Testimony of

Prof. Rob Steinbuch

March 10, 2006

Mr. Chairman, I support the ideals behind imposing some criminal liability on corporate actors who knowingly, or with reckless disregard for life, introduce excessively risky products or services into the stream of commerce. The existing system of assigning liability for such acts solely to the corporate entity is inefficient as a consequence of the externalization of the cost of harm. That is, corporate actors rationally interested in maximizing personal remuneration will necessarily undervalue the costs on society of risky corporate behavior because those costs either remain externalized to society or, to the extent that they are internalized by the corporation through a liability rule, they rest exclusively at the corporate level. In contrast, however, the benefits of risky behavior are shared by both the corporate entity and the corporate actors themselves. Thus, corporate actors enjoy some benefit without bearing any cost of corporate risk taking. This disincentive/incentive asymmetry rationally leads corporate actors to pursue riskier than optimal activities. The proposed legislation is designed to improve upon the existing incentive scheme in order to optimize the production and provision of beneficial products and services and minimize the production and provision of excessively dangerous products and services.

Specifically, corporate actors receiving the typical compensation package of stock options and salary will seek to maximize relatively short-term profits by exploiting the higher return associated with risk-taking and will not discount this return by the expected cost of liability for that risky behavior. Since corporate actors fully realize the gains of salary and executed stock options, but do not bear the potential liability costs, they have no incentive to limit the latter if doing so will negatively impact the former. Indeed, for various reasons, many not implicating strategic departure, corporate CEO tenure has been on the decline. Regardless of the cause, however, the cyclical nature of executive tenure fosters an environment in which they overvalue short-term return and undervalue long-term costs. The direct imposition of liability on corporate actors across time will increase their internalization of the long-term corporate costs of risk taking in such an environment.

While corporate law traditionally has sought to protect corporate actors from personal liability, the legal landscape has always resisted a dogmatic application of such a policy in an attempt, albeit inconsistent, to balance equities. As a preliminary matter, we should examine the two apparent exceptions to the limitation on personal liability in the corporate context before considering new rules to avoid the corporate shield.

First, the doctrine of piercing the corporate veil theoretically allows personal liability to be imposed directly upon corporate actors. The application of the doctrine to large publicly-held corporations, however, is highly limited; and, when viewed with the goal of achieving personal liability of corporate actors - rather than parent corporations - it is all but a theoretical curiosity.

Second, corporate actors may be exposed to personal liability in actions brought directly against them rather than against the corporations. Director and officers liability insurance ("D&O insurance"), and, to a lesser extent, indemnification and advancement-of-expenses clauses and post-VanGorkon statutes, such as Del. GCL § 102(b)(7), have virtually eliminated any significant likelihood of personal liability for corporate actors by allowing these actors to shift these costs back to the corporation. Indeed, given the diffuse nature of shareholders, resistance to corporations' assumption of director and officer liability or the costs of D&O insurance is insignificant. As such, neither of these devices to assign personal liability to corporate actors ultimately is relevant here, and we are left with an incentive scheme that allows corporate actors to insufficiently account for societal costs.

Criminal penalties, in contrast, are unique in two ways that prevent corporate actors from shifting the costs of personal liability back to the corporation. First, criminal penalties, regardless of their form or nature, carry a social stigma of moral condemnation. As such, even if the penalty is de minimus and does not infringe personal freedom, the sanction has a significant non-transferable cost to corporate actors. Given their relative risk adversity, corporate actors are particularly sensitive to this sanction. Second, these non-pecuniary costs typically translate to direct financial costs by limiting corporate actors' future access to the executive labor market.

Mr. Chairman, as the Committee pursues this important issue, I believe that we can take many lessons from the success of recent legislation to craft a statute that achieves the goals discussed above, while limiting the negative consequences. Indeed, the recent enactment of Sarbanes-Oxley provides us with significant guidance: Sarbanes-Oxley requires the Chief Executive and Chief Financial Officer of covered corporations to personally certify that SEC

reports comply with regulatory standards. The failure to do so personally exposes these senior executives to criminal sanctions, ensuring that corporate actors cannot shift responsibility to unwitting or powerless subordinates. As such, this statute applies criminal penalties directly to corporate actors and, at the very same time, prevents them from asserting the ignorance defense adopted by Ken Lay and others. The legislation under consideration today should mirror these requirements by incentivizing businesses to elicit and maintain organized data on serious injuries and deaths sustained as a result of their products and services, with senior executives being required to review this information.

Further, the legislation under consideration should seek to protect whistle-blowing activity. By offering security to whistleblowers and imposing criminal liability on corporate executives who knowingly and intentionally retaliate against them, we encourage the efficient communication of critical information. Again, such provisions are found in Sarbanes-Oxley. Similarly, the Standards Development Organization Advancement Act of 2004 ("SDOA") put into place a criminal-prosecution amnesty program for disclosures of criminal-antitrust-law violations. Under SDOA, if a corporate conspirator self-reports its illegal antitrust activity to the Department of Justice and meets certain conditions, e.g., it is the first conspirator to confess, it is not the ringleader of the conspiracy, and it agrees to cooperate fully with the investigation, this corporate conspirator may both obtain amnesty from criminal liability and avoid the exposure to treble civil damages in private actions. These devices encourage the distribution of relevant information to law enforcement and the consumer market.

These requirements can be applied without undue cost to the health of corporate America. Indeed, notwithstanding the sizeable criminal penalties of Sarbanes-Oxley, we have not seen the mass exodus of corporate executives predicted by some during the statute's enactment. I believe that comparable prognostications offered about the current proposal ultimately will be relegated to a similar position of obscurity. That is not to say, however, that legislation of this type will not have negative consequences. It may indeed. But, as with any policy decision, the costs must be balanced against the benefits. If the imposition of such significant personal responsibility on corporate actors can, and indeed has, been adopted for financial wrongdoing with the adoption of Sarbanes-Oxley, the same approach certainly should be available for wrongs that directly result in physical injury or death.

Mr. Chairman, there are myriad areas in which the current tort system provides insufficient incentives to prevent disreputable corporate actors from knowingly injuring and killing people. In fact, I discuss some of these issues in my forthcoming article: Preventing Under-Equipped Medical Facilities from Killing Heart-Attack Patients: Correcting Inefficiencies in the Current Regulatory Paradigm for Providing Critical Health-Care Services to Patients with Acute Coronary Syndrome. In this Article, I describe how individuals in the midst of heart attacks are deceptively and intentionally lured into sub-standard medical facilities to enhance these institutions' revenue at the expense of patients' lives.

Heart Attacks are the number one killer in the United States. Each year about 1.2 million Americans suffer from heart attacks and approximately 500,000 die as a result. When a patient suffers from a blockage-caused heart attack, doctors have a very limited time to open the obstructed artery. The "gold standard" method to do so is through angioplasty -- that is, by threading a balloon-tipped catheter through an artery of the patient's leg, and crushing the blockage against the wall of the artery.

Since, (1) half of the treatable heart-attack patients are brought to the hospital by friends, relatives or drive themselves, and (2) chest pain is the number two reason for all emergency room visits, small hospitals in need of revenue seek to attract these customers by self designating and advertising as "Chest Pain Centers" or the like, without any angioplasty facilities whatsoever. These under-equipped community hospitals knowingly exploit patient ignorance for their own profit. For example, one hospital, Mather Memorial Hospital in New York, sends flyers to all households in the community advertising its "Chest Pain Emergency Room" and the ability to "stop a heart attack in progress." Mather, however, has no angioplasty capability. In this advertising, Mather boasts the following "upgrades" to assist in the care of heart-attack and other patients: a cellular-phone system and a "state-of-the-art" blood pressure monitor.

Such advertising might be acceptable if angioplasty facilities were a rare occurrence, so that under-equipped facilities' "modest" care was the only available treatment. But, eighty percent of Americans live within one hour's drive of a facility that performs angioplasty, and that is well within the timeframe to perform this procedure. For example, Mather Memorial Hospital is only a few minutes from a fully-equipped angioplasty center at a state university hospital. Mather executives know this, but still advertise for heart-attack patients. Indeed, these executives are apparently aware enough of the importance of angioplasty-capability that they are now seeking to obtain such technology. Interestingly, however, they have long been advertising as having a chest-pain emergency room.

Experts recognize that most heart-attack patients end up in under-equipped community hospitals instead of nearby angioplasty centers and "the real reason has more to do with economics [than anything else]. 'There is no incentive to change. . . . The small hospitals don't want to divert patients to larger hospitals, because that is lost revenue.'"

Such modeling is supported by evidence that the existing regulatory scheme predictably leads to rent seeking by sub-

optimal facilities desirous of maintaining their inefficient market share. As Dr. Joseph Carrozza, Chief of Interventional Cardiology at Boston's Beth Israel Deaconess Medical Center, said: "[t]here are a lot of strong community hospitals that aren't offering primary angioplasty and would line up all their politicians against an effort to have heart attacks taken away from their hospitals."

While institutions are civilly liable for the fraudulent claims that they make, this liability - to date -- has not dissuaded this behavior. Non-mass tort or class actions often do not efficiently distribute market-correcting information in large measure because most cases settle, and these settlements routinely require confidentiality. Evidence from the legal community demonstrates that great efforts are taken by hospitals in false advertising cases to ensure their confidentiality upon settlement. So, executives at these ill-equipped facilities continue to put sub-standard service on the market and present it as a state-of-the-art technology. This intentional deceptions leads to preventable deaths every day, and we need appropriate incentives to avoid this result.

Mr. Chairman, you have been a leader on these issues of consumer welfare. Indeed, you and six of your colleagues wrote a bipartisan letter to leading heart-health organizations last year, questioning, inter alia, the practice of under-equipped medical facilities self designating as "Chest Pain Centers."

In addition, as a leading expert on the health-care regulatory environment, Senator DeWine has introduced the Heart Attack Safety Act ("HASA") to require hospitals to meet specific requirements set by the Secretary of H.H.S. in order to advertise as having a "Chest Pain Center" or otherwise solicit heart-attack patients away from nearby facilities. This is an excellent start. And, I recommend a unified approach, where HASA is combined with your current proposal to create an integrated bill to address these important issues, much like Senator Hatch did with the many outstanding bills that contributed to the Justice for All Act.

Indeed, there are many other areas of corporate behavior that could be improved through your important proposal. For example, as we know, the automotive industry sells products with inherent risks. We must analyze the relative level of risk imposed by individual product lines in this industry and the efforts taken to maintain the safety of the public. Thus, while we acknowledge that the industry cannot ensure that no injuries or deaths result from the use of their products, we should expect manufacturers to study the comparative safety of their products to ensure that they are not inherently more dangerous than what prevails.

There have been numerous occasions in which automobile companies have been accused of falling short of this modest standard. The now classic case of the Ford Pinto demonstrates just one example of this phenomenon. Similar accusations have been levied against General Motors regarding their pick-up trucks produced in the 1970s and 1980s, the 1975 Ford Mustang, and the 1979 Chevy Malibu. The resulting inquiry, indeed, is two-fold: what did these manufacturers know and when did they know it? Thus, as discussed, liability should coincide with a duty of reasonable investigation and data collection, on the one hand, and disclosure safe-harbors, on the other. This positive and negative incentive scheme will cause corporate actors to seek out and disseminate information on the safety of their products and services - allowing consumers to make rational decisions that were otherwise made unwittingly on their behalf by corporate actors.

Recent events cause us to ask the very same questions about the corporate decisions made at Firestone and Ford: what did corporate executives know about the dangers of the Firestone tires used in conjunction with Ford Explorers and when did they know it? Why did it take so long for the information to become publicly available? What efforts did executives take to gather, analyze, and disseminate such critical information? Were individuals injured or killed as a result of delays in communicating such information after it was discovered? While we do not know the answers to all of these questions, what seems clear is that the current incentive scheme encourages ignorance, secrecy, and denial at the expense of openness and safety. This model needs to be changed.

Mr. Chairman, your proposal, if appropriately tailored, will allow us to optimize the benefits of an ever-advancing technological environment, while minimizing unreasonable risks to the safety of the public. Thank you for considering my remarks.