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COMMENTARY

The Deferred Prosecution Racket

 By **RICHARD A. EPSTEIN**
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Corporations suffer a peculiar vulnerability. The rules of criminal liability allow federal and state prosecutors to unduly punish those corporations that fall within their crosshairs. But the recent emergence of deferred prosecution agreements (DPAs) to force major changes in corporate governance should give pause to even the most ardent populist.

A DPA is a provisional settlement of a criminal lawsuit whereby the prosecutor agrees to suspend -- but not to dismiss -- any prosecution in exchange for the corporation's promise to reform its internal operations in specified ways. A sensible settlement can split the difference, by having a defendant pay half the maximum fine or sentence. But with corporations they take on an entirely different -- and sinister -- complexion.

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The last thing a corporation fears (since it cannot be imprisoned) is the maximum fine from a successful criminal conviction. Rather, the deadly force of the DPA rests in a combination of two key factors: vicarious corporate criminal liability, and the collateral consequences of the initial indictment prior to, and independent of, any eventual conviction.




David Klein

Vicarious liability, as first developed in tort law, allows innocent third parties to sue not only an individual wrongdoer for damages, but also his employer, so long as the wrongdoer's act is within the scope of his employment. In the context of tort law, this rule ensures funds for compensating innocent victims, while giving a firm the incentive to monitor its employees. Many judicial decisions have, however, unwisely imported this doctrine wholesale into the criminal arena -- allowing a corporation to be punished criminally for the actions of any midlevel or senior employee, even if the corporation neither authorized nor condoned the wrongful action.

Writing in January 2003, Larry Thompson, then deputy U.S. attorney general, exhorted federal prosecutors to use vicarious liability to extract favorable settlements to reform corporate defendants from the outside. The Thompson memorandum insisted that corporations receive a temporary reprieve only if they purge themselves of individual wrongdoers and agree to extensive government oversight to make them walk the straight and narrow path.

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In pursuing Mr. Thompson's strategy, prosecutors face both a dilemma and an opportunity. Their only credible threat against a recalcitrant corporation is the criminal indictment -- yet simply filing an indictment triggers huge collateral repercussions sufficient to drive the firm out of business, as teams of state and federal regulators are now duty-bound to suspend the licenses and permits under which the corporation does business. Thus, the corporation that has strong protections against false convictions -- proof beyond a reasonable doubt of the elements of the crime, the ability to examine evidence or cross-examine witnesses -- is helpless to protect itself. A conviction carries at most a million-dollar fine, but simple indictment, which lies wholly within the prosecutor's discretion, imposes multibillion-dollar losses.

Faced with that kind of pressure, the indictment is all that matters. Yet given these weird incentives, DPAs no longer serve the public interest. The agreements often read like the confessions of a Stalinist purge trial, as battered corporations recant their past sins and submit to punishments wildly in excess of any underlying offense.

Evidence of the gravity of the situation is only a mouse-click away. In one such notable agreement, the U.S. attorney for New Jersey, Christopher J. Christie, put the screws to Bristol-Myers Squibb, which got into hot water because of a potential securities violation for inflating its quarterly earnings by a business practice known as channel stuffing. BMS told its distributors that they had to take into inventory large amounts of BMS products immediately, with the understanding that down the road they could return the excess for a refund. The alleged securities violation arises from the overstated earnings quarterly reports, without indication of any expected future write-offs.

The naïve reader might think that a DPA should prohibit the firm from engaging in future conduct of the sort that got it into hot water in the first place. But Mr. Christie had larger ambitions. The most striking evidence of the abuse of power is paragraph 20 of the agreement, which requires BMS to "endow a chair at Seton Hall University School of Law," Mr. Christie's alma mater, for teaching business ethics, a course that he himself could stand to take.

That mild government peccadillo is a mere prelude to the sterner stuff to come. BMS agreed not only to abide by the law and to purge its ranks of the parties responsible for the scheme, but also to exhibit "exemplary corporate citizenship." To that end, all its activities have been overseen by Mr. Christie's independent adviser, former federal district court judge Frederick B. Lacey, who has the power to attend all meetings and review all documents -- and to report his findings to Mr. Christie. BMS was ordered to restructure its internal operations and appoint a new chief compliance officer to assist Mr. Lacey. It also agreed to pay a \$100 million fine and make contributions of \$350 million to a fund for present and former shareholders.

All these key provisions flunk the most elementary standards of business rationality -- if the object of these DPAs is to restore the confidence of shareholders in the firm. How can any firm act decisively with a government mole in its midst? What other firm would seek to acquire BMS, knowing that they must thereby give Mr. Christie the keys to its boardroom? And what purpose do shareholder funds serve, other than to impose random transfers among shareholders?

A DPA such as this one erodes the most elementary protections of the criminal law, by turning the prosecutor into judge and jury, thus undermining our principles of separation of powers. The Bristol-Myers Squibb DPA allows the prosecutor to lower the boom following the recommendation of Mr. Lacey. The corporation's sole remedy is to plead its case before the prosecutor in an environment wholly devoid of the most rudimentary procedural protections.

These powers were implemented when Mr. Christie threatened to reinstate the indictment if the board did not remove CEO Peter R. Dolan for his role in an aborted agreement with Canadian corporation Apotex. The agreement -- to delay Apotex's introduction of a generic competitor to Plavix, BMS's best-selling blood thinner -- led to a criminal antitrust investigation. Any connection between channel stuffing and price fixing remains unclear.

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BMS is not the only instance of prosecutorial zeal. A New York deferred prosecution agreement with KPMG in essence required the firm to stop payment to former employees to cover the defense expenses in criminal prosecutions for tax fraud before Judge Lewis A. Kaplan in New York's southern district. Mr. Kaplan rightly treated the government's decision as an unwarranted interference with the defendants' constitutional right to the assistance of counsel and a deprivation of liberty without due process of law. He has ordered a cessation of proceedings until the defense lawyers could regroup their forces.

Yet we should do far better. For starters, the Department of Justice should engage in unilateral disarmament by disavowing the odious Thompson memo, and rethinking why it ever needs to threaten the nuclear option of a corporate indictment. For its part, our new Congress should repeal by statute the doctrines of vicarious liability for criminal conduct in a corporate context -- because these give the government unwarranted and arbitrary power over corporations.

At bottom, corporations are just individuals tied together by an elaborate network of contracts; and we don't need yet another sorry reminder of how mindless government policies harm the innocent shareholders whom they are supposed to protect. The government has a vital role in criminal enforcement. So let it go after real, i.e., human, criminals the old-fashioned way, by careful investigation and skilled prosecution.

Mr. Epstein is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago and the Peter and Kirsten Bedford Senior Fellow at the Hoover Institution at Stanford University. He is the author, most recently, of "Overdose: How Excessive Government Regulation Stifles Pharmaceutical Innovation" (Yale University Press, 2006).

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