



EMORY  
LAW

Emory Corporate Governance and Accountability  
Review

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Volume 1 | Issue 1

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2014

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Michael Wiseman

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### Recommended Citation

Michael Wiseman, *Judge Rakoff, the Justice Department, and Corporate Crime: Lack of Will or Lack of Cause?*, 1 Emory Corp. Governance & Accountability Rev. 81 (2014).

Available at: <https://scholarlycommons.law.emory.edu/ecgar/vol1/iss1/11>

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## **JUDGE RAKOFF, THE JUSTICE DEPARTMENT, AND CORPORATE CRIME: LACK OF WILL OR LACK OF CAUSE?**

Is Judge Rakoff right? In the wake of the Great Recession, has the Justice Department neglected its duty to prosecute officers of financial institutions, or are prosecutorial options insufficient under current law?<sup>1</sup>

The salient corollary to those questions is whether the financial sector has re-stabilized to the extent where individuals, if not financial institutions themselves, might bear a bit of criminal culpability for the collapse. If so, then as Judge Rakoff puts it, the question that prosecutors must ask is whether “[the Great Recession was] the result, at least in part, of fraudulent practices, of dubious mortgages portrayed as sound risks and packaged into ever more esoteric financial instruments, the fundamental weaknesses of which were intentionally obscured?”<sup>2</sup>

Enter Rule 10b-5, a Securities and Exchange Commission regulation that provides a possible prosecutorial option with which to attack the banks for willful violations that might include misbranding AAA-rated collateralized debt obligations (CDOs), or improperly influencing the credit rating agencies.<sup>3</sup> However, some claim that sophisticated disclosure provisions included in investment documents either neutralize 10b-5’s disclosure requirements regarding the quality of the financial instruments, or qualify the nature of those

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<sup>1</sup> Judge Jed S. Rakoff, United States District Court for the Southern District of New York, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?*, N.Y. REV. OF BOOKS, Jan. 9, 2014, <http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/>.

<sup>2</sup> *Id.*

<sup>3</sup> 17 C.F.R. § 240.10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(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, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*See also* 15 U.S.C. § 78ff (a) (2006); *U.S. v. O’Hagan*, 521 U.S. 642, 665–66 (1997) (“To establish a criminal violation of Rule 10b-5, the Government must prove that a person ‘willfully’ violated the provision.”).

investments to the extent where the seller sidesteps actual deception.<sup>4</sup> Regardless of whether these provisions put parties on actual notice, the penultimate deals to the 2008 crash spelled ruin for many purchasers of these instruments. In order to rid the largest banks of their most risky investments, top-rated CDOs were bought and sold in a high-stakes game of hot potato. When the CDOs were ultimately downgraded to junk status, the purchasing institutions were left with worthless investments, and losses into the hundreds of millions.<sup>5</sup> Caveat emptor.

Lanny Breuer, the former head of the Department of Justice's Criminal Division, stated in a 2012 interview with Frontline that the Department of Justice had given Wall Street a "hard look" and investigated suspected crimes related to the crisis.<sup>6</sup> Breuer continued, "when we cannot prove beyond a reasonable doubt that there was criminal intent, then we have a constitutional duty not to bring those cases."<sup>7</sup> But intent alone is insufficient; reliance is required as well. "In a criminal case . . . I have to prove not only that you made a false statement but that you intended to commit a crime, and also that the other side of the transaction relied on what you were saying."<sup>8</sup> To Breuer, the fatal insufficiency was the lack of reliance by sophisticated Wall Street buyers, their attorneys and accountants. "[T]he reality is, if a Wall Street executive was involved in a transaction, and on the other side of that transaction was another Wall Street executive, and they both had sophisticated lawyers and they both had sophisticated disclosure documents, as much as the conduct is reprehensible . . . that is not what makes a criminal case."<sup>9</sup>

Breuer may have been construing the materiality requirement of Rule 10b-5(b)<sup>10</sup> to ask whether a reasonable investor thought the disclosures were important enough to discount the credit rating. This is an amazing idea—nothing supports this. It is rebuttable on the fraud-on-the-market theory

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<sup>4</sup> See Breuer interview, *infra* note 6.

<sup>5</sup> See Matt Taibbi, *The People vs. Goldman Sachs*, ROLLING STONE, May 11, 2011, <http://www.rollingstone.com/politics/news/the-people-vs-goldman-sachs-20110511>.

<sup>6</sup> *Lanny Breuer: Financial Fraud Has Not Gone Unpunished*, FRONTLINE, PBS.ORG (Jan. 22, 2013), available at <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/untouchables/lanny-breuer-financial-fraud-has-not-gone-unpunished/>.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> See Rule 10b-5(b), *supra* note 3.

alone.<sup>11</sup> Judge Rakoff agrees. In a January 2014 article in the *New York Review of Books*, Judge Rakoff takes Breuer to task and succinctly argues that reliance is nowhere an element in criminal law.<sup>12</sup> Although Breuer's statement seems to echo the law for private actions brought under Rule 10b-5 and its concomitant common law requirement that in order for deceptive packaging to constitute fraud, the buyer had to actually believe the label,<sup>13</sup> perhaps he instead meant that there could be no deceit or manipulation of the market if all the players knew the CDOs were not really AAA quality. Even if the parties were fully aware of the risks involved in these transactions, another underlying question persists. Should disclosure or common knowledge truly mitigate behavior that severely strained the system and helped cause the recession? The logical next question is whether individual prosecutions or alternative regulatory approaches might curb future abuses.

*A. The Shift to Deferred Prosecution Agreements and the Frustrating Lack of Individual Prosecutions*

When agents of a financial institution commit criminal acts while acting within the scope of their duties with intent to benefit the institution, the institution may be held criminally liable under the doctrine of *respondeat superior*.<sup>14</sup> The mere possibility of an indictment can seriously imperil the firm. For example, government licenses and contracts could be revoked, accelerated debt repayment provisions might kick in under existing loan covenants, investors might exit, employees might lose jobs, and the institution itself might fail. The benchmark horrible is Arthur Andersen.<sup>15</sup> A more recent and perhaps less sympathetic example of another type of business entity that

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<sup>11</sup> See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988) (Under the fraud-on-the-market theory, "an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action.")

<sup>12</sup> See Rakoff, *supra* note 2.

<sup>13</sup> See, e.g., *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011) (explaining that under Rule 10b-5, reliance is an element of a private action).

<sup>14</sup> See Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dep't of Justice for Heads of Dep't Components and U.S. Attorneys on Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), available at: [http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20\\_privwaiv\\_dojthomp\\_authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/migrated/poladv/priorities/privilegewaiver/2003jan20_privwaiv_dojthomp_authcheckdam.pdf) [hereinafter Thompson Memo].

<sup>15</sup> See generally Elizabeth K. Ainslie, *Indicting Corporations Revisited: Lessons of the Arthur Andersen Prosecution*, 43 AM. CRIM. L. REV. 107 (2006) (describing the prosecution of Arthur Andersen and his accounting firm in the wake of the Enron scandal). See also Peter Spivak & Sujit Raman, *Regulating the 'New Regulators': Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 165-66 (2008) [hereinafter *The New Regulators*].

was indicted for systemic violations, S.A.C. Capital Advisors, L.P., has been rebranded and reduced to trading one private account, that of its founder, Steven A. Cohen.<sup>16</sup>

In light of these dangers, and even prior to the recession, deferred or non-prosecution agreements have become a favored tool among prosecutors.<sup>17</sup> These agreements allow corporations to avoid an indictment in return for the payment of fines, the institution of compliance procedures and monitors, and enhanced cooperation with the Justice Department.<sup>18</sup> This new norm posits a role for the Department of Justice where they essentially become the new regulators for corporate behavior.<sup>19</sup> The threat of indictment, which would cause the loss of government licenses and permits, coupled with the compliance strictures of these agreements, which generally require the entity to “enact substantial internal reforms” in return for the dismissal of charges, allows the government to reform corporate governance.<sup>20</sup> This is in contrast to the retroactive effects of a criminal prosecution and its associated punishment and deterrence elements.

Though the use of these agreements to reform corporate governance has grown in popularity, many contain provisions designed to advance the traditional goal of “effectively [helping] prosecutors build a case against individual employees.”<sup>21</sup> Indeed, the continuing stance of the Justice Department is that individual prosecutions can effect systemic changes in behavior that carry great social good.<sup>22</sup> Larry Thompson, the former United States Deputy Attorney General, mandated that United States Attorneys always assess the merits of corporate prosecution while emphasizing that in the majority of cases individual prosecutions should also be pursued:

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<sup>16</sup> See Matthew Goldstein, *SAC Capital, Meet Point72 Asset Management*, N.Y. TIMES DEALBOOK, April 7, 2014, <http://dealbook.nytimes.com/2014/04/07/sac-capital-meet-point72-asset-management/>; see also Ben Protess & Alexandra Stevenson, *After Scandal, SAC Capital Begins to Fade to Black*, N.Y. TIMES DEALBOOK, Feb. 2, 2014, <http://dealbook.nytimes.com/2014/02/02/after-scandal-sac-capital-begins-to-fade-to-black/>.

<sup>17</sup> See the New Regulators, *supra* note 9, at 159; David M. Uhlmann, *Prosecution Deferred, Justice Denied*, N.Y. TIMES, (Dec. 13, 2013) (“From 2010 to 2012, the [DOJ’s criminal] division reached twice as many deferred prosecution and nonprosecution agreements with corporations as there were plea agreements”), available at [http://www.nytimes.com/2013/12/14/opinion/prosecution-deferred-justice-denied.html?\\_r=0](http://www.nytimes.com/2013/12/14/opinion/prosecution-deferred-justice-denied.html?_r=0) (“From 2010 to 2012, the [DOJ’s criminal] division reached twice as many deferred prosecution and nonprosecution agreements with corporations as there were plea agreements”).

<sup>18</sup> David M. Uhlmann Op-Ed., *Prosecution Deferred, Justice Denied*, N.Y. TIMES DEALBOOK, Dec. 13, 2013, <http://www.nytimes.com/2013/12/14/opinion/prosecution-deferred-justice-denied.html>.

<sup>19</sup> See the New Regulators, *supra* note 9., at 161.

<sup>20</sup> *Id.* at 160.

<sup>21</sup> *Id.*

<sup>22</sup> See Thompson Memo, *supra* note 12.

Charging a corporation, however, does not mean that individual directors, officers, employees, or shareholders should not also be charged. Prosecution of a corporation is not a substitute for the prosecution of criminally culpable individuals within or without the corporation. Because a corporation can act only through individuals, imposition of individual criminal liability may provide the strongest deterrent against future corporate wrongdoing. *Only rarely should provable individual culpability not be pursued, even in the face of offers of corporate guilty pleas.*<sup>23</sup>

However, even what appear to be more straightforward cases of neglect, recklessness, or even intentional wrongdoing at financial institutions may only infrequently lead to prosecution of individuals. For example, Georgia led the nation in failed banks from 2008–2013, with almost ninety banks having gone under in this period.<sup>24</sup> Mortgage fraud, aggravated by aggressive lending practices and problematic construction loans,<sup>25</sup> may have led to over-leverage on sub-prime mortgages and contributed to some of these failures.<sup>26</sup>

The United States Attorneys' Office for the Northern District of Georgia has identified the prosecution of mortgage fraud as one of its top priorities.<sup>27</sup> Yet even with a thorough internal review of failed regional banks, there have only been a handful of successful prosecutions.<sup>28</sup> One assistant United States attorney proffered that while all bank failures in Georgia are investigated, many are turned down due to insufficient evidence of misrepresentation, fraud, or other violations of law. Absent a “smoking gun,” proving the intent necessary for acts to constitute fraud beyond a reasonable doubt is difficult.

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<sup>23</sup> *Id.* (emphasis added).

<sup>24</sup> See *Failed Bank List*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Feb. 14, 2014).

<sup>25</sup> See, e.g., Todd, *infra* note 28.

<sup>26</sup> See Paul Krugman, *Op-Ed: Georgia On My Mind*, N.Y. TIMES, April 12, 2010, <http://www.nytimes.com/2010/04/12/opinion/12krugman.html>. See also, e.g., Ben Steverman, *Get Ready for More Bank Failures*, BLOOMBERG BUSINESSWEEK, Sept. 14, 2009, [http://www.businessweek.com/investor/content/sep2009/pi20090914\\_866281.htm](http://www.businessweek.com/investor/content/sep2009/pi20090914_866281.htm).

<sup>27</sup> See Divisions, U.S. ATTORNEY'S OFFICE FOR THE N. DIST. OF GA., <http://www.justice.gov/usao/gan/divisions/criminal.html> (last visited Feb. 14, 2014) (“The nation’s financial crisis was caused in part by corrupt bank insiders and major borrowers whose crimes contributed to the failures or bailouts of financial institutions previously believed to be secure. Unfortunately Georgia leads the nation in bank failures, with numerous banks having been shut down by the FDIC since the crisis began. Attacking this ongoing problem through the aggressive prosecution of bank fraud is one of our district’s high priorities.”).

<sup>28</sup> See, e.g., Sarah Todd, *Former CEO of Failed Ga. Bank Pleads Guilty in Fraud Case*, AMERICAN BANKER, Nov. 13, 2013, <http://www.americanbanker.com/people/former-ceo-of-failed-ga-bank-pleads-guilty-in-fraud-case-1063642-1.html?zkPrintable=true>.

### B. *Attempts at Quasi-Strict Liability and Steps Forward*

Congress has noticed the obstacles to the successful prosecution of bank fraud, and there have been attempts to impose quasi-strict liability. However, laws that theoretically box in corporate officers by requiring them to sign-off on the veracity of financial statements and to attest to corporate compliance have been eviscerated, either in practice or on the cutting block of regulatory compromise. As an example of the former, the certification requirements of Sarbanes-Oxley have been all but completely neutered by the corporate practice of sub-certification—where lower-level employees certify financial statements before the top officers sign off on them, thus undermining proof of the element of knowledge.<sup>29</sup> Although *respondeat superior* might still lead to corporate liability in this scenario, sub-certification subverts individual liability under Sarbanes-Oxley. As an example of the latter, regulators involved with writing final regulations enforcing the Volcker Rule, the centerpiece of the Dodd-Frank legislation, disagreed on whether to force top officers to attest to corporate compliance with the Rule’s provisions.<sup>30</sup> Under the current version of the rule, those officers are required only to attest that the bank “has in place processes to establish, maintain, enforce, review, test and modify” compliance with the Rule.<sup>31</sup>

Still, some in Congress, including Senators Carl Levin and Elizabeth Warren, continue to attempt to curb this behavior through aggressive investigations, potentially incriminating reports,<sup>32</sup> and calls for prosecutors to prosecute larger financial institutions in addition to smaller banks.<sup>33</sup> However,

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<sup>29</sup> See Alison Frankel, *Sarbane-Oxley’s Lost Promise*, THOMSON REUTERS, July 27, 2012, <http://www.reuters.com/article/2012/07/27/us-financial-sarbox-idUSBRE86Q1BY20120727>.

<sup>30</sup> See Ben Protess & Peter Eavis, *At the Finish Line on the Volcker Rule*, N.Y. TIMES DEALBOOK, Dec. 10, 2013, <http://dealbook.nytimes.com/2013/12/10/regulators-vote-to-approve-volcker-rule/> [hereinafter *At the Finish Line*].

<sup>31</sup> *Text of the Final Common Rules*, FEDERALRESERVE.GOV, <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a1.pdf> (last visited Feb. 14, 2014) (describing final rules implementing the Volcker Rule).

<sup>32</sup> See United States Senate, Permanent Subcommittee on Investigations of the Committee on Homeland Security and Governmental Affairs, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse at 624* (April 13, 2011) (commonly referred to as the “Levin-Coburn Report”) (reporting on the Subcommittee’s investigation into the origins of the 2008 financial crisis and stating that “Goldman CEO Lloyd Blankfein said publicly about the firm’s securities: ‘If we believed it would fail . . . the security wouldn’t work, we would not sell it. But Goldman marketed the Anderson and Timberwolf securities to clients knowing that each CDO had poor quality assets that were continually losing value.’”).

<sup>33</sup> See Mollie Reilly, *Elizabeth Warren Takes on Eric Holder’s ‘Too Big to Jail’ Statement*, THE HUFFINGTON POST, March 6, 2013, [http://www.huffingtonpost.com/2013/03/06/elizabeth-warren-eric-holder\\_n\\_2823618.html](http://www.huffingtonpost.com/2013/03/06/elizabeth-warren-eric-holder_n_2823618.html).

Congress has stopped short of enacting new laws that might place bank executives under anything approaching strict criminal liability. On the civil liability front, despite the recent issuance of regulations implementing the Volcker Rule,<sup>34</sup> there are lingering concerns that Dodd-Frank may be insufficient to stem aggressively risky investments by the banks.<sup>35</sup> Although those developments will continue to play out over the next few years, it seems clear that for the moment, the plenary Congress has opted to steward the banking ship's treasury, but not its captains' course.

MICHAEL A. WISEMAN\*

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<sup>34</sup> See At the Finish Line, *supra* note 26.

<sup>35</sup> See William Greider, *Don't Get Too Excited About the Volcker Rule*, THE NATION, Dec. 12, 2013, <http://www.thenation.com/blog/177574/dont-get-too-excited-about-volcker-rule#>. But see Mike Konczal, *There are Six Big Arguments Against the Volcker Rule. Here's Why They're Wrong.*, WASH. POST, Dec. 10, 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/12/10/there-are-six-main-arguments-against-the-volcker-rule-heres-why-theyre-wrong/> (arguing the Volcker Rule is "important and worth strengthening").

\* Emory University School of Law, J.D. with Honors, 2014; E-Content Specialist, Managing Editor, *Emory Corporate Governance and Accountability Review*; M.M. with Academic Distinction, Violoncello Performance, New England Conservatory of Music; B.M. Music Performance, San Francisco Conservatory of Music. With much appreciation to Professor Frank Vandall for his advice and insight. Many thanks also to Meredith Yoon, Joseph Gillman, and Christian Miele for their fine editorial work, suggestions, and encouragement.