CRIMINAL ASPECTS OF BUSINESS
A Need for Corporate Governance Reform

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Abstract

The purpose of this research is to describe past conduct of corporate officers, in their use of corporate assets, including reputation. This is beyond lawful use of their corporate positions. The paper uses a literature review to describe corporate officer actions, and identify impacts on the corporate reputation and its leaders. Findings are presented in exhibit form, as (a) assigning criminal liability, and (b) the range and detail of sanctions to be imposed.

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Introduction

Development of Criminality of the Corporation

While there is consideration that the corporation should be on the same legal basis as individuals, the legislatures consider the economic-basis of the corporation. As corporations are driving the national economy, some latitude should be provided to corporate actions. So criminality was set apart from corporations.

Two reasons are given for that action/protection: One is that a corporation is a legal entity, not a real person. The other was the distinct nature of the corporation, as an entirely created entity for productivity, and for protection of the employees in the interest of the corporation.

As corporations were at the same time seen by the public as "bad actors", there was public interest to ascribe criminality to the corporation. That interest grew as inferior products were marketed to the public. Also, plants were recognized as "unsafe" for workers. From an accumulation of individual actions, the development of criminality of corporations was adopted in the late twentieth century.

The word adopted is wisely used. When the U.S. was a target of actions against corporation, Congress and state legislatures were urged, by consumers, to hold corporations broadly to the same standards as individuals. Congress began in the early 1970s, to protect the public in the antirust arenas. By numerous antitrust violations, judged as misdemeanors to felonies, and imprisonment of corporate officials, some immunity to corporations was recognized. As a result, a corporate shield was authorized, under a number of statutes, to allow legal methods by corporations, but to protect them from incidental legal attacks.

Corporate Liability

A corporation is exposed to criminal liability in several ways (Brickey, 1991):(a) direct commission of a criminal act;(b) attribution of criminality, due to corporate position;(c) imputation of criminality, to corporate officers.

Note that the corporate entity is properly treated due to the approach in which its leaders seek to avoid liability. With this broad exposure, recognized as "direct liability" and "derivative liability", doctrines were needed to cover this exposure. Two specific procedures evolved are imputation and attribution (see Exhibit 1).

Note that criminal acts require intent to be proven. The method of showing intent is found in the "tail wagging the dog"; that is, the other elements must be proven, but if intent is not proven, there is no crime. For example, can a person steal his own property?

Where the property is totally owned by the person, there is no criminal intent, and therefore no crime. Congress has enacted criminal laws pertaining to business. Several corporations have disappeared under the charges, and others have made payouts of fines, for these criminal charges. The need is to maintain a system of accounting control to bar corporate criminal acts, as illustrated by the Foreign Corrupt Practices Act (15USC78).

Purpose of the Research

Business crime is not a recent action. Beginning in the 19^{th} century, corporate conduct was determined as criminal. Laws were passed, with the purpose to control conduct in the securities area (Securities Act, Securities & Exchange Act, and Sarbanes-Oxley Act). See Exhibit 2. Sanctions were considered needed, given actions by corporate officers.

This research analyses conduct of corporations that leads to deterioration of the organization. Corporate officers mistake their position as owners, rather than as managers. The business press on a regular basis chronicles that conduct. Consequences are easy to record as crimes.

There has been a renewal of manipulation termed as scandalous practices. Recently rational has changed; now the main rational is to achieve personal wealth of corporate officers. While it could be argued that was the basis earlier, the degree of wealth enhancement currently has led to criminal use of corporate property (including securities funds, currency, and reputation).

The rationale of this research is to identify effective mechanisms to control organizational conduct.

Corporate Officer Actions

Actions of individual officers can become systematic. This is done as: manage or influence unfairly; adapt or change to suit one's purpose, or advantage.

It is clear that those in "control" of assets have the power to determine an outcome. Indeed, corporate officers have both physical custody of corporate property, and legal control. The legal control derives from their positions as officers. Corporate officers are in a position to "take" corporate property for non-corporate purposes (Smith, 2003).

Who in the corporation has such power? The corporate charter identifies persons with power over assets: officers of the corporation. Note that officers are also directors where appointed to be part of the Board of Directors. Directors are not synonymous with officers; they may have a specialized role in the corporation, for example, as outside directors. So then officers are empowered to perform acts for their own purposes. Under corporate governance, officers can make such decisions. Where officers conduct corporate decisions, for their own purposes, this is referred to as *manipulation*. Note that legal terminology and general terms are consistent with the meaning of manipulation. As a consequence, regulation of corporations has tightened. Regulation has been enforced by an inferential method, that is, imputation and attribution (see Exhibit 1). This is an opening for a charge of manipulation.

Duties of the Board

The prime interest above also introduces the need for a realignment of duties within the corporation. The array of duties, duty of care, duty of loyalty, and usurping of corporate opportunity, multiplies many times the opportunity to perform and control the corporation. There is little need to define duties or to describe their coverage in the corporation. The rationale for imposing duties is to establish standards as a mode of control. A positive approach is given by the Business Judgment Rule. That approach anticipates that officers of a corporation will have the expertise and interests that is in the best interests of the shareholders.

Note that the shareholders are investors, and are primarily focused on profitability of the corporation.

Breaches of Board Members

Individual members of the Board can breach their duties. The issue addressed here deals with that individual action, rather than a collective action of the Board. Members of a board can make collective breaches.

Some of these corporations have suffered gigantic financial losses: ENRON, Worldcom, and Global Warming.

The issue here is to determine the causes of breach, in particular for corporations that have taken such action. In most situations, it is not the business that is the cause. Clearly those earnings are gained positively and statutorily, and invested in the business. So then the fall from such position comes from fraud (mismanagement), in taking funds from corporate earnings.

It must be recognized that the "taking" is not for corporate purchases. Illustrations (above) show that the purpose of the "taking" is for (1) officer wealth, and (2) non-corporate purposes. These appear primarily for officers in control of corporate assets.

Control signifies that the transfer of ownership is established. The corporate role, for control purpose, is usually more than one officer.

Prosecution is against all officers involved, not solely against the leader, but against each individual involved. The main officers in corporations are the Chief Executive Officer and the Chief Financial Officer. As noted above, these officers have control of the assets, fixed and fluid. Prosecutions are against them. As leaders of the corporation, it is clear that their interests are involved in the main criminal charge. An underlying connection is the wealth of the CEO and the CFO. This "taking" of corporate funds and assets are needed to maintain the "style of living" to which these officers have become accustomed. An interesting showing also is that the wives of the officers are caught in the effort, and are living in the benefits of the taking. Their companionship of the charged officer is beyond a showing, but is true spirit of owners.

Criminal Acts

Manipulation

As noted above, not all non-business actions of officers are criminal. Manipulation is not necessarily criminal. Manipulation is defined as to change by artful or unfair means, to serve one's own purpose. It is recognized as artful management or control of operations, often in an unfair or fraudulent way. The artful connotation included shrewd use of influence as officers. That relation to ordinary management makes manipulation difficult to detect. (Note that manipulation may be a first step toward criminal action inside the corporation.)

Property Offenses

As property is fixed, as well as liquid, the "taking" by officers to acquire for personal purposes may be difficult to determine based on appearance. Fixed property is readily determined for a "taking". Fluid property is less readily determined as to ownership. This is particularly true for certain classes of that property: commercial paper, as checks, notes, mortgages. Commercial paper has intrinsic property value, to facilitate exchange. As a consequence, "taking" of commercial paper may be difficult to determine, separate from the person of ownership.

Crimnal Offences

Where an officer takes property, under proof of wrongfulness, legislation has defined the offense as a crime: a misdemeanor or as a felony (Brickey, 1991). The difference is the time of imprisonment, the amount of fine, and the need for restitution.

As sanctioning quantities differ, through state legislation, sanctions are left indefinite: amounts taken; fines; and times of imprisonment. Generally a misdemeanor involves less than a year of imprisonment while a felony is more than a year.

Bankruptcy

From the depletion of cash streams of the corporation, the questions for bankruptcy: Is it proper? Why do corporations file for bankruptcy? Chapter 11 is reorganizing financing; Chapter 7 is dissolution of the organization. Chapter 11 is more popular now, in situations where financing is the key issue.

The principal reason for an urgent basis is that corporate officers do not want to place the corporation, in control of the bankruptcy court (a special branch of the U.S. federal court system.) At times, the threat of a bankruptcy involves the filing for protection. This provides time for the debtor to negotiate with creditors, to a settlement. When both parties present to the court an agreed settlement, the court accepts as a final order of the court.

Basis of Bankruptcy

The corporation is exposed to bankruptcy, by several avenues. The prolonged imbalance of cash flow is recognized as the onset of bankruptcy. Another is a substantial deficit of the corporation's cash position.

The purpose of this analysis is to probe into the rationale for "taking" by action of officers. Exhibit 3 provides a list of reasons for bankruptcies. Note that "business result" and "business losses" cover the range of reasons.

Nature of Bankruptcy

Bankruptcy is generally not regarded as a criminal offense, rather as a civil offense.

Reputation

Corporate reputation is a valuable asset of the organization. The 'valuable' terminology designates that reputation ranks on a level of other important assets of the organization. It is identified as an external manifestation, to give a view of the corporation's culture, internal practices, management talent, people skills, and overall competitiveness (Resnick, 2004).

Reputation is found influential in many phases of the corporation. The cultural purpose of the corporation is its business that creates profit; at the same time, the corporation also projects its culture and values. The key advantage of the reputation is to gain competitive advantage that is, improving performance against competitors. Corporate reputation is reflective of identity and integrity of the organization. The characteristics are sufficiently basic, to contribute to business growth and stock price increase. Its strength is found to sustain business, in the US, and in international competition (Kitchen, 2003)

From this positive view, reputation can fail. Such failure can result in sales loss, and stock price reduction. Criminal actions are difficult to separate from the reputation of the organization (Alsop, 2004). As the organization is recognized as able to manage its property as it chooses, its reputation is not readily at stake.

This is also reflected as the loan practices available: availability of loans, or the cost of capital of a loan. This is reflected in local practices available to the organization, based on its reputation to repay loans and associated assurances. If the corporation's reputation is questionable, loans are not available. Once an unethical reputation has been established, for even a brief period of time, the problem of erasing is considered difficult–to-impossible.

Leaders of the Corporation

As noted earlier, the officers of a corporation may be the individuals responsible for the criminal acts (Derocher, 2001). Clearly a court may determine the causal link to individual officers. The severity of conditions is also determined by a court. Where intent of officers is proven, a court will establish the causal link to those officers. These officers will then be held individually liable.

Impact on Investors

Clearly, if officers are "pocketing" unlawful gains by taking corporate property, then that gain is diverted from lawful owners. That provides a basis for legal complaints by investors. Consequently, not only are governing officers given opportunity but investors also join in complaints by investors, due to diversion of their "just rewards'. For ordinary corporations, profits are from operations plus investment, without diversion. All profits generated are ultimately recognized in corporate accounting. To short corporate profit is a fraud on the corporation.

Regulation by Agency

As corporations are the actors in the instances reported here, regulation of corporations is by a number of federal and State agencies. At the outset, state law initiated corporate life. Although federal law authorizes some corporations, the vast number are authorized, and created, under State law. Compared numerically, it is clear that State far exceeds the federal government in authorizing corporations. This is due to the interstate power of the corporations; they can, and do, execute business on an interstate basis.

Property ownership, commercial transactions, and recognition, all constitute corporate reputation.

So then, which agencies regulate corporations?

Authority over Corporations

The federal agency to regulate corporations is generally the Security & Exchange Commission. Their authority is based on the Interstate Clause of the US Constitution. Federal regulation of securities of corporations is found in charter, by-laws, and corporate procedures. The SEC has that constitutional foundation to regulate the conduct of corporations.

State Regulation

On a State basis, the State's Commerce Commission is the typical agency, to authorize and regulate corporations. As indicated (above), the Federal Interstate Commerce Commission performs a limited task in that State area. With this broad scope, federal corporations tend toward control of specific areas, likely interstate pricing and service. For example, the Federal Reserve Board regulates banks and banking in interstate operation. The Freddie Mac agency regulates mortgages in interstate operation. In the physical realm is the Interstate Energy Commission (formerly, the Interstate Commerce Commission); authority is for setting prices and assuring delivery of electricity, gas, and coal, on an equivalent basis.

Regulation by Agencies

As agencies perform essential services to corporations, regulatory boards are appointed. The areas are well defined by the service and geographic areas. The authority of such regulation is virtually total within their area of influence. Those agencies promulgate regulations, and enforce their own regulations. Both, the focus of regulation and the reach (extent) of regulation are included. Manipulation is likely seen in faulted regulation, or in absent regulation.

Corporate Governance Reform

Corporate governance is the basis for formal rules that the Board and Shareholders have adopted to govern the affairs of the corporation. It is a shortened way of stating rules for governing a corporate organization. The actual rules are determined by ownership structure; composition of the corporate board; and influence of stakeholders.

The general purpose of corporate governance is to shape values that are apparent for the entire corporation. The last statement has real meaning. Values are an integral part of the corporation's decision process. In all decisions, major and minor, values provide guidelines and standards, for determining the proper course for the corporation. A related question deals with delegation. While the corporate board selects, and empowers, officers of the corporation, does that delegation make the officers independent of the Board? Clearly that is not the situation. The board is a supervisor of individual officers in the corporation. If the officers and the board are not in sync, the board can take action to override decisions or to discharge offending officers. (Note: this is rare for such board actions.)

While the purpose of corporate governance is operational, there is a theoretical approach as well. The theoretical approach is based on legal theory. First is agency relationship of the board, with the shareholders. The shareholders appoint the officers of the corporation. That is, the officers are legal agents to conduct the business and to represent the corporation in its many venues. Representation is by corporate authority, and is focused in the purposes of achieving goals and objectives of the corporation.

From that relationship between officers and shareholders, the main role of corporate governance is to lead the corporation into profit maximization activities. The generally accepted view of the corporation is to "maximize its profit", given circumstances of the corporation.

From that view, the board and officers must determine the extent of maximization; the future also determines that extent. So the board is key to make that profit determination.

Any substantial deviation from by-laws of the charter, that is, the commercial purpose, is actionable by the board, or by shareholders.

From the foregoing, corporations should depend on corporate governance to control conduct of officers. At the time of corporate scandals, clearly the lack of oversight provided opportunity for unethical managers, to take advantage of their corporate position. Clearly, corporate governance is now focused on apparent conduct of corporate officers.

It is not the place of corporate governance to be removed from conduct of leaders of the organization. It is to provide rules and express guidelines, to officer conduct. Unless a repeat of the scandals is anticipated, reform of corporate governance is needed.

The actors now responsible for corporate governance are the higher-level officers of the corporation: Chairman and CEO. Clearly, a published set of rules satisfies that view of corporate governance. As reported above, a true reform is needed.

First, a "big brother" (governmental) approach is not needed. Next, an alternative effect is to introduce reformed corporate governance. The likelihood of individuals making the changes is minimal. Officers consider that the least intrusive is considered the best.

It is the duty of professional organizations responsible for publication of corporate governance basis and rules. The details on corporate governance make it the more difficult to evade. As the Interstate Commerce Commission of each state, is responsible for changes to corporate Governance, there lies the duty to make change.

So then the state legislature has the duty to develop the rules to support its version of corporate governance. A national commission unifies the rules. Rudimentary rules form the following: individual involvement is a requirement; opposition is on a scientific basis. Goals and objectives for corporate governance are openly applied. Goals are founded on duties of the corporation.

Sanctions

Organization Protection

A range of sanctions for business crimes may be assessed by the Court. The range of sanctions is presented in the Exhibit 2. An abbreviated list of sanctions for business crimes is presented by Drutman (2002) as: accounting conflict-of-interest; improperly booked expenses; insider loans & insider trading; bribery overseas. In addition, special purpose entities are used for illicit purposes.

The total loss in market value, from these business crimes, has been estimated at $5 trillion (Drutman, 2002). Their loss is based on the interest as investors. The loss is attributed to business leaders, as misleading information, "taking" property (fixed or liquid), and dissipation of assets.

Criminal statutes have sanctions set over a wide range (see Exhibits 2 and 3). Sanctions for violations are presented in Exhibits 2 and 3. Violations are first defined; then sanctions are categorized, from fines to required internal corporate activities (for example, restructure the organization)

The sanctions provided under the various financial acts Securities Act, Securities & Exchange Act, and Sarbanes-Oxley Act, are severe. A rationale for such severity is to turn those acts into regulatory statutes (see below). Severity is based on a straight-forward approach, to require disclosure of a security beyond required by other statutes. These statutes, which control the sale or exchange of securities, are intended to adopt by business as the way to conduct their business.

Charges against Officers

The sanctions imposed on corporations are beyond fines and imprisonment. Rather, crafted sanctions are imposed, and proving more restrictions to corporate functioning. Compelled changes to the corporation, restructure, removal of leadership, and de-barring from certain business customers, are likely aimed as sanctions for the unlawful actions or to recover illegitimate gains from these corporations.

Charges against officers held liable include the CEO and the CFO, and other financial officers. Clearly leadership in the instances of Exhibit 3 brings the corporation into a "scandalous" reputation. From this, leaders cannot deny consequences of the sanctions imposed.

Sentencing as an Extreme Regulation

Sentencing appears out of line with the actions of Exhibit 3. The purpose of a sentence is normally related to the criminal action. A 'white-collar' crime generally deals with financial markets. Financial markets have a timing condition, that a concern can impact the entire market negatively.

Note that corporate officials are limited on public statements referring to securities offered in a market. That rationale is not the magnitude of the security itself, but its impact on the overall market (Allio, 2004). An understanding of sentencing then is to focus on the 'face value' of the item, versus its impact on the market. Crime associated with a security shows a highly elastic effect on price of the security. Sellers are not seen in the market; however, their effects are found in the price of the buy/sell transaction. So then, corporate leaders have learned the underlying message: understand the appropriate way to conduct their business (McTague, 2003). As a result, the offering of a security, and the status of the enterprise offering the security, are tightly regulated. By limiting statements regarding the security (mail, wire, and electronic), violations can be considered severe for the purpose of regulation. So then sanctions for violations do have a regulatory effect (Anonymous, 2004). Trades are cautioned against securities in violation. As a consequence, markets are kept 'clean' for trading.

Crime or Manipulation

The first part of this research deals with corporate conduct as criminality. Thain (2004) stated that this results from conflicts within the corporation. The conflict is laid to the Board, as the following:(1) group culpability within the Board;(2) general failure of the Board's duties and responsibilities, oversight, authority, and responsibilities;(3) specific failure, as greed, dishonesty and incompetence. The effort to correct, to undo, these issues by the Board, is not one-stop-fits-all, but is doable as a turnaround.

The turnaround requires, at the outset, a clear understanding of officer duties and responsibilities. Thain (2004) describes Board requirements as: fully understand their duties and responsibilities; fully committed to their duties and responsibilities; and competent to perform the turnaround. These are general requirements, as Holtfreter (2004) describes their application to broad categories of organizations that is, private business, publicly traded companies, non-profit organizations, and government agencies. That application is supported by a survey of 662 companies, reporting fraudulent cases.

Conclusion

In recent years, many companies covering a spectrum of industries have been "charged" with a variety of legal complaints that is relatively limited: obstruction of justice; document destruction, falsifying an investigation; accounting fraud; securities fraud; mail fraud, and wire fraud; conspiracy; perjury; larceny; money laundering; bribery; and antitrust, in merger. These offenses encapsulate the crimes of business organizations.

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Exhibit 1. Assigning Criminal Liability

<u>Imputation of Criminal Intent</u>

Standard: action within 'agency'
course of 'agency'
scope of 'agency'
with participation or knowledge

Conduct: contrary to role
or
antagonistic objectives

To be proven:
Intent to directly benefit corporation
or forward some corporate purpose
Assent to pattern of criminal conduct
with responsibility to eliminate conduct

<u>Attribution of Criminal Conduct</u>

vicarious liability: respondent superior
also as 'accessory liability'
Actors: officer, manager, supervisor

To be proven:
direct action
(as accessory before the fact)
present at the location, with intent
(as accessory after the fact)

Criminal act:
Select acts:
securities fraud, mail fraud
Foreign Corrupt Practices Act
sensitive domestic payment
offense against IRS laws

Sanctions: fine, imprisonment, probation

Defense: no knowledge, no participation

<u>Special statute: RICO</u> Racketeer Influenced Corporate Organization Act
To be proven: enterprise in interstate commerce
pattern of criminal activity
fraud, banking, domestic & foreign payment
Foreign Corrupt Practices Act
Sanction: forfeiture of gain

Exhibit 2. Range of Sanctions on Corporate Practices
(Brickey, 1991)

<u>Range of Statutory Sanctions</u>

Types of Sanctions
Administrative Order
Civil Sanctions
Disgorge results
Criminal Sanction
Obstruction of Justice
Ban from practice before agency
Pleas re: Civil or Criminal issue

Types of Violations
Theft
Fraudulent Transactions
Fraudulent Accounting Practices
Destruction of legally required instruments

Ex-Range of Statutory Sanctions

	Reach settlement Restructure organization Enter Bankruptcy
Defendants	Firm Director & Officer Individual
Plaintiffs	Government, by agency (e.g., SEC) Corporation, for recoupment Shareholder, for lost stock value

Exhibit 3. Specific Violations and Sanctions of Corporate Actions

Violations as Fraudulent Transactions
- False financial statements
- False research reports on securities in the market
- "Spinning" share prices (for IPO)
- Destroy/Alter business records
- False business transactions
  - use of illegal incentives
- Purchases based on "late timing/trading"

Violations as Fraudulent Accounting Practices
- False reporting, to boost earnings
- Hidden corporate costs
  - to exaggerate profit
- Hidden organization structure,
  - to avoid recognition of liabilities
- Create off-the-book organization units
- Personal loans, without expectation of re-payment
- Improper recognition of expenses/income

Direct Criminal Activity
- Conspiracy to inflate profits,
  - To cover-up illegal practice
- Extraordinary Influence on investment banking
- Enterprise corruption, under
  - Racketeer Influenced Corrupt Organization Act
- Mail Fraud, Wire Fraud

Sanctions
- Fines, imprisonment, interest
- Disgorge "payments", forfeiture of proceeds

- Restatement of financial statements
- Displace Board of Directors,
  - in part or in total

- Bankruptcy settlement
  - by negotiation
- Organization spinoff,
  - avoiding bankruptcy
- Disclosure of fraudulent transactions