. 1995) ("While a court may seek from the public record to ascertain the collective intent of Congress when it interprets a statute, the subjective intent of any particular person involved in the legislative process is not determinative.").

[82] Colvin, *supra* note 77, at 33-34.

[83] *Id.*

appellate court opinions. Appellate courts and juries both render collective judgments; rarely do we concern ourselves with the singularity of each actor's personal opinion in reaching that collective judgment.[84]

### ii. Historical Evolution of Corporate Thought

While early corporate liability jurisprudence was essentially nominalist in character, it has gradually relaxed into a broader realist inspired scope of corporate criminal liability.[85] The corporation, once referred to by Chief Justice John Marshall in 1819 as "an artificial being, invisible, intangible, and existing only in contemplation of law,"[86] underwent an anthropomorphic makeover in the eyes of American jurists beginning in the early twentieth century. Whether "nominalist" or "realist" in thought, society often speaks of corporations "as 'real' entities in ordinary language and in moral discourse."[87] Every day, newspaper and magazine articles serve to illustrate society's acceptance of corporate personae being described in terms much like those

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[84] See Samuel A. Alito, Jr., Note, *The Released Time Cases Revisited: A Study of Group Decisionmaking by the Supreme Court*, 83 YALE L.J. 1202 (1974).

[85] *See* Kathleen F. Brickey, *Corporate Criminal Accountability: A Brief History and an Observation*, 60 Wash. U. L.Q. 393, 396 (1981). *See generally* L.H. Leigh, THE CRIMINAL LIABILITY OF CORPORATIONS IN ENGLISH LAW 1-12 (1969) (discussing the development of English corporate criminal liability).

[86] Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 636 (1819).

[87] Colvin, *supra* note 77, at 24. In the authors' own experience, interestingly, one of the most telling and frequent grammatical errors among undergraduate business students is the use of personal pronoun "they" to refer to a corporation, rather than employing "it." This practice also is often found in popular literature, and of course, in common parlance.

used to refer to an individual's personality—"beloved," "very, very nice," or even "having a playful spirit."[88]

Regardless of society's inherently realist lexis, the struggle between nominalism and realism in the imposition of liability on corporate entities continues. Not surprisingly, the United States has a more developed corporate criminal jurisprudence than other countries, which is perhaps a testament to the influential role that corporations have assumed in the development of American society. Foreign lawmakers have traditionally regarded the American approach, exemplified in *New York Central*, with skepticism and confusion.[89] In fact, the entire classical European doctrine of criminal law has strong roots in the nominalist camp and, as such, it has routinely rejected the notion that an enterprise could possess the capacity to act or even possess guilt, a highly personal reproach.[90] It was not until after 1988—almost eighty years after criminal liability was held to apply to corporations in the United States—that some European countries (including France and the Netherlands) endorsed an approach allowing the imposition of criminal liability on legal bodies.[91]

### b. Practical Struggles with Corporate Personhood and Liability

From a practical standpoint, the foundation for punishing corporate criminal wrongdoing is no easier to assess. First, corporate wrongdoing is by its nature easily concealed and often highly sophisticated and technical. As noted scholar John Coffee has pointed out, "[u]nlike victims of classically

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[88] Matthew Boyle, *The Wegman Way*, FORTUNE, Jan. 24, 2005, at 62 (referring to Wegman's Food Markets, J.M. Smucker Co., and National Instruments, respectively).

[89] *See* Gunter Heine, *New Developments in Corporate Criminal Liability in Europe: Can Europeans Learn from the American Experience-or Vice Versa?*, 1998 ST. LOUIS-WARSAW TRANSATLANTIC L.J. 173 (1998).

[90] *Id.* at 173.

[91] *See* Eli Lederman, *Models for Imposing Corporate Criminal Liability: From Adaptation and Imitation Toward Aggregation and the Search for Self-Identity*, 4 BUFF. CRIM. L. REV. 641, 644-47 (2000).

underreported crimes (such as rape or child abuse) . . . the victim of price-fixing may never learn that he has overpaid . . . ."[92] Second, there are often insurmountable evidentiary obstacles to proving both the identity and mental states of the guilty actors within a vast corporate organization.[93] Even when overwhelming circumstantial evidence of guilt within the organization exists, it is often difficult, if not impossible, to locate the single guilty agent or the constellation of guilt in the corporation. It is similarly difficult to produce sufficient direct evidence of guilt. This problem prompted the judge in the recent criminal trial against Bernard Ebbers, CEO of WorldCom, to give the following admonition to jurors before they began their deliberations: "It would be a rare case where it could be shown that a person wrote, or states, that as of a given time in the past, he committed an act with fraudulent intent . . . . Such direct proof is not required."[94]

An added evidentiary obstacle is the issue of witness credibility. In criminal cases against corporations, most, if not all, of the individuals familiar with the alleged wrongdoing are former employees of the corporation. Many are disgruntled and some may face individual criminal charges of their own. As part of plea deals, these witnesses

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[92] Coffee, *supra* note 59, at 390-91.

[93] *See* Ann Foerschler, Comment, *Corporate Criminal Intent: Toward a Better Understanding of Corporate Misconduct*, 78 CAL. L. REV. 1287, 1297-98 (1990) (citing a survey of California district attorneys reporting that difficulty of establishing intent discourages them from undertaking corporate prosecutions). For a discussion regarding evidentiary hurdles in prosecuting corporations, see William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647, 706 (1994) (noting that "relatively few" federal corporate prosecutions are successful); *see generally* Stacey Neumann Vu, *Corporate Criminal Liability: Patchwork Verdicts and the Problem of Locating a Guilty Agent*, 104 COLUM. L. REV. 459 (2004).

[94] Jonathan D. Glater & Ken Belson, *In White Collar Crimes, Few Smoking Guns*, N.Y. TIMES, Mar. 12, 2005, at C1. The judge's instruction, typical in a criminal case against an individual as per the Federal Pattern Jury Instructions, allows jurors to infer intent from circumstantial evidence. 2B FEDERAL JURY PRACTICE AND INSTRUCTIONS § 17.07, at 622 (Kevin F. O'Malley et al., eds., 2000).

may have agreed to testify against the corporation. Ironically then, many of the witnesses pointing fingers are the very same actors within the corporation that may have perpetrated the wrongdoing.[95]

Finally, society's need to attach moral blameworthiness may not be entirely satisfied by entity liability. Many commentators have noted that juries are often unwilling to convict agents tried along with an accused corporation.[96] Some have attributed this phenomenon to "judicial and jury empathy for middle class defendants"[97] or to the unwillingness of juries to stigmatize individuals for acts they may not view as immoral. Moreover, a jury may suspect or detect the existence of organizational pressures contributing to the violation. After Arthur Andersen's conviction for obstruction of justice,[98] critics lashed out against holding corporations liable, reasoning that the effects of such a decision would adversely affect shareholders and employees who had not participated in the fraud:

> The attitude was Arthur Andersen got what it deserved . . . . What is Arthur Andersen and who got what they deserved? You know, some secretary in Des Moines that doesn't have a job now or some

[95] Much was made of this witness credibility gap by the defense in the criminal trial against Worldcom CEO Bernard Ebbers. In this massive corporate fraud case, CFO Scott Sullivan, who had already pled guilty to his role in the fraud and faced twenty-five years in jail, was the prosecution's key witness. Defense attorneys attempted to discredit this testimony, pointing out that Sullivan had agreed to do so in return for a reduced sentence. *See* Glater & Belson, *supra* note 95; Ken Belson, *Ex-Chief of WorldCom Convicted of Fraud Charges*, N.Y. TIMES, Mar. 15, 2005, at A1. *See also* United States v. Martin, No. 04-13458, 2005 U.S. App. LEXIS 12284, at *4 (11th Cir. June 21, 2005) (discussing the reduction of the criminal sentence of a high ranking HealthSouth employee based on fact that he testified against other corporate officials).

[96] *See, e.g.*, Coffee, *supra* note 59, at 433 ("In general, it is difficult to identify culpable individuals with sufficient assurance to convict them.").

[97] *Id.*

[98] United States v. Arthur Andersen, LLP, 374 F.3d 281 (5th Cir. 2004), *overturned by* Arthur Andersen, LLP v. United States, 125 S. Ct. 2129 (2005).

> junior auditor in Atlanta? . . . That's who got punished . . . . You can't punish a legal entity.[99]

Despite the seemingly broad corporate liability made possible by the doctrine of respondeat superior, it is noteworthy that very few corporations are ever convicted of crimes.[100] This reality is likely due to the difficulty of establishing corporate guilt. The recent epidemic of corporate scandals[101] also illustrates an apparent trend against prosecuting corporations and toward prosecuting culpable individuals. The United States Department of Justice's web page lists eighty-seven corporations that were recently alleged to have been involved in corporate wrongdoing.[102] An unscientific perusal of this list reveals that only one corporate entity—Arthur Andersen, LLP—was initially successfully prosecuted,[103] and even this lone

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[99] Robin Phelan et al., *Remember When—Recollections of a Time When Aggressive Accounting, Special Purpose Vehicles, Asset Light Companies and Executive Stock Options Were Positive Attributes*, 11 AM. BANKR. INST. L. REV. 1, 10-11 (2003).

[100] *See* Laufer, *supra* note 93, at 706. Professor Laufer further observes that data from the U.S. Sentencing Commission reveals that there are a mere two to three hundred convictions of corporations each year, suggesting a "weakness in liability rules," "inadequate prosecutorial resources," or "that prosecutors are . . . using their discretion to avoid the appearance of unreasonable imputations, thus limiting the utility of vicarious liability." *Id.*

[101] Scandals involving accounting frauds and so-called "white collar" criminal offenses at corporations, such as Enron, WorldCom, ImClone, Arthur Andersen, Adelphia Communications, HealthSouth, Dynegy, Tyco International and, most recently, AIG, have abounded since 2001.

[102] DOJ, OFFICE OF THE DEPUTY ATTORNEY GENERAL, PRESIDENT'S TASKFORCE AGAINST FRAUD, SIGNIFICANT CRIMINAL CASES AND CHARGING DOCUMENTS, *available at* http://www.usdoj.gov/dag/cftf/cases.htm (last modified Nov. 15, 2004).

[103] *See Arthur Andersen*, 374 F.3d at 281. Although the DOJ brought charges against both Merrill Lynch & Co. and Canadian Imperial Bank of Commerce for their involvement in the Enron scandal, both corporations have entered into deferred prosecution agreements with the government. SECOND YEAR REPORT TO THE PRESIDENT, CORPORATE FRAUD TASK FORCE, at 3.5, *available at* http://www.usdoj.gov/dag/cftf/2nd_yr_fraud_report.pdf.

conviction was recently overturned by the Supreme Court.[104] In the other eighty-six cases (including charges against WorldCom, Adelphia Communications, and HealthSouth), one or more executives was charged with criminal wrongdoing, but no charges were brought against the corporations themselves.

Despite the spate of heavily publicized instances of corporate wrongdoing, these recent trends seem to indicate that, in the face of daunting evidentiary and theoretical challenges, there is no sufficient intellectual construct in place to ascribe blame to named, yet literally faceless, wrongdoers.

### 2. Corporate Criminal Liability and Agency Law

The Supreme Court has maintained its recognition from *New York Central* that Congress has the power to "personify the company,"[105] and thereby, to charge an entity with criminal and civil liability "through the doctrine of respondeat superior."[106] A distinct corporate mens rea or actus reus thus is not always necessary for a corporation to be found liable. In *United States v. A. & P. Trucking Co.*, the Court stated that "corporations and other . . . impersonal entities can be guilty of 'knowing' or 'willful' violations of regulatory statutes."[107] Again, the Court's reasoning is couched in the familiar concepts of civil tort and agency law.

In 1972, the Ninth Circuit broadened corporate criminal liability beyond the traditional contours of respondeat superior as applied in tort law. In *United States v. Hilton Hotels Corp.*, the court held that a corporation "is responsible

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[104] Arthur Andersen, LLP v. United States, 125 S. Ct. 2129, 2130 (2005) (concluding that jury instructions were flawed in their interpretation of meaning of "corruptly persuades" for the purposes of the criminal obstruction of justice statute).

[105] United States v. A. & P. Trucking Co., 358 U.S. 121, 126 (1958).

[106] *Id.* at 125 ("[I]t is elementary that such impersonal entities can be guilty of 'knowing' or 'willful' violations of regulatory statutes through the doctrine of respondeat superior . . . .").

[107] 358 U.S. at 125.

for acts and statements of its agents, done or made within the scope of their employment" but added that this was true "even though their conduct may be contrary to their actual instructions or contrary to the corporation's stated policy."[108] In further developing and expanding the doctrine laid out in *New York Central*, the Ninth Circuit took into account the "complex business structures, characterized by [the] decentralization and delegation of authority, commonly adopted by corporations for business purposes,"[109] and the fact that commercial violations are usually "motivated by a desire to enhance profits."[110] Hence, there was an inherent difficulty in identifying the particular corporate agents responsible for such violations.[111] Moreover, the court held that the same evidence that connected the employee to the wrongdoing (in this case, a conspiracy to violate the Sherman Act) could be used to convict the employer despite the employee's acquittal.[112]

In a 1984 case, Minnesota's Supreme Court added a fourth prong to the respondeat superior test: whether the criminal acts were authorized, tolerated, or ratified by corporate management.[113] In *State v. Christy Pontiac-GMC, Inc.*, the court upheld the theft and forgery conviction of a car dealership whose employees illegally retained manufacturer rebates intended for customers. Although management did not give express directives to the employees to engage in such activities, the court reasoned that their failure to impede the criminal activity amounted to authorization and ratification of the criminal acts.[114] Like the court in *Hilton*, the Supreme Court of Minnesota recognized that "it is not to be expected that management authorization of illegality would be expressly or openly

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[108] 467 F.2d 1000, 1004 (9th Cir. 1972).

[109] *Id.* at 1006.

[110] *Id.*

[111] *Id.*

[112] *Id.* at 1006-1007.

[113] State v. Christy Pontiac-GMC, 354 N.W.2d 17 (Minn. 1984).

[114] *Id.* at 19.

stated,"[115] and thus, "there may be instances where the corporation is criminally liable even though the criminal activity has been expressly forbidden."[116] The court stated that the key factor was whether "those in positions of managerial authority or responsibility acted or failed to act in such a manner that the criminal activity reflects corporate policy."[117] By analyzing the corporation's omissions, the court reasoned that an implicit corporate policy ratifying the crimes existed, and therefore, intent could be imputed to the corporation itself.[118]

### 3. Respondeat Superior is Both Overinclusive and Underinclusive

Although it is the most traditionally accepted method of imputing liability to a corporation, the theory of respondeat superior is not perfect. The theory can be both underinclusive and overinclusive and, as one scholar has pointed out, it "has survived as a matter of necessity—no other theory of liability has been proposed that would ensure that federal and state legislation extends to corporations."[119] Some critics have questioned the wisdom and fairness of applying human constructs to corporations; others have called for abandonment of the concept of respondeat superior altogether in favor of alternate forms of imputation of corporate liability.[120]

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[115] *Id.*

[116] *Id.*

[117] *Id.* at 20.

[118] *Id.* at 20-21.

[119] Laufer, *supra* note 93, at 654. For a review of issues relating to inclusiveness and the vicarious liability standard, see Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 758-64 (1992).

[120] *See* Khanna, *Faulty Notion, supra* note 8, at 359 ("Corporate mens rea standards are generally undesirable . . . . I recommend that we replace corporate mens rea standards in all forms of corporate liability with either strict liability or negligence."); V.S. Khanna, *Corporate Liability Standards: When Should Corporations Be Held Criminally Liable?*, 37 AM. CRIM. L. REV. 1239, 1240 (2000) [hereinafter Khanna,

Respondeat superior may in certain cases lead to unfairly broad liability. If a rogue employee commits a crime unbeknownst to and without the direct or indirect encouragement of his superiors, and his offense—however indirectly—benefits his employer, the employer may be liable for the employee's actions. The doctrine's critics claim that its weakness lies in the fact that it fails to distinguish between offenses committed with the participation, pressures, or encouragement of upper management, and those committed by the proverbial "black sheep" employee whose act violated company policy and could not have been prevented by monitoring and corporate compliance programs.[121] While the fault of an employee does not necessarily bear any relation to corporate culpability, under the theory, employee fault is a necessary and inevitable precursor to corporate liability.

Respondeat superior may, on the other hand, be underinclusive in certain scenarios. For instance, where the case against a single actor within an organization does not contain all of the requisite elements of the crime, respondeat superior liability would not attach to the corporation.[122] Similarly, in situations where a corporate policy, procedure, or *sub rosa* encouragement of illegal or tortious behavior results in the commission of an offense, but there is no single

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*Corporate Liability Standards*]. Similarly, Professor Brent Fisse has proposed a model of corporate liability requiring that: (1) the external elements of the offense be satisfied by an actor whose conduct results in vicarious liability for the corporation and (2) evidence of fault be found in the corporation's failed policies, precautions, and measures. *See* Brent Fisse, *The Attribution of Criminal Liability to Corporations: A Statutory Model*, 13 SYDNEY L. REV. 277, 279 (1991). For a discussion of respondeat superior as it relates to Section 10(b), see Robert A. Prentice, *Conceiving the Inconceivable and Judicially Implementing the Preposterous: The Premature Demise of Respondeat Superior Liability Under Section 10(b)*, 58 OHIO ST. L.J. 1325, 1325 (1997) (examining the effect of the Supreme Court's decision in *Central Bank* and arguing that "the imposition of respondeat superior liability for violations of Section 10(b) remains consistent with Congress' intent in enacting the statute").

[121] Moore, *supra* note 119, at 759.

[122] *See infra* Section III(B)(4).

identifiable culpable actor, the doctrine would not place the requisite culpability on the corporation.[123] The perceived weaknesses in the respondeat superior approach have led to the development of a corollary to the agency principle that allows for aggregation of the knowledge of several corporate employees in order to find the corporation liable: the collective knowledge doctrine.

### 4. Collective Knowledge

According to criminal law principles, if no individual culpable actor can be shown to have satisfied all of the requisite elements of the criminal or wrongful act, then no corporate criminal liability can arise. The notorious criminal obstruction of justice case against Arthur Andersen illustrates the growing tension surrounding this basic principle as applied in the corporate context. At trial, the defense sought to weaken the government's case by applying respondeat superior reasoning and asking the jury to identify a single blameworthy Andersen agent. After eight days of deliberations, the Andersen jurors posed an unprecedented question to the court regarding the prerequisites for holding the corporation accountable:

> "If each of us believes that one Andersen agent acted knowingly and with corrupt intent, is it [necessary] for all of us to believe it was the same agent? Can one believe it was Agent A, another believe it was Agent B, and another believe it was Agent C?"[124] The judge, in addressing the latter question and without

[123] *See* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Corporate Criminal Liability*, 75 MINN. L. REV. 1095, 1104-05 (1991); Moore, *supra* note 119, at 767.

[124] Jonathan Weil et al., *Dramatic Question from Jury Could Shape Andersen's Fate*, WALL ST. J., June 14, 2002, at A1. *See also* Sterling P.A. Darling, Jr., Note, *Mitigating the Impressionability of the Incorporeal Mind: Reassessing Unanimity Following the Obstruction of Justice Case of United States v. Arthur Andersen, L.L.P.*, 40 AM. CRIM. L. REV. 1625, 1648-54 (2003).

> explanation, implicitly acknowledged the importance of collective knowledge by simply answering "yes."[125]

In some extreme cases of corporate wrongdoing, where no one individual actor can be held responsible, courts have resorted to aggregating and imputing corporate agents' actions and states of mind. Thus, even if no single employee has the intent necessary to commit a crime, in certain circumstances, the corporation can be convicted on the basis of its employees' collective knowledge and intent. Legal scholars and courts have discussed this alternative to respondeat superior theory extensively, variously referring to it as "collective knowledge,"[126] "composite knowledge,"[127] "collective intent,"[128] "piecemeal attribution,"[129] "attribution of knowledge," and "aggregate corporate knowledge,"[130] among other terms.

Corporate criminal liability may be established under a collective knowledge theory when several actors, none of

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[125] Darling, *supra* note 124, at 1648; Jonathan Weil, *Jury Cuts off an Andersen Appeals Route*, WALL ST. J., June 17, 2002, at C13. On appeal before the Fifth Circuit, the defense urged that Andersen could not be charged with the collective knowledge of all its agents. The government defended the propriety of collectivization, citing *Bank of New England*. *See infra* notes 132 and 134. The Fifth Circuit found it unnecessary to resolve that debate as direct evidence showed that an Andersen in-house lawyer had the requisite knowledge while committing the act in question. United States v. Arthur Andersen, LLP, 374 F.3d 281, 290-91 (5th Cir. 2004), *overturned by* Arthur Andersen, LLP v. United States, 125 S. Ct. 2129 (2005). As such, the court found it futile to discuss or to entertain a collective knowledge approach when straightforward respondeat superior neatly applied. On appeal to the Supreme Court, Andersen's conviction was reversed on separate grounds.

[126] Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004).

[127] Woodmont, Inc. v. Daniels, 274 F.2d 132, 137 (10th Cir. 1959).

[128] United States v. Shortt Accountancy, 785 F.2d 1448, 1454 (9th Cir. 1986).

[129] Donald C. Langevoort, *Agency Law Inside the Corporation: Problems of Candor and Knowledge*, 71 U. CIN. L. REV. 1187 (2003).

[130] Thomas A. Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 GEO. WASH. L. REV. 210 (1997).

whom could be found guilty individually, each have committed one or more requisite elements of a crime such that their actions, when taken as a whole, constitute criminal conduct. This represents a significant departure from the respondeat superior doctrine as conventionally employed. The doctrine also may apply to situations where no single agent knows all of the facts, but multiple agents hold pieces of information that together would amount to the corporation's guilty knowledge.[131]

The First Circuit's decision in *United States v. Bank of New England, N.A.*[132] pioneered the use of this revolutionary concept. Since that landmark decision, the significance of the collective knowledge doctrine has been extensively analyzed and discussed.[133] The *Bank of New England* case

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[131] *See, e.g.*, United States v. Bank of New England, N.A., 821 F.2d 844 (1st Cir.), *cert. denied*, 484 U.S. 843 (1987); Riss & Co. v. United States, 262 F.2d 245 (8th Cir. 1958); United States v. T.I.M.E.-D.C. Inc., 381 F. Supp. 730 (W.D. Va. 1974); United States v. Sawyer Transport, Inc., 337 F. Supp. 29 (D. Minn. 1971).

[132] *Bank of New England*, 821 F.2d at 844.

[133] The following is a small sample of citations to *Bank of New England* intended only to give the reader a sense of the extensive academic discussion and debate that the decision and, indeed, the doctrine of collective knowledge has sparked. *See*, e.g., H. Lowell Brown, *Vicarious Criminal Liability of Corporations for the Acts of Their Employees and Agents*, 41 LOY. L. REV. 279, 300-02 (1995) (discussing the ability of corporations to be held liable for a knowing criminal violation of law based upon the composite knowledge of a variety of persons at different levels throughout the corporate structure); Colvin, *supra* note 77, at 7 (citing *Bank of New England* in a discussion of vicarious liability as a general principle for corporate liability, even for mens rea offenses); Hagemann, *supra* note 130 (criticizing *Bank of New England* as a "mythicizing" case establishing aggregate corporate knowledge); Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 47 RUTGERS L. REV. 605, 625 (1995) (discussing the *Bank of New England* decision); Martin J. Weinstein & Patricia Bennett Ball, *Criminal Law's Greatest Mystery Thriller: Corporate Guilt Through Collective Knowledge*, 29 NEW ENG. L. REV. 65, 78 (1994) (discussing the *Bank of New England* decision as a "watershed moment" establishing organizational guilt by collectivizing the conduct of disparate and unrelated corporate employees); Sarah Calcote, Note, *Criminal Intent in Federal Environmental Statutes: What Corporate*

was an appeal from a jury verdict finding the Bank of New England guilty of thirty-one violations of the Currency Transaction Reporting Act while acquitting the individual bank employees involved in the relevant transactions.[134] Department of the Treasury regulations promulgated under the Act require banks to file currency transaction reports (CTRs) within fifteen days of customer currency transactions exceeding $10,000[135] and impose felony liability when a bank willfully fails to file such reports "as part of a pattern of illegal activity involving transactions of more than $100,000 in a twelve-month period . . . ." [136] The indictment arose out of a series of bank withdrawals by a customer. For each transaction, the customer presented the head teller with multiple checks, none of which individually amounted to more than $10,000. Each of the thirty-one times he did so, the same customer then withdrew sums of cash greater than $10,000 from a single corporate account at the bank, consequently triggering the requirement that the bank file a CTR, which the Bank failed to meet.[137]

At trial, the judge's instructions informed the jury of the "two modes of establishing [the bank's] knowledge—either through one of its individual employees or through the aggregate knowledge of all its employees."[138] Invoking traditional vicarious liability, the court stated that "if any employee knew that multiple checks would require the filing of reports, the [b]ank knew it, provided the employee knew it

*Officers and Employees Should "Know"*, 20 AM. J. CRIM. L. 359, 367-68 (1993) (noting that the *Bank of New England* standard may encourage corporations to develop a stronger system of reporting and internal regulation); Kevin B. Huff, Note, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1256 n.26 (1996) (citing *Bank of New England* as establishing the theory of "collective knowledge").

[134] 31 U.S.C. §§ 5311-22 (1982).

[135] 31 C.F.R. § 103.22 (1986).

[136] 31 U.S.C. § 5322(b) (2000).

[137] United States v. Bank of New England, N.A., 821 F.2d 844, 844 (1st Cir. 1987).

[138] *Id.* at 855 (quoting the trial court's jury instructions).

within the scope of his employment . . . ."[139] It further instructed:

> In addition, however, you have to look at the bank as an institution. As such, its knowledge is the sum of the knowledge of all of the employees. That is, the bank's knowledge is the totality of what all of the employees know within the scope of their employment. So, if Employee A knows one facet of the currency reporting requirement, B knows another facet of it, and C a third facet of it, the bank knows them all . . . .[140]

The trial judge also outlined the factors necessary to impute "willfulness" to an organization. Among these factors were: "whether the bank as an organization consciously avoided learning about and observing CTR requirements;"[141] whether the bank possessed "some flagrant organizational indifference" to the reporting requirements;[142] "evidence as to the bank's effort, if any, to inform its employees of the law; its effort to check on their compliance; its response to various bits of information that it got,"[143] and "its policies, and how it carried out its stated policies."[144]

On appeal, the bank contended, among other things, that the trial court's instructions on knowledge and specific intent were erroneous and effectively vitiated the statute's requirement of "willfulness." Specifically, the bank argued that the jury instruction on collective knowledge rendered it liable "for negligently maintaining a poor communications network that prevented the consolidation of the information held by its various employees."[145] The appellate court resoundingly rejected the bank's argument, calling forth

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[139] *Id.*

[140] *Id.* at 855-56 (quoting the trial court's jury instructions).

[141] *Id.*

[142] *Id.*

[143] United States v. Bank of New England, N.A., 821 F.2d 844, 855-56 (1st Cir. 1987).

[144] *Id.* at 856 (quoting the trial court's jury instructions).

[145] *Id.*

reasoning similar to that of the courts in *New York Central* and *Hilton* concerning the context, structure, and acts common to all large corporations:

> [C]orporations compartmentalize knowledge, subdividing the elements of specific duties and operations into smaller components. The aggregate of those components constitutes the corporation's knowledge of a particular operation. It is irrelevant whether employees administering one component of an operation know the specific activities of employees administering another aspect of the operation.[146]

The First Circuit opinion endowed a corporation with its own mind,[147] and thus determined that the corporation could be found guilty if the necessary mens rea was present in the sum of its parts.

The collective knowledge theory has been used in many criminal cases, particularly those where it is hard to point to a single defendant whose behavior and thoughts embody the elements of the offense.[148] An example of note is *United States v. Shortt Accountancy Corp.*, in which the Ninth Circuit found a small accounting firm guilty of making and subscribing to false income tax returns.[149] One of the firm's tax advisors prepared a client's tax return and subscribed as to its correctness on behalf of the company. Unbeknownst to that advisor, the firm's CEO, who had supplied the advisor with all of the relevant information for the tax return, had

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[146] *Id.*

[147] In doing so, the First Circuit relied on a string of earlier cases particular to the trucking industry. *See, e.g.*, Riss & Co. v. United States, 262 F.2d 245 (8th Cir. 1958); United States v. T.I.M.E.-D.C., Inc., 381 F. Supp. 730 (W.D. Va. 1974); United States v. Sawyer Transport, Inc., 337 F. Supp. 29 (Minn. 1971);.

[148] *See, e.g.*, *Riss & Co.*, 262 F.2d at 250; *T.I.M.E.-D.C.*, 381 F. Supp. at 738-39; People v. Am. Med. Ctr. Ltd., 324 N.W.2d 782, 793 (Mich. 1982); *Sawyer Transport*, 337 F. Supp. at 31; *see also* United States v. Osorio, 929 F.2d 753, 761 (1st Cir. 1991); United States v. Shortt Accountancy, 785 F.2d 1448, 1454 (9th Cir. 1986); Camacho v. Bowling, 562 F. Supp. 1012, 1025 (Ill. 1983).

[149] 785 F.2d 1448 (9th Cir. 1986).

advised the client to improperly claim a deduction. On appeal, the corporation argued that its conviction should be reversed because the COO who possessed the intent did not physically complete the tax return, and the tax advisor who had committed the act did not have knowledge of its inaccuracy nor any intent to defraud the IRS. The Ninth Circuit dismissed this argument quickly, concluding that if this illogical line of reasoning were accepted, then "any tax return preparer could escape prosecution for perjury by arranging for an innocent employee to complete the proscribed act of subscribing a false return."[150]

Varying the facts of *Shortt* illustrates the potential breadth of the collective knowledge doctrine. What if it was the firm's receptionist who told the client to take the improper deduction? What if, at the eleventh hour on April 14th, the client submitted false information to the corporation and the falsity was discovered, but, due to a personal family emergency, management was unable to convey this discovery to the tax preparer before the return was timely filed? Such scenarios have led some critics to caution that, although appealing at first glance, the collective knowledge doctrine is potentially dangerous in its scope.[151] With this concern in mind, some scholars and courts have proposed that the proper way to apply the collective knowledge doctrine is in conjunction with other considerations that may more accurately point to culpability, most notably the presence of willful blindness. The court in *United States v. Jewell*[152] first articulated the doctrine of willful blindness.[153] In *Jewell*, the

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[150] *Id.* at 1454.

[151] *See* Hagemann & Grinstein, *supra* note 130, at 237 (criticizing the decision as akin "to a frightening bedtime story" and noting executive fears that the "collective knowledge bogeyman will creep up on them and convict their companies of criminal acts that neither they nor any employee had any intention of committing: innocent individual behavior wholly transmogrified into corporate guilt").

[152] 532 F.2d 697 (9th Cir. 1976).

[153] Willful blindness is also known as "deliberate blindness," "deliberate indifference," "deliberate ignorance," "willful ignorance," and "conscious avoidance." *See* Robin Charlow, *Wilful Ignorance and Criminal*

defendant crossed the U.S.-Mexican border in an automobile "in which 110 pounds of marijuana . . . had been concealed in a secret compartment between the trunk and rear seat."[154] The evidence showed that the defendant knew of the automobile's secret compartment and knew that it may have contained contraband, but—by his own design—avoided having positive knowledge of the presence of the marijuana. The Ninth Circuit found that deliberately and consciously avoiding knowledge for the purpose of avoiding criminal liability can itself amount to intent.[155]

Although not articulated initially in a corporate setting, the principle of willful blindness befits corporate conduct as well, as many individuals act in compartmentalized capacities, and only top management is often able to see the whole picture. Collective knowledge is therefore best applied in settings where it is clear that corporate management sought to avoid liability by intentionally avoiding the acquisition of knowledge. In this way, the concept of willful blindness mitigates the doctrine's tendency toward overinclusiveness.

### 5. Innovative Approaches

As the above discussion illustrates, neither respondeat superior nor collective knowledge presents an ideal way of establishing corporate mens rea. Recognition of the deficiencies of these theories has led to the search for a more equitable and viable conceptualization of corporate culpability. A number of innovative approaches have arisen, such as the "corporate character" (also known as "corporate ethos") theory and the U.S. and Australian model criminal codes. These share an implicit acknowledgment that

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*Culpability*, 70 TEX. L. REV. 1351, 1352 n.1, 1354 n.8 (1992) (noting the wide range of terminology used to describe willful blindness). For the sake of clarity, this Article refers to the concept as "willful blindness," except in quoting sources that employ alternative terminology.

[154] *Id.* at 698.

[155] *Id.* at 701.

corporate action possesses distinct characteristics that do not fit into traditional human paradigms of liability.

### a. Corporate Character and Compliance

The notion that "bad" corporations can influence individual and group criminal behavior is at the heart of the corporate character theory. This foundation is based on the recognition that "at least some criminal behavior may be viewed not as personal deviance but rather as a predictable product of the individual's membership in, or contact with, certain organizational systems."[156] Legal scholars have noted the many explicit and implicit ways in which corporations themselves encourage illegality for their own benefit, from *sub rosa* encouragement[157] to fostering a culture of "making the numbers" at all costs, including illegality.[158] Forces at work within a corporation thus can cause, foster, or promote criminal behavior on the part of its agents.

Press reports on the recent corporate scandals have focused of the mercenary cultures present in companies accused of massive frauds, such as WorldCom[159] and HealthSouth.[160] For instance, a recent report by a special

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[156] Martin Needleman & Carolyn Needleman, *Organizational Crime: Two Models of Criminogenesis*, 20 SOC. Q. 517 (1979).

[157] *Sub rosa* encouragement occurs when senior corporate managers preach the message that profitability is the firm's or division's top priority; left unspoken is that this is to be achieved regardless of any illegality.

[158] Professor Coffee has noted that complex organizations can send contradictory messages to those in their lower to middle echelons. "Exposed to the remote threat of criminal prosecution and the clear and present threat of dismissal, lower echelon employees know to which message it is more in their interest to respond." John C. Coffee, *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 192 at 229-230 (1993); *see also* Vu, supra note 93, at 489.

[159] Ken Belson, *WorldCom Head Is Given 25 Years For Huge Fraud*, N.Y. TIMES, July 14, 2005, at A1; *WorldCom's World Record Fraud*, WALL ST. J., Apr. 8, 2005, at A13.

[160] *Inquiry of HealthSouth Widens*, N.Y. TIMES, July 25, 2003, at C18; Carrie Johnson, *HealthSouth Founder Is Charged With Fraud*, WASH. POST, Nov. 5, 2003, at A1; Lisa Fingeret Roth et al., *Diagnosis of Fraud:*

investigative committee appointed by WorldCom's board of directors described the firm as having "a culture emanating from corporate headquarters that emphasized making the numbers above all else." The report continued that "[t]his culture began at the top . . . Ebbers created the pressure that led to the fraud. He demanded the results he had promised, and he appeared to scorn the procedures (and people) that should have been a check on misreporting."[161] Similarly, at the sentencing hearing of a former top executive at HealthSouth, one of the government's arguments for a tougher sentence was to create a deterrent to fostering such virulent cultures within corporations.[162] Despite these examples, respondeat superior and collective knowledge doctrines do not address corporate culture.

A number of writers instead have called for a consideration of corporate personality, character, and ethos as indicators of corporate culpability.[163] These commentators share the assumption that each corporate entity has a unique and identifiable personality, character, or "ethos" apart from its individual agents, which is probative in assessing the corporation's culpability. The standard for finding criminal liability under the corporate character theory is whether, considering several indicative factors, it is proven that the corporation perpetuated an environment or a demonstrable personality that encouraged the violation. If no such corrupt organizational "character" is found, then no corporate liability will follow, in spite of the commission of a

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*How Employees of HealthSouth Fooled Colleagues, Auditors and Investors for 15 years*, FINANCIAL TIMES, Apr. 15, 2003, at 19.

[161] *Former WorldCom Chief Indicted*, CBS News, Mar. 2, 2004, http://cbsnews.com/stories/2004/03/02/national/main603504.shtml.

[162] United States v. Martin, No. 04-13458, 2005 U.S. App. LEXIS 12284, at *7 (11th Cir. June 21, 2005).

[163] This concept has also been called "Corporate Ethos" theory. *See* Bucy, *supra* note 123, at 1099; Moore, *supra* note 119, at 759-60; Anthony Ragozino, Notes and Comments: *Replacing the Collective Knowledge Doctrine with a Better Theory for Establishing Corporate Mens Rea: The Duty Stratification Approach*, 24 SW. U. L. REV. 423 (1995).

prohibited act.[164] The factors that are deemed probative of a corporation's guilty knowledge are: the corporation's remedial or reactive efforts, if any, after the wrongdoing; any preventative measures that the corporation may have had in place before the offense; the corporate hierarchy; the corporate goals and policies; the corporation's historical treatment of prior offenses; and the corporation's compensation scheme.[165]

### b. Model Penal Code

The Model Penal Code ("MPC") provides the American Law Institute's response to the breadth and general awkwardness of corporate criminal liability as premised on the doctrine of respondeat superior.[166] The MPC acknowledges the need for a reconceptualization of corporate liability and points to inconsistent verdicts as symptomatic of this need. In numerous criminal cases where both corporations and their agents have been jointly tried for an offense, the MPC notes that juries sometimes convict the corporate defendant while acquitting the individual defendants.[167] Because respondeat superior theory imputes

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[164] *Id.* at 1182.

[165] *Id.* at 1100. Similarly, the U.S. Federal Sentencing Guidelines have adopted this concept. *See infra* note 230 and accompanying text. *See generally* Moore, *supra* note 119.

[166] Following its codification by the American Law Institute in 1962, the Model Penal Code was adopted in whole or in part by thirty-seven states, creating some uniformity in state corporate criminal law. MODEL PENAL CODE AND COMMENTARIES §2.07 cmt. (Official Draft and Revised Comments 1985) [hereinafter MPC].

[167] *See, e.g.* United States v. Hughes Aircraft Co., 20 F.3d 974, 976-77 (9th Cir. 1994). Interestingly, the civil Section 10(b) arena is witnessing the inverse of this problem, where corporations are found civilly liable and their constituent employees are not. *See* Klebanow v. NUI Corp. (*In re* NUI Secs. Litig.), 314 F. Supp. 2d 388, 418 (D. N.J. 2004). For other examples of inconsistent verdicts, *see* Am. Med. Ass'n v. United States, 130 F.2d 233, 252 (D.C. Cir. 1942) (allowing inconsistent verdict to stand although they are "explained by no rational considerations"), and United States v. Austin-Bagley Corp., 31 F.2d 229, 233 (2d Cir. 1929) ("[t]he

both conduct and intent from the individual to the corporation, the result in these cases has perplexed and often exasperated judges and scholars. To explain this curiosity, some courts and commentators have blamed a range of factors from irrationality[168] to mistake,[169] juror capriciousness, or even lenity.[170] Others have speculated that inconsistent verdicts may be simply a logical byproduct of the use of respondeat superior theory and the collective knowledge doctrine.[171] Nevertheless, most commentators would probably agree that this phenomenon attests to the

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verdict in either case may have been the result of considerations not rational at all.").

[168] *See* Imperial Meat Co. v. United States, 316 F.2d 435, 440 (10th Cir. 1963) (holding that the jury must find at least one of the individual defendants guilty in order to find the corporation guilty); Pevely Dairy Co. v. United States, 178 F.2d 363, 370-71 (8th Cir. 1949) (reversing the lower court and stating that the conviction of the corporate defendants and the acquittal of the individual defendants "stripped the verdict . . . of all semblance of logic").

[169] For example, the Fifth Circuit has stated that such verdicts may be a "result of compromise, or of a mistake on the part of the jury." United States v. Cargo Serv. Stations, Inc., 657 F.2d 676, 685 (5th Cir. 1981) (quoting Dunn v. United States, 284 U.S. 390, 394 (1932)). Justice Frankfurter adopted this view as well, suggesting "carelessness or compromise" caused such verdicts. United States v. Dotterweich, 320 U.S. 277, 279 (1943).

[170] For example, in allowing a corporate conviction to stand, the court in *Steckler v. United States*, 7 F.2d 59, 60 (2d Cir. 1925), assumed that the jury agreed on an agent's guilt, but interpreted the agent's acquittal "as no more than their assumption of a power which they had no right to exercise, but to which they were disposed through lenity."

[171] In *American Medical Ass'n*, however, the D.C. Circuit upheld the "inconsistent" convictions of the two corporate defendants without acknowledging any inconsistency in the verdicts. 130 F.2d at 252-53. The associations and key individuals were charged with antitrust violations, and although the individuals were acquitted, the court stated: "When a corporation is guilty of crime it is because of a corporate act, a corporate intent. . . . The fact that a corporation can act only by human agents is immaterial." *Id.* at 253. *See also* Cargo Serv. Stations, 657 F.2d at 679 (permitting inconsistent verdicts despite the fact that "every person who could have acted as [the corporation's] agent has been acquitted of criminal wrongdoing"); *Hughes Aircraft*, 20 F.3d at 974.

incongruity of human liability models vis-à-vis the corporation.

Indeed, in attempting to formulate a superior rule for corporate liability, the MPC's drafters carefully studied the corporate form and jury behavior to reach the following conclusion:

> A number of . . . juries have held the corporate defendant criminally liable while acquitting the obviously guilty agents who committed the criminal acts. This may reflect more than faulty or capricious judgment on the part of the juries. It may represent a recognition that the social consequences of a criminal act may fall with a disproportionately heavy impact on the individual defendants where the conduct involved is not of a highly immoral character. *It may also reflect a shrewd belief that the violation may have been produced by pressures on the subordinates created by corporate managerial officials even though the latter may not have intended or desired the criminal behavior and even though the pressures can only be sensed rather than demonstrated.*[172]

The MPC's drafters attested to what many criminologists, organizational behaviorists, and perhaps many corporate employees already know: inconsistent verdicts reflect a deeper wisdom regarding the corporate form and collective action. This insight regarding the corporation informs the MPC's formulation of a more limited application of respondeat superior doctrine.

To limit the scope of respondeat superior, the MPC establishes a three-part framework for corporate criminal liability. According to its text, where no "legislative purpose to impose liability on corporations plainly appears," a corporation is liable via respondeat superior only for crimes "authorized, requested, commanded, [or] performed . . . by a high managerial agent acting in behalf of the corporation

[172] MPC § 2.07 cmt. c (1985) (emphasis added).

within the scope of his office or employment."[173] Similarly, a corporation incurs liability for specific intent crimes (offenses defined in the MPC as "true" crimes) only when the illegal conduct is "authorized, commanded, solicited, performed, or recklessly tolerated by the board of directors or a high managerial agent acting in behalf of the corporation within the scope of his office or employment."[174] Therefore, the MPC's proposed rules limit corporate liability to those instances in which a person in command (a proxy for the "brain" of the organization), has direct involvement or a direct link to the crime or otherwise recklessly allows it to proceed. Under the MPC, in those cases where the legislature has plainly intended to impose criminal liability on corporations, conventional principles of respondeat superior apply. However, a corporation is permitted to establish an affirmative defense if it proves that a "high managerial agent having supervisory responsibility over the subject matter of the offense employed due diligence to prevent its commission."[175]

The MPC provides a substitute philosophy on the subject of corporate liability and the imputation of corporate mens rea. The drafters saw the urgent need within the then-existing jurisprudence for a clear cut, uniform, and practicable rule sketching the contours of corporate liability. Principally, the MPC rule is significant in its recognition that a competent and effectual rule for assigning liability to corporations must break away from routine human oriented constructs and must aim to perceive and to speak to the true nature of collective action and corporate thought.

### c. Australian Model Criminal Code

Australian law has radically, yet elegantly gone a step beyond the MPC in gauging corporate intent by adding an element of what has been described above as the corporate character theory. In doing so, the Australian Model

[173] *Id.* § 2.07(1)(a), (c).
[174] *Id.* § 2.07(1)(c).
[175] *Id.* § 2.07(5).

Criminal Code ("Australian Code") attempts to eliminate the law's imperfect reliance on respondeat superior and collective knowledge doctrines in the context of corporate intent.[176] At the heart of the Australian Code (and reminiscent of the Supreme Court of Minnesota's holding in *State v. Christy-GMC*[177]) is the notion that a corporation should be held criminally responsible if it "authorised or permitted the commission of the offence."[178] Under Australian law, there are two ways to prove a corporation's explicit or implicit authorization of the offense. The first—similar to the MPC—is via respondeat superior, but the application is limited to "key" personnel (or "high managerial agent[s]").[179] Alternatively, a corporation's criminal intent can be proved if "corporate culture . . . directed, encouraged, tolerated, or led to non-compliance" with the law.[180] "Corporate culture" is defined in broad terms that include informal or implicit conduct and practices (including *sub rosa* encouragement), as well as stated policies and formal rules: "'Corporate culture' is an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or within the area of the body corporate in which the relevant activities take place."[181]

The Australian Code disconnects the actus reus from the mens rea in an effort to find effectively the location of each criminal element within the vast corporate structure. The actus reus is attributed from the conduct of officers, employees, and agents acting within the scope of their authority or employment in a straightforward respondeat

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[176] MODEL CRIMINAL CODE § 501 (Crim. Law Officers Comm. of the Standing Comm. of Atty's-Gen. 1992) (Austl.) [hereinafter AUSTL. MCC], *codified in* CRIMINAL CODE ACT, 1995 §§ 12.1-12.6 (Austl.). For an in-depth discussion and critique of the Australian model, see Colvin, *supra* note 77, at 678-81; Laufer, *supra* note 93, at 29-30, 34-42.

[177] See *supra* notes 113-118 and accompanying text.

[178] AUSTL. MCC § 501.2.

[179] *Id.* § 501.3.1.

[180] *Id.*

[181] *Id.* § 501.3.2.

superior fashion.[182] The element of intent, however, can also be located in the culture, attitudes, or practices of the corporation, even though it is not present in any particular individual.

The Australian Code is revolutionary in two respects. First, it is the original national legislation that recognizes the role that institutional systems and entities may play in the perpetration of an offense. Second, the Australian Code divorces the actus reus from its human executor to enable an integrated and novel approach to corporate mens rea. While the MPC responds to the inadequacy of traditional agency law by limiting its scope to corporate hierarchy, the Australian Code broadens the inquiry to give authority to appreciable, yet previously uncontemplated legal aspects of corporate behavior.

The "corporate character" theory, the MPC, and the Australian Code all recognize that corporate intent may stand apart from the intent of individual corporate agents. Thus, the focus of the intent inquiry shifts from the individual to the corporation's internal systems, including its personality, decisionmaking structure, and policies. Unlike the respondeat superior and collective knowledge doctrines, these standards consider the complexity of the corporate form while seeking to preserve the intent requirements of the criminal law. Effective or not, they also encourage corporations to implement internal procedures such as compliance programs to reduce the potential for corporate liability.[183]

## C. Criminal Law—Conclusions

In evaluating corporate mens rea, criminal law has confronted both intellectual and practical stumbling blocks. One major challenge is finding the correct equation for attribution of mens rea to a corporation. Without any better intellectual paradigms to apply, courts have reluctantly used

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[182] *Id.* § 501.2.

[183] Bucy, *supra* note 123, at 1159.

human agency theories to assess corporate intent while accepting that the corporate form possesses unique characteristics incompatible with "individual" liability models. The ability to evade justice through willful blindness is just one symptom resulting from the inapplicability of agency principles to corporate criminal liability. Another symptom, which has prompted courts to craft the collective knowledge doctrine, arises when the act and the intent to commit the act do not reside within the same corporate actor. In practical terms, the likelihood that both elements will coincide in one individual within a vast corporation (and that both elements can be proven), as mandated by respondeat superior doctrine, may effectively immunize corporations from the implications of the law more often than we as a society believe to be appropriate.

As a solution to these obstacles, criminal law theorists have examined the nature of corporate conduct. In doing so, they have identified the need for a new conceptualization to reconcile what we know about corporate conduct and mentality. This has led to the adoption of clearly realist approaches. Following the lead of the MPC and Australian Code, we now turn to the civil enforcement context to resolve a similar theoretical conundrum: locating scienter within a corporation in civil securities fraud suits.

## IV. CIVIL SECURITIES FRAUD SUITS AND COLLECTIVE SCIENTER

Equipped with the lessons learned from criminal law regarding corporate intent, we may now revisit the intellectual dissonance created by the *Apple Computer* and *Bridgestone* decisions. In Part Two, we described how the operation of different assumptions regarding corporate intent yielded different conclusions on similar facts. In *Apple Computer*, where intent and action did not coincide in the same individual (or the plaintiffs were unable to muster sufficient particular proof thereof to rise to the level required

by the "strong inference" pleading standard of the PSLRA[184]), the Ninth Circuit affirmed dismissal of a securities fraud action against the corporate defendant by expressly refusing to apply collective scienter theory.[185] Thus, the Ninth Circuit embraced a strict or pure respondeat superior view of corporate liability.[186] On the other end of the spectrum, the Sixth Circuit in *Bridgestone* began with a premise quite different from that of the Ninth Circuit in *Apple Computer*—that a corporation may be liable when one corporate agent possesses the requisite intent and another speaks or otherwise acts on behalf of the corporation.

Analyzing the roots of these divergent approaches, *Apple Computer* demonstrates an evidently nominalist viewpoint. According to nominalist philosophy, a corporation is nothing more than a collection of individuals, therefore, it cannot act on its own much less have its own intent. Consequently, for nominalists, the personification of a corporation via the aggregation of one corporate agent's intent with another's action is inconsistent and illogical. As the *Apple* court said:

> A [defendant] corporation is deemed to have the requisite scienter for fraud only if the individual corporate officer making the statement has the requisite level of scienter i.e., knows the statement is false, or is at least deliberately reckless as to its falsity at the time that he or she makes the statement.[187]

In other words, as there can be no collectivized corporate action or knowledge, one can look only to an individual corporate agent's act and his or her contemporaneous state of mind.[188] According to this logic, to find the corporation liable, there can be no spatial or temporal disconnect between the act and the intent. It is irrelevant whether another

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[184] 15 U.S.C.S. § 78u-4 (2005).

[185] *See supra* notes 187-89 and accompanying text.

[186] *See infra* Section Two.

[187] *Apple Computer*, 2005 U.S. App. LEXIS 5511, at *16-17 (citation omitted).

[188] For purposes of the discussion regarding securities fraud, the act is necessarily a misstatement to the market.

responsible corporate agent may have known of or encouraged the statement's falsity in furtherance of a fraudulent purpose. Taken to its logical extreme, this argument actually militates against any kind of corporate liability.[189]

By contrast, the Sixth Circuit's *Bridgestone* rationale is implicitly informed by realism. Recall that realism acknowledges a distinct corporate persona independent from that of its human members. As such, corporate fault is accepted as distinct from personal fault. The Sixth Circuit in *Bridgestone* had no difficulty allowing a Section 10(b) class action to proceed against the corporation, even though scienter and the misstatement did not reside in the same natural person. Consequently, the court implicitly recognized that a corporation is an aggregation of the states of mind and acts of its members.

Juxtaposing these two recent 10(b) opinions demonstrates the fundamental ambiguity plaguing corporate securities law with regard to the assessment of corporate scienter. Although understanding the theoretical foundations of the divergent assumptions is a necessary starting point for dissecting the problem, criminal law tells us that in the

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[189] Professor Langevoort acknowledges this thought-provoking question in passing:

> Arguably, it is something of an open question as to whether companies can be held liable at all under Rule 10b-5 as primary violators (as opposed to controlling persons under section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a) (1994)). By most accounts, they can, if by nothing else than reference to the definition of "person" in section 3(a)(9) of the Act, which refers specifically to juristic persons. See id. § 78c(a)(9) ("The term 'person' means a . . . company . . . ."). As corporations almost by necessity speak through agents, the natural construction of section 10(b), id. § 78j(b), and section 3(a)(9), id. § 78c(a)(9), read together, makes it possible for corporations and other business entities to violate the antifraud provision directly.

Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 126 n.82 (1997).

realm of corporate action, the best way to handle such philosophical and practical quandaries is to formulate a straightforward and workable rule that will deliver uniform, predictable, and theoretically justified results.

## A. The Proposed Rule

Our proposed rule resolves two fundamental questions. The first asks whose individual state(s) of mind reflects the corporation's Section 10(b) scienter. The second question asks whether and under what circumstances the corporation itself can have a demonstrable state of mind without imputation or aggregation.

Recently, the Fifth Circuit articulated what appropriately may be characterized as the antecedent to our rule. In the context of a Section 10(b) class action, the court rejected a broad collective knowledge argument in favor of the following statement:

> For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.[190]

[190] Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2005).

The rule we offer refines this line of thinking.[191] It is paramount to note that the proposed rule does not purport to address the secondary question regarding what types of facts, on an ad hoc basis, may suffice to plead properly or to establish the strong inference of scienter for a corporate defendant. Nor does this rule claim to be the final word on evaluation of corporate liability. It is merely an indicator of where or to whom we should look to properly locate a corporate defendant's scienter, as an element of a Section 10(b) case.

Our rule identifies the locus of corporate scienter in Section 10(b) cases, as follows:

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[191] The list of persons within our locus of scienter is also roughly consistent with the delineation of persons liable for misrepresentations and omissions in a registration statement. Section 11(a)(1-5) of the Securities Act of 1933 states in relevant part:

(a) Persons possessing cause of action; persons liable

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue –

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; [and]

(5) every underwriter with respect to such security.

15 U.S.C. § 77k(a) (2000).

*The state(s) of mind of any of the following are probative for purposes of determining whether a misrepresentation made by a corporation was made by it with the requisite scienter under Section 10(b):*

*1. Any individual in the "locus of scienter," which includes:*

> *a. The individual agent who uttered or issued the misrepresentation;*
>
> *b. Any individual agent who authorized, requested, commanded, furnished information for, prepared (including suggesting or contributing language for inclusion therein or omission therefrom), reviewed, or approved the statement in which the misrepresentation was made before its utterance or issuance;*
>
> *c. Any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance; OR*

*2. The corporation itself.*

Let us begin to dissect the rule by revealing its underlying assumptions. As stated above, the proposed rule applies where the requisite Section 10(b) scienter of a corporate defendant is at issue.[192] We start with the premise that the act in question is a misrepresentation or omission, as it is in Section 10(b) cases. Corporate actors typically convey such misrepresentations verbally (e.g., in interviews, press conferences, conference calls, or road show presentations) or in writing (e.g., in SEC filings, annual

[192] As such, the individual liability of the corporate agents, either under 10(b) or 20(a), is beyond the scope of the rule and of our discussion.

reports, or press releases). For purposes of the rule, we have used the single word "misrepresentation" to mean either an affirmative misstatement or a misleading omission.[193] Next, we have assumed that the misrepresentation is properly attributable to the corporation. In other words, the corporate agent(s) responsible for uttering, writing, or publishing the misrepresentation did so in the scope of his or her employment and for the benefit of the corporation.

Finally, we have rejected the notion that a guilty corporate agent's title is necessarily diagnostic of the employer-corporation's intent. As such, whether a corporate actor falls within the locus of scienter is determined by the agents' actual participation in the preparation, approval, or dissemination of the harmful misrepresentation to the market. Thus, the locus of a corporation's scienter is delineated by the discrete roles played by human corporate actors who are connected to the misrepresentation, regardless of their positions within the corporate hierarchy or precise relationships to the corporation.[194] So, the rule dictates a cognizable link between the misrepresentation and

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[193] Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2001). The operative language of Rule 10b-5 provides:

> It shall be unlawful for any person . . . (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . in connection with the purchase or sale of any security.

[194] This is in line with the holdings of courts that have concluded that allegations that corporate officials, because of their positions within the company, must have known a statement was false or misleading do not suffice to establish their individual scienter under the PSLRA, regardless of the individual defendants' positions within the company. *See* Abrams v. Baker Hughes Inc., 292 F.3d 424, 432 (5th Cir. 2002); City of Philadelphia v. Fleming Cos., 264 F.3d 1245, 1263-64 (10th Cir. 2001); *In re* Advanta Corp. Secs. Litig., 180 F.3d 525, 539 (3d Cir. 1999) ("Generalized imputations of knowledge do not suffice, regardless of the defendants' positions within the company."). *See generally*, William O. Fisher, *Don't Call Me a Securities Law Groupie: The Rise and Possible Demise of the "Group Pleading" Protocol in 10b-5 Cases*, 56 BUS. LAW. 991 (2001).

corporate scienter in the form of the corporate agent's meaningful participation in the misrepresentation. Consequently, if there is a corporate agent with the requisite scienter within the organization who is not so linked to the misrepresentation, his or her scienter is not imputable to the corporation for purposes of Section 10(b) liability.

In the following Subsections, we first parse and explain each part of the rule, apply it in a real world scenario, and finally show how it is justified by civil and criminal jurisprudence, well-established legal theories, and its own even handed results.

## B. Subpart 1(a) and the Individual Utterer or Issuer

The first subpart of the rule naturally places within the locus of scienter any individual agent of the corporation who physically utters a verbal misrepresentation or who personally issues an attributed written statement on behalf of the corporation. An "agent" is "any director, officer, servant, employee or other person authorized to act in behalf of the corporation."[195] According to our formulation, a third party agent or other independent contractor, like a public relations consultant, lawyer, accountant, or other professional service provider, may also be in the locus of scienter. This subpart is unremarkable, but it enables a standard and uncontroversial respondeat superior analysis of corporate scienter.

### 1. Subpart 1(a) in Practice

In a televised interview, the CEO of Corporation A touted his company's software products and pending deal with Corporation B. He stated that the deal would add $0.05 per share to 1999 earnings. Beyond that, the corporation would be "on track to report EPS[196] of $1.20 in 2000," and the deal

[195] This definition is borrowed from MPC § 2.07(4)(b) (1985).

[196] "EPS" is an abbreviation for the earnings-per-share metric.

"would generate $35 million in year one revenues."[197] In reality, the corporation's software products had critical flaws that rendered A unable to perform the contract with B. Just days after the interview, A's CEO "dumped" forty percent of his stock in the corporation at a price artificially inflated by his misleading statements. Corporation A's shareholders filed a class action under Section 10(b) generally contending that the defendants—the CEO and Corporation A—engaged in a fraudulent scheme to deceive investors about the company's performance for the purpose of inflating the price of Corporation A stock for their own financial benefit.[198]

This scenario presents the least difficult and perhaps rarest case in a corporate context.[199] A high level corporate agent uttered the statement containing an actionable misrepresentation or omission, and the agent simultaneously possessed the requisite Section 10(b) scienter. Act and intent were united temporally and physically in the same corporate actor. Traditional vicarious liability dictates that the corporation has the requisite 10(b) scienter because the corporate agent made the misrepresentation in the scope of his employment and for the benefit of the corporation. The firm's corporate agent was in fact its highest "managerial agent," its CEO. In addition, the misrepresentation occurred in the context of an interview in which the CEO was acting in his official capacity as the head of Corporation A.

[197] None of these statements was qualified by any meaningful cautionary language, and therefore, no defense was available under the PSLRA's safe harbor provision. 15 U.S.C. §§ 78(u)-(5)(c), §77(z)-(2)(c) (2000).

[198] The facts as described here are loosely based on Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 359 (5th Cir. 2005).

[199] It is indeed a rare situation for an individual corporate actor to issue a written corporate statement for which he is the sole author. Similarly, although verbal statements made during press conferences, interviews, and conference calls may appear to be individual statements, our assumption based on experience is that they are typically scripted or, at the very least, heavily "coached" or "choreographed" by other corporate actors. In the event that another corporate agent participated in the statement, that person's scienter would be equally probative for purposes of discovering corporate guilt as per Section 1(b) of our rule.

Moreover, it goes without saying that the misrepresentation regarding the viability of the company's software products and hence, its ability to perform on pending contracts, provided a direct financial benefit to the corporation. On these facts, pure respondeat superior theory would hold the corporation vicariously liable for the CEO's misrepresentation.

The Fifth Circuit recently allowed a Section 10(b) class action suit with facts similar to those described above to proceed against the corporate defendant, as well as the individual CEO defendant.[200] Although for some reason the court felt obliged in dicta to engage in a somewhat lengthy analysis of corporate scienter that concluded with a rejection of the collective knowledge doctrine,[201] its holding rests squarely on a straightforward respondeat superior analysis. Subpart 1(a) of the rule we propose, if applied in the above scenario, would not stray from the Fifth Circuit's respondeat superior holding. In cases where the act and the intent reside within the same corporate actor, respondeat superior theory clearly and effectively locates corporate scienter.[202]

## C. Subpart 1(b) and the Locus Surrounding the Statement

Subpart 1(b) covers typically unattributed, written corporate statements (such as statements in prospectuses, registration statements, annual reports, press releases, or

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[200] *Southland*, 365 F.3d at 380 ("Because it is alleged that Dunham, with the requisite scienter, made these statements as INSpire's CEO and on its behalf, and in the course of his INSpire employment, INSpire's respondent [sic] superior liability for those statements is also adequately alleged.").

[201] *Id.* at 365-367.

[202] *Cf.* New York Cent. & Hudson R.R. Co. v. United States, 212 U.S. 481, 495 (1909). *See also* S. Scott Luton, *The Ebb and Flow Of Section 10(b) Jurisprudence: An Analysis of Central Bank,* 17 U. ARK. LITTLE ROCK L. REV. 45, 78 (1994) ("Given the fact that the doctrine of respondeat superior is not expressed within the text of Section 10(b) and because application of the doctrine is seemingly inconsistent with the expressed language of Section 20(a), the validity of the doctrine is in doubt.").

other group published documents), which we assume are the collective work product of a number of corporate agents. This premise is consistent with both common sense and the underlying assumptions of extant Section 10(b) case law.[203] Reflecting this reality, Subpart 1(b) of the rule defines participation in the misrepresentation as engaging in any of the following actions: authorizing, requesting, or commanding the statement in which the misrepresentation was made; furnishing information for the statement; preparing the statement (including suggesting or contributing language for inclusion therein or omission

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[203] It also serves as the basis for the controversial "group pleading" doctrine. *See* Phillips v. Scientific-Atlanta, Inc., 374 F.3d 1015, 1016-17 (11th Cir. 2004); Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987) ("In cases of corporate fraud where the false or misleading information is conveyed in prospectuses, registration statements, annual reports, press releases, or other 'group-published information,' it is reasonable to presume that these are the collective actions of the officers."); Luce v. Edelstein, 802 F.2d 49, 54-55 (2d Cir. 1986); *see also* Bruns v. Ledbetter, 583 F. Supp. 1050, 1052 (S.D. Cal. 1984); Zatkin v. Primuth, 551 F. Supp. 39, 42 (S.D. Cal. 1982). The group pleading doctrine has alternatively been referred to as the "group published" doctrine, and the "group published information presumption." *See Southland*, 365 F.3d at 363; Fisher, *supra* note 194, at 995.

Our rule simply acknowledges the group published character of corporate statements for purposes of determining which corporate agents might be indicative of the corporation's scienter when issuing such a statement. Dissimilarly, the group pleading doctrine calls for a presumption that officers and directors participated in a misstatement contained in a group prepared document—*for purposes of establishing their personal liability as individual defendants*. There has been considerable debate regarding whether this judge-made rule survived the PSLRA's strict pleading requirements. But, resolution of this question is irrelevant here as we refer to the doctrine really only for the sound premise upon which it is based regarding the collective authorship of corporate statements. Even the Fifth Circuit, which summarily rejected the group pleading doctrine in *Southland*, recognizes that "corporate documents that have no stated author or statements within documents not attributed to any individual may be charged to one or more corporate officers provided specific factual allegations link the individual to the statement at issue." Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 365 (5th Cir. 2005).

therefrom); and finally, reviewing or approving the statement in which the misrepresentation was made before its utterance or issuance. Logically, anyone who crafted a portion of the statement with guilty knowledge may have caused the corporation to perpetrate a fraud on the market, even if other participants had clean hands. Next, we clarify each of these functions as they relate to the statement in which the misrepresentation was made.

### 1. Authorizing, Requesting, and Commanding the Corporate Statement

The MPC states that a corporation may be convicted of the commission of an offense if such offense was "authorized, requested, commanded . . . by the board of directors or by a high managerial agent acting in behalf of the corporation within the scope of his office or employment."[204] The drafters of the MPC inserted this provision to mitigate the possible overbreadth of the respondeat superior doctrine. We adopt this same "authorized, requested, commanded" language in the proposed rule so as to include within the locus of scienter those (usually high level) agents of the corporation who may have authorized, requested, or commanded the issuance of the statement, but who did not participate directly in its drafting or utterance.

Following the guidance of the MPC, it is appropriate to look to the scienter of these individuals to assess whether the corporation itself has guilty knowledge. Including these individuals in the locus of scienter also avoids the potential for shielding the corporation from liability via willful blindness. However, a rule like the MPC's, which fails to encompass lower level employees' scienter as probative of the corporation's, is problematic in the context of corporate action. Such a rule would effectively encourage higher level employees to *order* corporate wrongdoing and then to disassociate themselves from the act in question. In such a scenario, the high level employee avoids personal liability

[204] MPC § 2.07 (1)(c) (1985).

because he or she did not utter a misrepresentation, and the corporation avoids liability by insuring that the mouthpiece has no guilty knowledge. Such a result is unacceptable.

It is important to note that the parallel to the MPC is a loose one. The MPC uses the subject language in referring to the actual authorization, request, or command of the specific criminal act in question.[205] In the context of our rule, we have adopted this language but broadened the scope of the object of the authorization, request, or command. Here, that object (of the authorization, request, or command) is the issuance or utterance of the corporate statement containing the misrepresentation, not the misrepresentation itself. He who authorizes, requests, or commands a corporate statement should be ultimately responsible for and knowledgeable of its contents.[206] Such knowledge and conduct, thus, are properly attributable to the corporation for purposes of Section 10(b) scienter.

### 2. Furnishing Information

Next, the locus of scienter includes any corporate agent who furnished information for the larger statement in which the misrepresentation was made. Given that most corporate statements are the work product of a group of individuals, this segment of the rule merely recognizes that the state of mind of anyone who furnished information is probative of

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[205] *Id.*

[206] Title III of Sarbanes-Oxley requires that the "principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions" certify the corporation's financial reports. In doing so, they verify that they have reviewed the report and that it does not contain any untrue or otherwise misleading statement regarding the financial condition of the corporation. *See* Sarbanes-Oxley Act of 2002 § 302(a)(1)-(3), 15 U.S.C. § 7241 (2000). These certifications were designed to make high ranking corporate officers personally liable for corporate misrepresentations. S. REP. NO. 107-205, at 27 (2002) ("The Committee believes that management should be held responsible for the financial representations of their companies."). In a similar fashion, our rule provides a rubric for preventing the corporation from escaping liability via the willful blindness of one or another corporate actor.

corporate scienter, whether that information was in the form of data or verbiage.

### 3. Participating in Preparation of the Statement

Participation in the "preparation" of the statement in which the misrepresentation is made is perhaps the broadest prerequisite for membership in the locus of scienter. Following our rule, the scienter of any corporate agent who drafted, wrote, scripted, or edited the statement (or assisted in any of these functions) is probative of the corporation's scienter. Thus, the argument goes, the guilty mind of any of a group of employees participating in the crafting or editing of the statement could have committed or may have furthered a fraud on behalf of the corporation.

### 4. Reviewing and Approving

Similarly, the scienter of any corporate agent who reviewed or approved the statement before it was released to the market can be reflective of the corporation's scienter. Similarly, the scienter of final reviewers—those who do not necessarily participate in the process of statement preparation, utterance, publication, or distribution—does not escape scrutiny under our rule.

### 5. Subpart 1(b) in Practice: A Hypothetical

Corporation C, an international telecommunications giant, issued a press release announcing that it and Corporation D, a Greek mobile telecommunications company, had "entered into a contract worth $1.5 billion to provide infrastructure and associated services to expand the countrywide telecommunications network in Greece." That day, C's shares closed at $50.92 per share, up from $48.21 the day before. The press release mischaracterized the nature of the deal for Corporation C. It did not disclose the facts that: (1) C had already provided $1.333 billion in financing to Corporation D, collection of which was gravely in doubt; (2) D was technically in breach of the parties' prior agreements by refusing to provide C with financial

statements or other records; and (3) the entire amount of the new contract was contingent upon C's provision of 100% financing for the equipment purchased and additional financing for D in the form of working capital. Finally, the press release did not reveal that the sole collateral for D's obligations was shares in D, which were both illiquid and of uncertain value. Predictably, D defaulted on the loan and breached the contract with C, sending C's stock price into a tailspin. Several actors contributed to the original press release: the CEO requested the announcement; an outside public relations agency wrote and disseminated the release; and the corporation's communications, legal, and investor relations departments reviewed the disclosure before releasing it. In addition, Corporation C's top finance department managers provided all of the information that Corporation C included therein.

In this fact pattern, the corporation's scienter may be somewhat more difficult to assess. The traditional approach to corporate scienter would first look to respondeat superior, which would fail to set the stage for liability against the corporation because, although many corporate agents "touched" the alleged misrepresentation, it might be quite difficult to locate a single corporate agent who both engaged in the misrepresentation and possessed the requisite demonstrable scienter. Therefore, a court might next choose to engage in a collective scienter analysis. After locating any corporate agent with guilty knowledge, this court would aggregate that person's scienter with another corporate agent's act to conclude that the corporation had violated Section 10(b). Some may find this problematic because of the lack of a direct link between the allegedly violative corporate conduct and the corporate agent who purportedly possessed scienter.

Our rule quells this concern by limiting the scope of permissible scrutiny. Simply put, it requires a tangible link between the physical act (which is uncontroversially imputable to the corporation by means of respondeat superior) and the requisite Section 10(b) scienter. Unlike the collective scienter doctrine, with our proposed rule, the

scienter of the proverbial janitor—any agent of the corporation who clearly had no link to the misrepresentation—cannot be deemed probative of the corporation's scienter for purposes of the misrepresentation in question. Through its Subpart 1(b), our rule draws clear (albeit necessarily broad) lines as to whose scienter is attributable to the corporation. Unlike the MPC, this rule does not make distinctions based on an individual's position within the corporate hierarchy. In fact, as the foregoing scenario demonstrates, even an outside agent can be part of the locus of scienter by virtue of his or her direct or indirect participation in the formulation or issuance of the misrepresentation *sub judice*.

Continuing with the analysis of the hypothetical presented under Subpart 1(b) of the rule, to establish the scienter of the corporation, a plaintiff could plead and prove that any one of the following involved individuals possessed the requisite scienter: (1) the members of Corporation C's outside public relations agency who wrote and disseminated the press release; (2) the members of Corporation C's communications, investor relations, and legal departments who reviewed and approved the release before its dissemination; (3) Corporation C's top finance managers who furnished information for inclusion in the dissemination; and finally, (4) the President and CEO who personally ordered the press release.

On analogous facts, the court in *In re Motorola Securities Litigation*[207] dismissed a securities class action against the individual defendants[208] but permitted it to proceed against the corporate defendant. The court in *Motorola* concluded that the company knew or was reckless in not knowing that its various public statements were false or misleading. On the other hand, the court found insufficient evidence of knowledge or recklessness on the part of the individual

[207] *In re* Motorola Sec. Litig., No. 03 C 287, 2004 U.S. Dist. LEXIS 18250, at *91 (N.D. Ill. Sept. 9, 2004).

[208] We do not necessarily concur with this result, but analysis of this issue is totally outside the scope of this Article.

defendants.[209] Using an inherently realist calculation, the court apparently started with the premise that the corporation itself could have scienter, and it simply aggregated the states of mind and levels of knowledge of Motorola's corporate agents to conclude that Motorola itself must have known of or had access to information suggesting that its public statements were materially inaccurate. Our proposed rule supports the result in this case.

## D. Subpart 1(c) and Corporate Behavior Ex Post Facto

This Subpart is temporally distinct from Subparts (a) and (b) in that it refers to high managerial agents' and board members' behavior *ex post facto*. It provides that any high managerial agent or member of the board of directors who ratified, recklessly disregarded, or tolerated the misrepresentation after its utterance or issuance is properly includable in the locus of scienter.[210] Accordingly, the proposed rule imposes an implied duty on the corporation's high managerial agents and board of directors to correct misrepresentations to the market. Failure to do so is an objective indicator of the corporation's scienter under our rule.

### 1. Subpart 1(c) in Practice

At a recent press conference, a member of the press asked the CEO and CFO of Corporation E a question regarding Corporation E's new product, a fuel-efficient sports utility vehicle called the Metro Wagon. In her unscripted answer, the CEO stated that "the Metro Wagon, which will be launched in March 2005, will revolutionize the way people in America drive." She also stated that "objective internal data

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[209] *Motorola*, 2004 U.S. Dist. LEXIS 18250 at *91.

[210] As defined by the MPC, a "high managerial agent" refers to an officer of a corporation or an unincorporated association, or in the case of a partnership, a partner, or any other agent of a corporation or association "having duties of such responsibility that his conduct may fairly be assumed to represent the policy of the corporation or association." MPC § 2.07(4)(c) (1985).

shows that this product will be the most fuel-efficient and safe in its class," and that "preliminary road tests have shown its fuel efficiency to be 25 miles per gallon in the city and 60 on the highway." The CFO lauded the new vehicle as a "victory" that will turn Corporation E around financially and place it among the top car manufacturers in America.

Unbeknownst to both the CEO and CFO, the Metro Wagon was having serious technical malfunctions and had failed several safety tests. Corporation E engineers had expressed serious concerns to other top Corporation E executives regarding the road-worthiness and alleged fuel efficiency of the vehicle, yet that information had not been conveyed to the CEO or CFO. On news of the Metro Wagon's future success, Corporation E's stock price increased from $25.29 to $30.00 in one afternoon. Months later, when the corporation decided to postpone its launch of the Metro Wagon indefinitely due to its defects, the stock price crashed to $18.00.

Under existing liability models, plaintiffs would be hard put to prove that the corporation knew that its statement was false when made so as to permit a finding of liability under Section 10(b). Although the CEO's representation regarding the "revolutionary" qualities of the Metro Wagon certainly would be dismissed as mere puffery, her assertions regarding timing of the product launch, the superior fuel efficiency, and safety of the vehicle would be deemed actionable misrepresentations. But, the CEO did not know that these statements were untrue when she spoke. Thus, with no intersection of the act and scienter, respondeat superior theory could not provide a foundation for the corporation's scienter and resulting liability. Nonetheless, other responsible yet silent corporate executives knew the extent of the misrepresentation. Under our collective knowledge approach, liability might be found if a court were willing to aggregate the scienter of the top executives, who knew the true facts, and thus recognized that the CEO and CFO were making misrepresentations.

The court in *Apple Computer*, a case with facts roughly similar to those of Corporation E above, refused to look at

the state of mind of any corporate agent other than the one who uttered the misrepresentation (in this case, Apple CEO Steve Jobs). Following the lead of earlier Ninth Circuit dicta,[211] the court concluded that the coexistence of scienter and act within the same human being was a necessary antecedent to the corporation's Section 10(b) liability. Applying our rule to *Apple Computer* changes the case's outcome. Following Subpart 1(c), a court assessing Apple's scienter would look to the prior or contemporaneous knowledge of other top Apple executives. These executives knew that the product being developed had technical malfunctions both before and at the time that Jobs touted the product and arguably exaggerated its potential for commercial success. Our rule imposes upon these corporate agents a duty to correct promptly any public statements that they know to be false or misleading.[212]

The criminal context provides significant support for this idea.[213] As discussed above, the MPC proposes corporate liability for specific intent crimes when the illegal conduct is "authorized, requested, commanded, solicited, performed, or *recklessly tolerated* by the board of directors or a high managerial agent acting in behalf of the corporation within

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[211] Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424 (9th Cir. 1995).

[212] *In re* Warner Comm'ns Secs. Litig., 618 F. Supp. 735, 752 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986) ("As to Warner, plaintiffs arguably need only show . . . that Warner management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace"). Of course, this duty is a duty to do so internally or to cause the misrepresentation to be corrected by the corporation and would not justifiably lead to individual liability. It would be inconsistent to presume to take into account the reality of corporate life and simultaneously to advocate that corporate underlings "in the know" announce to the press and the market that their CEO was either incorrect or deceptive in his representations.

[213] As some have pointed out, "this notion conflicts with the traditional criminal law principle that one is generally not criminally liable for an act merely because he approved of it after the fact." Note, *Corporate Crime*, *supra* note 8, at n.38, *reprinted in* SANFORD H. KADISH & STEPHEN J. SCHULHOFER, CRIMINAL LAW AND ITS PROCESSES 689 (6th ed. 1995)

the scope of his office or employment."[214] Further, the corporate character theory advocates establishing a corporation's guilty knowledge through an analysis of its preventative and reactionary systems surrounding the offense. This theory provides that a corporation's essential character and culture can "adopt a corporate agent's violation of the law,"[215] and thus, demonstrate the firm's own guilt without need for attribution. Existing case law underscores this point. In *State v. Christy Pontiac-GMC*, the Supreme Court of Minnesota found it necessary and proper, in seeking to uncover the corporation's guilty knowledge, to look at corporate management's behavior after the act.[216]

The concept of examining management's postmortem behavior when judging a corporation's intent also is not a completely foreign approach in the civil securities fraud context. *In Re Warner Communications Securities Litigation*[217] provides one illustration. There, an insurance indemnity suit arose out of a class action suit alleging misstatements to the press regarding the performance of Atari, Inc., a Warner Communications subsidiary. In analyzing the scienter of both the corporation and the individual defendants, the court, in dicta, sanctioned an examination of Warner management's reaction to statements that one or more members knew were false:

> In addition, the requisite degree of scienter is likely to be easier to attribute to Warner than to the individual defendants. As to Warner, plaintiffs arguably need only show either that one or more members of top management knew of material information indicating an earnings decline, but failed to stop the issuance of misleading statements or to

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[214] MPC § 2.07(1)(c) (2000) (emphasis added).

[215] *See* Foerschler, *supra* note 93, at 1306.

[216] State v. Christy Pontiac-GMC Inc., 354 N.W.2d 17, 19-20 (Minn. 1984).

[217] *Warner*, 618 F. Supp. at 752.

> correct prior statements that had become misleading.[218]

Notably, our rule's Subpart 1(c) also finds support in the reasoning recently espoused by the district court in *In re WorldCom, Inc. Securities Litigation.*[219] Reminiscent of *Apple Computer*, the auditor defendant, Andersen, contended that plaintiffs were obligated to prove that the individual corporate actor who made the misrepresentation at issue also had the requisite scienter. Baldly rejecting this argument, the district judge grounded her resolution in the collective knowledge doctrine, thus implying that the danger of deliberate blindness dictated that the state of mind of other nonacting corporate agents be probative and attributable to the corporation.[220] The court went on to assert that "case law abounds with discussions of securities fraud by accounting firms that concentrate on the firm's collective state of mind, not that of individual partners or employees."[221] Although the discussion in *WorldCom* focused on an accounting firm defendant in a Section 10(b) case, the parallel between an accounting firm issuing its audit and a corporate agent speaking to the market on behalf of the issuer corporation is clear. In both cases, the work product of a collective—the reckless audit or a half truth spoken to the market—is the cause of the harm and the crux of the violation.

## E. Part Two and the Corporation Itself

Moving beyond new methods for imputing and aggregating the elements of a Section 10(b) claim, perhaps the most novel and without question a key component of our proposed rule is that it acknowledges and addresses the existence of corporate scienter separate and apart from that

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[218] *Id.* at 752 (emphasis added).

[219] *In re* WorldCom, Inc. Sec. Litig., 352 F. Supp. 2d 472 (S.D.N.Y. 2005).

[220] *Id.* at 497 (citing United States v. Bank of New England, N.A., 821 F.2d 844 (1st Cir.), *cert. denied*, 484 U.S. 843 (1987) and its progeny).

[221] *Id.* at 497 (citations omitted).

of any individual corporate actor or even group of actors. As discussed above, the Supreme Court concluded in *New York Central* nearly a century ago that an agent's culpable mental state may be imputed or attributed directly to the entity.[222] At that point, the notion of a distinct corporate mens rea or actus reus was ignored. Since that time, jurists and behaviorists have argued,[223] and thus, we have come to see that the collective affairs of a corporation, such as its goals, policies and procedures, history, habits, and customs, often reflect more than the collective nature of agents' intentions and actions. Indeed, they may reflect a well-developed corporate persona or ethos.[224]

Building on the realist notion that collectives may be separate "persons" with intent distinct from that of each member, the second part of our rule assesses corporate intent without resort to the fictional attributions and imputations inherent in the respondeat superior and collective knowledge doctrines. Of course, dispensing with traditional vicarious liability presents the formidable obstacle of objectively proving a corporation's state of mind. In this regard, Professor Laufer advocates using the application of a reasonableness standard. Pointing out that there are numerous instances in criminal law where culpability hinges on "inferences of mens rea based on what a reasonable person would have intended, given the accused's circumstances,"[225] he concludes that the most

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[222] N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 493 (1909).

[223] *See* DANIEL KATZ & ROBERT L. KAHN, THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS (Leigh L. Thompson ed., 1978); LAWRENCE B. MOHR, EXPLAINING ORGANIZATIONAL BEHAVIOR (1982); DIANE VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR: SOCIAL STRUCTURE AND CORPORATE MISCONDUCT (1983); Langevoort, *supra* note 189, at 102; Langevoort, *supra* note 129, at 1189.

[224] *See* Brent Fisse, *The Attribution of Criminal Liability to Corporations: A Statutory Model*, 13 SYDNEY L. REV. 277, 279 (1991). The Australian Code was heavily influenced by his work. *See also* Brent Fisse, *Corporate Criminal Responsibility,* 15 CRIM. L. REV. 166 (1991).

[225] *See* Laufer, *supra* note 93, at 695. In supporting his theory, Professor Laufer uses actions brought under Section 77q(a) of the

effective approach to assessing a corporation's state of mind is to ask whether a reasonable corporation of comparable dimensions would possess scienter, given a set of facts and circumstances including corporate culture.[226]

What kind of facts point to a lapse in "reason" by a corporation? We posit three conspicuous ways that a corporation displays its collective mindset: (1) its known corporate history; (2) common knowledge within the corporation, the industry, or the market; and (3) the corporation's internal environment. All three are demonstrable, definite, and verifiable. The presence of any of these factors can reveal whether a corporation had knowledge and intent when compared to other "reasonable" corporations of its same size and shape. Thus, Part 2 of the rule calls for consideration of the corporation's knowledge, policies, practices, and culture as an institutional locus of scienter.

### 1. Part 2 in Practice

Part 2 sets out three possible and conceptually overlapping scenarios that illustrate how a court applying the proposed rule could find that a subject corporation has the requisite Section 10(b) scienter without applying either the respondeat superior and/or simple aggregation theories. Each scenario is loosely based on the facts of a current court decision.

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Securities Act of 1933 as examples and asserts that a number of courts have ruled that knowledge of the falsity of representations made regarding the sale of securities need not be actual. *Id.* at 695. Guilty knowledge or scienter "may always be inferred from the proved circumstances, where its asserted lack is based on ignorance of evidentiary facts which any person under similar circumstances would be bound to know." *Id.* at 695 (quoting United States v. Vasen, 222 F.2d 3, 8 (7th Cir.), *cert. denied*, 350 U.S. 834 (1955)).

[226] *Id.*

### a. Known Corporate History

Corporation F recently acquired Corporation G to form Corporation FG. Corporation F is generally in the business of canned food, and Corporation G specializes in baby food. Prior to purchasing Corporation G, Corporation F engaged in extensive due diligence that confirmed details of what many already knew due to extensive reporting in the press: five years prior, Corporation G had been forced to recall 300,000 jars of baby food due to a problem at one of its plants. A year after F purchased G, a group of consumers of FG products brought a product liability suit against the new company. They claimed that their infants had contracted a rare ailment after ingesting Corporation FG baby food products canned at an FG plant, which Corporation G had formerly owned and operated. Corporation FG issued a statement questioning the veracity of these claims and maintained that internal investigations showed that all of its plants met the highest levels of hygiene. It dismissed plaintiffs' claims as isolated and without foundation. When it was later revealed that the plaintiffs' assertions were well founded, Corporation FG was forced to settle for an exorbitant amount of money. FG's stock price crashed, to the detriment of its stockholders.

Here, Corporation FG issued a statement that was clearly contrary to what it "knew" to be at least a contingent possibility, given its corporate history and the due diligence that it had performed. The fact pattern illustrates one way that a corporation can be deemed to "know" something independent of its constituent employees. When a major corporate event occurs and is a part of the public record or has been highly publicized, a corporation should be deemed to "know" it for purposes of proving the corporation's scienter.[227]

[227] It strains credulity for a corporation to deny knowledge of matters in its history that are not only public record but that were widely reported by the media and that many members of the public will undoubtedly recall. Consider for example TEXACO's discrimination scandals. *See* Elsa Brenner, *Texaco Accused of Bias in Suit by Blacks*, N.Y. TIMES, July 14, 1996, at 13WC; *Ex-Texaco Treasurer Indicted In Race Discrimination*

Under current law, a strong inference of scienter is established where "defendants published statements when they knew facts or had access to information suggesting that their public statements were materially inaccurate."[228] Plaintiffs, however, face an uphill battle vis-à-vis corporate scienter when that knowledge is simply generalized "known corporate history." Our proposed rule addresses this obstacle by requiring a court to look at the firm's known corporate background or history when considering scienter even at the pleading stage.

Institutional knowledge of this type is easily demonstrable, and its existence in the corporate context is hard to deny. In the example above, the documented problems at Corporation G were widely known to both insiders and the public. As such, this corporate history alone would be sufficient at the pleading stage to demonstrate corporate knowledge of the misstatement under our rule. Presumably working under a similar assumption, the Sixth Circuit in *Bridgestone* discussed the parent company's known history as part of its analysis of whether the facts as presented sufficiently indicated scienter at the pleading stage. The court focused on Bridgestone's knowledge of its

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*Case*, N.Y. TIMES, June 28, 1997, §1, at 36; Thomas S. Mulligan & Chris Kraul, *Texaco Settles Race Bias Suit for $176 Million*, L.A. TIMES, Nov. 16, 1996, at A1; *Texaco Women Get a Settlement*, BUSINESS WEEK, Jan. 18, 1999, at 52; *Online NewsHour: Texaco Race Relations* (PBS Broadcast Nov. 12, 1996); *see also* Leonard Buder, *Beech-Nut is Fined $2 Million for Sale of Fake Apple Juice*, N.Y. TIMES, Nov. 14, 1987, §1, at 1 (discussing the widely publicized Beechnut apple juice scandal); Leonard Buder, *2 Former Executives of Beech-Nut Guilty in Phony Juice Case*, N.Y. TIMES, Feb. 18, 1988, at A1; Alix M. Freedman, *Nestle Quietly Seeks to Sell Beechnut, Dogged by Scandal of Bogus Apple Juice*, WALL ST. J., July 6, 1989, §1, at 4.

[228] Fl. State Bd. of Admin. v. Green Tree Fin. Corp., 270 F.3d 645, 665 (8th Cir. 2001) (citing Phila. v. Fleming Cos., 264 F.3d 1245, 1260-61 (10th Cir. 2001)); Hollin v. Scholastic Corp. (*In re* Scholastic Corp. Sec. Litig.), 252 F.3d 63, 76 (2d Cir. 2001); Howard v. Everex Sys., Inc., 228 F.3d 1057, 1064 (9th Cir. 2000). *Cf.* Helwig v. Vencor, Inc., 251 F. 3d 540, 552 (6th Cir. 2001).

subsidiary's persistent tire tread problems, pondering as follows:

> Consider also Firestone's previous tire tread problems, fine, and massive recall, with which it is reasonable to assume, given due diligence standards, that Bridgestone, as its suitor in a multi-billion dollar purchase the previous decade, was aware. This history was in the known corporate background and should have made Bridgestone more attuned to the likelihood, or at least non-trivial, contingent possibility, of a major financial hit to Firestone as the lawsuits, settlements, and regulatory and public scrutiny surrounding the Firestone ATX tires, as used on the Explorer, intensified from 1996 to 1999.[229]

While this is admittedly dictum, the Sixth Circuit is not the only court to have found facts regarding "known corporate history" important enough to mention when addressing a corporate defendant's scienter.[230]

Aside from case law, the Federal Sentencing Guidelines allow inquiries into known past behavior when assessing culpability. As with individual repeat offenders, the guidelines allow for augmentation of a corporation's culpability score if the corporation "committed any part of the instant offense" within ten years after either a "criminal adjudication based on similar misconduct" or a "civil or administrative adjudication based on two or more separate

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[229] City of Monroe Employees Ret. Sys. v. Bridgestone, 399 F.3d 651, 687 (6th Cir. 2005).

[230] *See, e.g.*, *In re* Blech Sec. Litig., No. 94 CIV. 7696 RWS, 2002 WL 31356498, at *3 (S.D.N.Y. Oct. 17, 2002) (concluding that Bear Stearns & Co.—with scienter—"directed" or "contrived" and agreed to fund specific fraudulent trades by Blech & Co., which Bear Stearns "knew" had a history of sham trading); Nordell Int'l Resources Ltd. v. Triton Oil, No. 94-56110, 1996 U.S. App. LEXIS 11594, at *11 (9th Cir. May 3, 1996) (finding no fraudulent intent on behalf of a corporate defendant where "any inference of fraud from Nordell's alleged undercapitalization [was] completely negated by the evidence of Nordell's corporate history").

instances or similar misconduct."[231] The Guidelines apply an objective test in defining the extent of a corporation's culpability by taking into account well-documented criminal, civil, or administrative adjudications that were similar in subject matter to the instant offense. Our proposed rule takes this line of reasoning only one step further in calling for the consideration of documented corporate history (whether in the form of a public adjudication or a well-publicized internal scandal) for the purposes of finding and establishing the guilty knowledge of a corporation. Yet again, criminal law reinforces an innovative approach in the area of civil securities fraud.

### b. "Common Knowledge"

Corporation H is a leading provider of satellite radio in a fiercely competitive industry. After announcing the launch of its Super Power Satellite Radio, an upgrade that will double the standard number of stations available to 300 while improving the sound quality of each, Corporation H issued a press release claiming that it had achieved the technology to compress more stations into its satellite signal without losing clarity or overall sound quality. The written press release was not attributed to any particular Corporation H official.

After reading the release, Corporation H engineers joked to one another, "I didn't know it could do that," referring to H's claims about the capabilities of the Super Power Satellite Radio. Conventional wisdom among Corporation H's employees is that the new Super Power Satellite Radio will not be capable of maintaining the same sound quality as the original version. Technically speaking, the compression of the extra stations severely diminishes the sound quality of all of the stations. In fact, in response to substandard results during product testing, the engineering/R&D and

[231] U.S.S.G. § 8C2.5(c)(1) (2005). "Similar misconduct" is defined as "prior conduct that is similar in nature to the conduct underlying the instant offense, without regard to whether or not such conduct violated the same statutory provision." *Id.* § 8A1.2, cmt. 3(f).

marketing department heads sent a joint interdepartmental memo to all customer service employees warning that telephone operators should "expect an overflow of calls regarding the poor sound quality of Super Power Satellite Radio." Finally, although Corporation H had heavily discounted the new system to employees, an alarming few ever took advantage of its offer.[232]

The preceding fact pattern depicts a second way that a corporation can be deemed to "know" something: through common knowledge. We define common knowledge as those facts known and accepted as truth by a large number of people.[233] In securities fraud cases, common knowledge may refer to the conventional wisdom within a number of different groups: the employees of the corporation, the industry, or the market.[234] Based on the facts presented in

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[232] Loosely based on Hawaii Structural Iron Workers Pension Trust Fund v. Apple Computer, Inc. (*In re* Apple Computer, Inc.), No. 03-16614, 2005 U.S. App. LEXIS 5511 (9th Cir. Apr. 4, 2005); Helwig v. Vencor, Inc., 251 F.3d 540 (6th Cir. 2001); *In re* Dura Pharmaecuticals Sec. Litig., No. 99cv0151-L, 2001 U.S. Dist. LEXIS 25907 (S.D. Cal. Nov. 2, 2001).

[233] A proposition that falls into the category of "common knowledge" is known and accepted as truth without further support, and as such, requires no authoritative citation in research papers. JOSEPH GIBALDI, MLA HANDBOOK FOR WRITERS OF RESEARCH PAPERS (6th ed. 2003).

[234] Although common knowledge as to the falsity of the corporation's misrepresentation can be present within the corporation, within the industry, and/or within the market, only its presence within the corporation is indicative of a corporation's scienter. Logic and case law both tell us that if the correct information is otherwise available to the market or the industry, the plaintiffs may have a difficult time proving reliance on and/or the materiality of the alleged misrepresentation. *See, e.g.*, Ganino v. Citizens Util. Co., 228 F.3d 154, 167 (2d Cir. 2000) (The "truth on the market" doctrine states that "a misrepresentation is immaterial if the information is already known to the market"); Longman v. Food Lion, Inc., 197 F.3d 675, 684 (4th Cir. 1999) ("Plaintiffs' securities fraud claim cannot succeed because, despite the fact that Food Lion denied the charges, the nature of the off-the-clock claims and the claims' risk to earnings were in fact well known to the market before the PrimeTime Live broadcast, and therefore Food Lion's omissions were not material"); *In re* Apple Computer Sec. Litig., 886 F.2d 1109, 1115 (9th Cir. 1989) ("We conclude that in a fraud on the market case, the defendant's failure to

the satellite radio hypothetical, it can be said that it was "common knowledge" among H's employees that the new product would not pass market muster. The company's engineers, marketers, and customer service representatives all knew that the new satellite radio would have serious defects. Despite the considerable discount, few Corporation H employees took advantage of the offer, which indicated that this important micro-market as a whole knew of the product's weaknesses. Nevertheless, the corporation issued an unattributed press release praising its new innovation with language exceeding mere puffery.

According to our rule, courts should take into account particularly pleaded allegations of common knowledge within a defendant corporation when assessing scienter. The court in *Apple Computer* failed to do so, and thus, it refused to allow the lawsuit to continue against the corporation regardless of a clear indication that many high and low level corporate employees knew of grave weaknesses in a product that Jobs ostensibly yet innocently touted. In fact, the *Apple Computer* court blankly refused to look at the scienter of any actor except Jobs, who uttered the misrepresentations, even though there was significant evidence of the product's inevitable failure within the "common knowledge" of the corporation.[235]

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disclose material information may be excused where that information has been made credibly available to the market by other sources.").

[235] Hawaii Structural Iron Workers Pension Trust Fund v. Apple Computer, Inc. (*In re* Apple Computer, Inc.), No. 03-16614, 2005 U.S. App. LEXIS 5511, at *15 (9th Cir. Apr. 4, 2005). Plaintiffs also argued that anecdotal evidence from Apple insiders indicated that that knowledge of the product's defects was widespread throughout the corporation. *Id.*; *see also In re* Apple Sec. Litig., 243 F. Supp. 2d 1012 (N.D. Cal. 2002). Although both the district and appeals courts considering *Apple Computer* agreed that the facts were not alleged with sufficient particularity to meet PSLRA standards, it bears repeating that the quality and quantity of the evidence presented is independent of our argument here, which is that common knowledge, under certain circumstances, can indicate corporate scienter. Plaintiffs alleged that such common knowledge was evident from the fact that a "product defect memo" allegedly was circulated to

Other cases have also invoked corporate common knowledge in discussing a defendant corporation's scienter. In *Southland*, the Fifth Circuit securities fraud class action arising out of the INSpire CEO's alleged misrepresentations regarding the quality of the company's software, the court discussed the plaintiffs' attempts to prove corporate scienter by alleging, among other things, that corporate engineers "regularly read unidentified INSpire 'press releases' and joked to one another, 'I didn't know it could do that' as to unidentified claims made about the capabilities of INSpire's software."[236] The *Southland* plaintiffs also made similar allegations based on reports and memoranda indicating that the failings of the product were common knowledge within the corporation.

The Fifth Circuit reinstated claims against the defendant CEO and defendant corporation based on respondeat superior theory,[237] but rejected any indications of common knowledge within the corporation as unsubstantiated, overly generalized, and impermissible group pleading.[238] Assuming that particular facts establishing common knowledge could be alleged, such as the existence of an internal memo, particular details of conversations among employees, or comments made by company speakers at well-attended internal seminars, our rule would dictate a different result in that case. While carefully acknowledging the PSLRA's heightened scienter pleading standard, courts have still demonstrated a willingness to consider internal corporate common knowledge as an indicator of corporate scienter in securities fraud cases.[239] Our rule formalizes this consideration.

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employees, senior managers, and executives. Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 376 (5th Cir. 2004).

[236] *Southland*, 365 F.3d at 376.

[237] *Id.* at 383.

[238] *Id.* at 365. *In re* Motorola Sec. Litig., No. 03 C 287, 2004 U.S. Dist. LEXIS 18250, at *91 (N.D. Ill. Sept. 9, 2004) (discussing the group pleading doctrine).

[239] In the recent and well-publicized *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 633 (S.D. Tex. 2002), the court noted

### c. Corporate Culture

The president of Corporation J is widely known in the firm for promoting a culture that entails meeting or beating Wall Street's estimates at all costs. He customarily tells his staff that he has and will continue to take "any action necessary to raise J's stock price," and he routinely sets unrealistic sales quotas, tying them to employees' year end bonuses. These aggressive goals implicitly encourage employees to engage in questionable activities, like recognizing sales revenue when purchased products are put on "customer hold" rather than when they are shipped out. This practice, a violation of both GAAP and Corporation J's written internal accounting policy, is called a "presale" within the firm. These so called "presales," which eventually encourage the creation of fictitious sales, soon become part of Corporation J's modus operandi, and hence, its corporate culture.

Last year, Corporation J included inflated revenue figures based on presales in its quarterly and annual earnings reports. This year, Corporation J was forced to restate its earnings and to issue a press release explaining the overstatement. Following the announcement, the company's stock price dropped by $17.89—from $53.13 to $35.24—in a single day of trading.

The idea of "corporate culture" is closely affiliated with the concept of "common knowledge" within a corporation. In this hypothetical, there is a clear mercenary atmosphere within the company that disrespects the law by tacitly encouraging fraudulent behavior. Although current Section 10(b) case law does not squarely support consideration of corporate culture as an independent source of evidence of corporate intent, by our rule, we contend that it should. A recent Third Circuit case presented a fact pattern similar to the one outlined above.[240] In *In re Alpharma, Inc. Securities*

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that "it was common knowledge [at Enron] that revenues and earnings were being falsified at the direction of top executives. Bonuses went to those who facilitated the company-wide fraudulent behavior."

[240] *In re* Alpharma, Inc. Sec. Litig., 372 F.3d 137 (3d Cir. 2004).

*Litigation*, the Brazilian subsidiary of a large pharmaceutical company was alleged to have engaged in suspect accounting practices that artificially inflated its sales figures. These fraudulent numbers were then incorporated into the parent company's earnings statements, which artificially inflated the value of the company's common stock.[241] The Third Circuit ultimately found that plaintiffs failed to plead scienter with sufficient particularity, therefore affirming the district court's dismissal of the lawsuit.[242] Nevertheless, the court repeatedly referred to the culture within the corporation—a culture that emphasized "making the numbers at all costs" —that seemed to disdain the law.

Part 2 of the proposed rule advocates the evaluation of corporate culture in any determination of corporate scienter. In doing so, it reflects evolving societal norms. For over twenty years, corporate culture theorists have studied and discussed the effects of corporate culture on a corporate organization, as well as on individual and group conduct.[243] In this Sarbanes-Oxley era of compliance, the law places unprecedented emphasis on such analysis of corporations' corporate cultures, using it to appraise corporate intent.[244]

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[241] *Id.* at 139.

[242] *Id.* at 149-50. The court referenced their prior decision in *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 539 (3d Cir. 1999), for the proposition that "generalized imputations of knowledge" do not satisfy the scienter requirement "regardless of the defendants' positions within the company."

[243] *See, e.g.*, TERRENCE E. DEAL & ALLAN A. KENNEDY, CORPORATE CULTURES: THE RITES AND RITUALS OF CORPORATE LIFE (1982); GAINING CONTROL OF THE CORPORATE CULTURE (Kilmann et al. eds., 1985); LARRY F. MOORE ET AL., ORGANIZATIONAL CULTURE (1985). Securities law scholars have attempted similar exercises, applying sociological and psychological constructs to explain group behavior in the Section 10(b) context. Langevoort, *supra* note 189, at 126.

[244] *See* Paul Fiorelli, *Will U.S. Sentencing Commission Amendments Encourage a New Ethical Culture Within Organizations?*, 39 WAKE FOREST L. REV. 565 (2004) (analyzing how various government agencies and departments are currently encouraging ethical behavior and a culture of compliance).

Moreover, corporations themselves have, by necessity, begun to emphasize it in analyzing their overall exposure to liability.[245] Though once viewed as intangible and hard to pin down, corporate culture is becoming accepted as increasingly palpable and indicative of a corporation's priorities. Corporate compliance and ethics officers are now scrambling to assess their firms' cultures to change any behavior that may be deemed too risky in the eyes of the law.[246] Even in case law, a corporation's culture has achieved a status and persona autonomous from its constituent employees.[247]

This part of our rule also follows in the footsteps of the criminal law's large body of precedent and theory. As discussed above, proponents of corporate ethos and character theories have long advocated for a reconceptualization of corporate culpability based on a corporation's inner

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[245] Section 404 of the Sarbanes-Oxley Act requires companies to report on the state of their internal controls, which are supposed to ensure good financial reporting and to guard against fraud. Many U.S. companies have recently complained about skyrocketing costs resulting from Section 404, which has proved to be the most complex and expensive provision of the Sarbanes-Oxley Act. *See, e.g.*, Arthur Bill, *The High Cost of Compliance: Three Years After Passage of Sarbanes-Oxley, a New Study Finds that Public Companies are Paying the Price*, LEGAL TIMES, July 18, 2005, at 19; Ira Sol & Mark E. Peecher, *SOX—A Billion Here, A Billion There . . .*, WALL ST. J., Nov. 9, 2004, at B2.

[246] *See, e.g.* Ed Petry, *Assessing Corporate Culture*, ETHIKOS AND CORP. CONDUCT Q. (2005).

[247] United States v. Brodie, 403 F.3d 123 (3d Cir. 2005) (discussing evidence of a "corporate culture" of deceit); Brewer v. Quaker State Oil Refining Corp., 72 F.3d 326, 333 (3d Cir. 1995) ("We have held that a supervisor's statement about the employer's employment practices or managerial policy is relevant to show the corporate culture."); Josey v. John R. Hollingsworth Corp., 996 F.2d 632, 641 (3d Cir. 1993) ("One could infer . . . that management permitted an atmosphere of racial prejudice to infect the workplace."); Dunkin' Donuts Mid-Atl. Distrib. Ctr., Inc. v. Nat'l Labor Relations Bd., 361 U.S. App. D.C. 1, 11 (2004) (discussing corporate conduct "so pervasive as to have created a corporate culture of lawlessness. While some employees may have voluntarily departed their jobs, those who remain will doubtless share this history with newcomers.") (citations omitted).

workings, policies, practices, and overall climate. Similarly, the Federal Sentencing Guidelines take into account the inherent differences in the constitution and psychology of corporations versus individuals, incorporating a realist approach to criminal law. Our rule injects a corresponding sensibility into the law of civil securities fraud.

Finally, our rule is responsive to a gaping deficiency in the Section 10(b) context. In 1986, the court in *Warner* issued a somewhat prescient warning regarding a corporation's duty to establish and to foster a law-abiding corporate culture. In discussing the elements necessary to demonstrate the corporation's scienter, the court stated, "As to Warner, plaintiffs arguably need only show . . . that Warner management had recklessly failed to set up a procedure that insured the dissemination of correct information to the marketplace."[248]

Today, after several highly publicized corporate fraud scandals, this statement from *Warner* rings truer than ever. Enron's spectacular fall in 2002 refocused Wall Street and the American public on unprincipled and avaricious corporate cultures. In the context of securities fraud litigation sparked by Enron's accounting irregularities, a district judge for the Southern District of Texas noted the following:

> Lead Plaintiff describes Enron's "corporate culture" as characterized by "a fixation on the price of Enron stock" and on pushing that price ever higher. "Throughout Enron's Houston corporate headquarters . . . [t]here was pressure to do anything necessary to make the numbers, and it was common knowledge that revenues and earnings were being falsified at the direction of top executives. Bonuses went to those who facilitated the company-wide

[248] *In re* Warner Comm'ns Sec. Litig., 618 F. Supp. 735, 752 (S.D.N.Y. 1985).

> fraudulent behavior . . . many Enron employees believe, 'We're such a crooked company.'"[249]

*We're such a crooked company.* These five words, written by an Enron executive, embody the argument. Their revealing realist semantics paint a picture of today's corporate world, where corporations are accepted as possessing human-like attributes independent of their employees. The statement also demonstrates that even a company's employees, although not personally identifying with or necessarily involved in a fraud, recognize their link to it via the firm's corporate culture. Moreover, collective acknowledgement of the firm's culture by its employees serves as a telling testimonial to the employer's scienter. Under current legal rubric, if this corporation's scienter were a snake, it would have bitten us, despite the fact that the law may not have recognized it as such. The law would be myopic to disregard what is clear to society.

## V. CONCLUSION

> "A criminology which remains fixed at the level of individualism is the criminology of a bygone era."[250]

For centuries, the law has struggled with the question of how to bring its legal creation—the corporation—to justice. In doing so, it has relied on the paradigm of human behavior and punishment, without a better model, assuming it to be sufficiently analogous to corporate behavior and punishment. This uneasy effort has yielded the development of frameworks of corporate liability and intent that depend on an attribution or derivation from the liability of individuals. As this Article shows, the underlying individual-oriented paradigm is a faulty foundation for corporate liability. It simply does not fit.

Criminal law has taught us that the respondeat superior doctrine is not always effective when applied to corporations.

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[249] *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 633 (S.D. Tex. 2002).

[250] J. BRAITHWAITE, CRIME, SHAME AND REINTEGRATION 148 (1989).

Due to the size and structure of modern corporations, it is a rare case in which the corporate act and intent reside in the same individual corporate agent. Accordingly, some courts have been willing to aggregate the knowledge and/or intent of various corporate actors to conclude that the corporation possesses that knowledge or intent. The use of this imperfect collective knowledge doctrine has been problematic in some contexts, primarily because it does not prescribe a link between the corporate act and the corporate actor that harbors the necessary intent.

Fortunately, experience shows us that these two approaches are not the only options. Perhaps society—and more significantly, lawmakers—did not or could not recognize the nuances of the corporate form and its behavior at the time of the early development and establishment of the law's reliance on agency doctrines. Today, however, the climate is quite different. We live in an era that has witnessed the power of corporations to cause great harm. In today's post-Enron / WorldCom / Arthur Andersen environment, there is a clear societal mandate to seek out and to eliminate corporate wrongdoing at every level.

Moreover, common sense tells us that corporations themselves are tangible, living societies with personalities and reputations that may induce their human agents to act wrongfully. The law is beginning to recognize this phenomenon and, in some areas, is responding to it. Although disincentives may have previously deterred disclosure of corporate wrongdoing, the law is beginning to develop a better-fortified refuge for corporate whistleblowers.[251] Seeking to end the practice of hiding behind collective action and corporate culture, the Sarbanes-Oxley Act marks the beginning of a legislative movement toward greater corporate accountability.[252]

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[251] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.).

[252] *Id.*

Accordingly, the time is ripe for the reconceptualization of corporate scienter in the Section 10(b) setting. This new perspective on corporate scienter must take into account the idiosyncrasies of the corporate form. It must recast corporate liability in a realist light, necessarily shedding its antiquated nominalist history. And it must take the form of a rule that is workable, practicable, and that does not lose its intellectual footing on the anthropomorphical riddle posed by corporate intent in its current state. This novel conceptualization comes to life in the rule we propose.

At its core, the proposed rule delineates where and specifically to whom the law should look when analyzing a corporation's scienter for purposes of a civil securities fraud suit. This new rule is legally significant on three grounds. First, it is practical. For the purposes of a given actionable statement or omission, it simply and straightforwardly lists a group of corporate agents whose scienter reflects that of the corporation. Second, the rule strikes a balance with respondeat superior theory without eviscerating it, and eliminates the civil law's troubled relationship with collective knowledge doctrine. Unlike previous rules, it does not identify the relevant corporate agents by their title or level of responsibility within the corporation, but rather by their direct or indirect participation in the misrepresentation. This creates a meaningful link between the state of mind of the corporation and its act, which is physically attributable to the corporation through respondeat superior. Finally, the proposed rule recognizes the influence of corporate personality in the perpetration of wrongdoing, thereby permitting an examination of formal and informal (as well as explicit and implicit) policies, rules, and practices to establish corporate scienter.

The law must reflect the reality of the corporate world. In Section 10(b) suits, the time has come to reveal and to repair this cognitive dissonance by way of a rule that takes into account the multifarious loci in which corporate scienter can be found.