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# AGENCY THEORY AND THE CRIMINAL LIABILITY OF ORGANIZATIONS

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## INTRODUCTION

In 1987, the United States Sentencing Commission took what was supposed to be "the first step in an evolutionary process"<sup>1</sup> whose ultimate goal was to establish rational policies and guidelines for criminal sentencing. The Sentencing Commission began its work by establishing guidelines and policies for sentencing natural persons. It now has proceeded to consider sentencing guidelines for corporations.<sup>2</sup> The consideration of penalties for corporations began with a "discussion draft" containing a proposal for sentencing guidelines for corporations,<sup>3</sup> and proceeded to public hearings on the topic in October and November of 1988. A year later, in November, 1989, events took a different turn as the Sentencing Commission itself published its own "Preliminary Draft" for the sentencing of organizational defendants.<sup>4</sup>

The central organizing premise of the 1989 Preliminary Draft is that corporations should be punished more severely for crimes than they have been in the past. According to Jeffrey S. Parker, a former Deputy Chief Counsel to the United States Sentencing Commission, and Michael K. Block, a former Member of the United States Sentencing Commission, "the 1989 proposal simply suggests very high—and apparently arbitrary—fine amounts."<sup>5</sup> The 1989 guidelines reflected a highly publicized effort by the Sentencing

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<sup>1</sup> United States Sentencing Commission, Sentencing Guidelines for United States Courts, 52 Fed. Reg. 18,049 (1987).

<sup>2</sup> U.S. SENTENCING COMM'N, DISCUSSION MATERIALS ON ORGANIZATIONAL SANCTIONS (1988).

<sup>3</sup> While the guidelines discussed in this paper refer to all forms of business organizations and not just to firms doing business in the corporate form, at times I use the term "corporation" because it is convenient to do so. Also, as a statistical matter, virtually all organizational offenders are business corporations. See Memorandum from David A. Lombardero and Jeffrey S. Parker to Members of the U.S. Sentencing Commission ("All Commissioners") on Principles for Organizational Sentencing 2 (Jan. 27, 1988) (on file with author).

<sup>4</sup> U.S. SENTENCING COMM'N, SENTENCING GUIDELINES FOR ORGANIZATIONAL DEFENDANTS (preliminary draft, Nov. 1989).

<sup>5</sup> Parker & Block, *The Sentencing Commission, P.M. (Post-Mistretta): Sunshine or Sunset?*, 27 AM. CRIM. L. REV. 289, 322 (1990).

Commission to portray itself as "tough on lawbreakers."<sup>6</sup> The effort was an unmitigated success. The sentencing schedule was "far heavier than any business executive would have imagined possible."<sup>7</sup> Fines were set as high as \$364 million, and convicted organizations also could have been sentenced to a unique form of "probation," that allowed courts to assume effective control of the daily operations of corporations whose managers actively participated in certain crimes.<sup>8</sup>

The original plan contained two alternatives for setting fines on convicted organizations. Under the first alternative, fines would equal two to three times the illicit profits or the amount of damage caused by a corporation in the course of its criminal activities. The amount of the fine would vary according to the presence or absence of a number of "aggravating"<sup>9</sup> or "mitigating"<sup>10</sup> factors. Each aggravating or mitigating factor could raise or lower the fine by ten to fifty percent.<sup>11</sup> Under the second alternative, fines would be set according to a thirty-two level scale. The fine would vary according to the severity of the offense. Under this system, the offense level for any particular crime would be raised or lowered according to the aggravating and mitigating factors employed under the first alternative.

The business community reacted strongly to the Sentencing Commission's original proposal. The National Association of Manufacturers testified before the Commission that the proposed guidelines were "extremely harsh, punitive, unwarranted and . . . place[d] many businesses on the threshold of insolvency."<sup>12</sup> The Corporate Counsel Association took an equally harsh line, commenting that judges "do not have the training, experience, or time to run companies in the manner the suggested conditions of probation would require."<sup>13</sup> By March, 1990, the Sentencing Commission responded to this pressure by issuing a new set of proposed guidelines that were at least marginally milder.

Notably, the Sentencing Commission's proposal for organizational sanctions was wholly devoid of empirical or theoretical foundation. Its proposals were politically oriented, rather than policy oriented. Indeed, if nothing else, the process of establishing sentencing guidelines has made it clear that

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<sup>6</sup> *Corporations Face Stiffer Sentencing: Panel Gets Tough on Lawbreakers*, Wash. Post, Nov. 8, 1989, at B1, col. 1.

<sup>7</sup> Etzioni, *Going Soft on Corporate Crime*, Wash. Post, Apr. 1, 1990 (Outposts), at C3.

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

<sup>9</sup> Aggravating factors include the "active involvement of high-level management in the crime, prior convictions, cover-ups during an investigation, and endangerment of an entire consumer market." *Id.*

<sup>10</sup> Mitigating factors include "prompt reporting of an offense, reasonable ignorance of a crime by top management, organizational policies forbidding such offenses, and timely action to prevent similar offenses from occurring." *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

the work of the Sentencing Commission has entered the realm of special-interest politics. As a result, the process of establishing sentencing guidelines has followed a pattern quite familiar to political scientists. The initial regulatory foray served to increase the notoriety of the relevant regulatory agency by attracting the press attention that usually accompanies threats to impose huge costs on an industry or interest group. This initial foray also attracted the attention of the relevant interest groups. The regulatory agency, having tested the regulatory waters, then proceeded to hold public hearings, which served as an auction, whose purpose was to customize the regulatory scheme to the interests of the highest bidders.<sup>14</sup> Where conflicting interests clashed, compromise resulted.

The politicization of the Sentencing Commission's efforts to promulgate guidelines for corporations is ironic in light of the Supreme Court's decision in *Mistretta v. United States*.<sup>15</sup> There, the Court upheld the constitutionality of the Sentencing Commission against a challenge that its existence violated the constitutionally mandated Separation of Powers. The Court opined that the presence of federal judges on the Commission did not politicize the judiciary because the Commission itself was viewed as "essentially neutral."<sup>16</sup> As such, judicial membership on the Commission did not threaten the impartiality of the judicial branch because

[t]he Sentencing Commission is devoted exclusively to the development of rules to rationalize a process that has been and will continue to be performed exclusively by the Judicial Branch. In our view this is an essentially neutral endeavor and one in which judicial participation is peculiarly appropriate.<sup>17</sup>

Justice Scalia took a much different and more pragmatic view of the role of the Sentencing Commission. Writing in dissent, he recognized that the Commission, and its judicial membership, inevitably would find itself

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<sup>14</sup> While public hearings by an agency do not resemble an auction in the sense that interest groups trade cash for regulatory forbearance, the public hearing process is analogous to an auction because both methods of allocating rights produce the same results. Public hearings do not produce discussion and comment from randomly distributed sectors of the population. Rather, those groups with the most at stake on a particular issue will express themselves most forcefully. When, as is so often the case, a proposed regulatory scheme distributes gains to a concentrated group in society, and imposes costs on a widely diffuse group or groups, only the group that stands to gain will make itself heard in the "public hearing" process. And, needless to say, these groups will not present an unbiased rendition of the relative merits of competing regulatory schemes. This skewing of information flow is a sufficient condition for causing the public hearing process to resemble an auction. Thus, because the public officials conducting the auction hear only one side of an issue, their thinking on an issue is likely to be systematically distorted in favor of the group with the most at stake.

<sup>15</sup> 488 U.S. 361 (1989).

<sup>16</sup> *Id.* at 407.

<sup>17</sup> *Id.*

entwined in political issues. Thus, he would have struck down the Act creating the Sentencing Commission as a violation of the Separation of Powers. In particular, Justice Scalia felt that the Sentencing Commission was "a sort of junior-varsity Congress,"<sup>18</sup> whose un-elected and unaccountable membership would be entrusted with political decisions that Congress would prefer not to have to make.<sup>19</sup>

This was not the way it was supposed to be, of course. Under the Sentencing Reform Act, the Sentencing Commission is required by law to establish sentencing policies and practices for the federal criminal justice system that, among other things, would "provide certainty and fairness,"<sup>20</sup> and "reflect, to the extent practicable, advancement in knowledge of human behavior as it relates to the criminal justice process."<sup>21</sup> Moreover, the Sentencing Reform Act "is as clear as any legislative product could be in the expression of a mandate [for the Commission] to 'do efficiency.'"<sup>22</sup> The conclusion is inescapable that guidelines and policies for criminal sentencing must be efficient if they are to be rational. After all, the criminal law itself is essentially economic in nature: its goal is to force people to internalize the costs of their own actions.<sup>23</sup>

Because the Sentencing Commission is dependent on Congress for its very survival, it is not surprising that its actions have become so highly politicized. The Commission had a precarious beginning especially because, from its inception until *Mistretta*, its constitutionality had been in question. Unlike many other regulatory agencies, the Sentencing Commission lacks a natural constituency who might be expected to fight for its survival. Because it lacks an interest group constituency, the political costs to Congress of disposing of the Sentencing Commission would be very low. The Commission, therefore, must be very careful to avoid activities that are antithetical to congressional interests. With this in mind, it is not surprising that the Commission's activities have become politicized. And, for this reason, it is also highly doubtful that the Sentencing Commission will produce guidelines that are an improvement over the existing sentencing practices of federal judges.

The purpose of this Article is to show that, despite whatever political appeal the subject may have, corporate sentencing is an inappropriate topic

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<sup>18</sup> *Id.* at 427 (Scalia, J., dissenting).

<sup>19</sup> *Id.* For an explanation of why Congress might prefer to delegate certain decisions to administrative agencies or to states, see Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990).

<sup>20</sup> 28 U.S.C. § 991(b)(1)(B) (1988).

<sup>21</sup> 28 U.S.C. § 991(b)(1)(C) (1988).

<sup>22</sup> Parker & Block, *supra* note 5, at 292.

<sup>23</sup> See Parker, *Criminal Sentencing Policy for Organizations: The Unifying Approach of Optimal Penalties*, 26 AM. CRIM. L. REV. 513, 553 (1989) ("Criminal conduct is prohibited mainly because of the external harm or loss that it imposes on persons other than the offender, including both victims in the narrow sense and society at large.").

for the attention of the U.S. Sentencing Commission. I will show that this conclusion would obtain even if the Commission were insulated from the pressures of the political marketplace, which it is not. In addition, the analysis in this Article casts considerable doubt on the conventional assumption among legal scholars, including law and economics scholars, that corporate shareholders invariably benefit from corporate crime. While it is true that shareholders benefit *ex post* when criminal activity goes undetected, it is not at all clear that shareholders benefit *ex ante* from such activity. The agency cost perspective taken in this Article makes clear that the most plausible explanation for corporate crime, at least in the large, publicly held corporation, stems from a deviation of interest between managers and shareholders.

The Article begins with a discussion of how agency theory can provide insights into the question of organizational sanctions. Agency theory is an elemental part of the modern theory of corporate finance. An understanding of agency theory is essential to any inquiry into the behavior of corporate actors. Applying basic principles of agency theory to the issue of criminal sanctions yields two insights. First, corporate officers and directors have a natural proclivity to refrain from taking risks. Engaging in criminal activity is a form of risk-taking. Excessive enforcement can exacerbate this proclivity toward excessive risk avoidance, in turn, stifling innovation and creativity and leading to a general decline in social wealth.

The second critical insight provided by agency theory is that corporate actors do not engage in criminal activity to benefit the firms for which they work but to benefit themselves. In some, but not all cases, these activities will benefit the firms for which the corporate actors work. But the basic motivation for the behavior is self-interest. Corporate actors may engage in criminal activities that, if undetected, will benefit their firms but this activity may not make shareholders better off *ex ante*. In other words, corporate actors' criminal behavior will sometimes benefit a firm and will sometimes harm a firm. The real aim of criminal behavior by organizations is to advance the careers of the responsible corporate actors. It is against these actors that the primary criminal sanction should be levied.

This Article does not conclude that imposing criminal liability on corporations is always a bad idea. Rather, the point here is that agency theory makes clear that the issue of corporate criminal liability is more complex than it appears at first blush. We are more likely to attain rational and consistent treatment for organizational defendants by allowing judges to work on an incremental, case-by-case basis than by requiring them to adhere to a set of guidelines that do not take full account of the varying circumstances of individual firms and their agents.

Part I of this paper contains a basic introduction to agency theory. This Part, which contains the core of the analysis, elaborates on the risk-aversion and self-interest insights mentioned above. Part II discusses the relationship between agency theory and optimal penalty theory as those theories relate to the criminal culpability of organizations. This Part makes the observation that, taken together, the insights of optimal penalty theory and agency the-

ory suggest that it is inappropriate to view corporations as risk-neutral in the context of corporate crime. In fact, such organizations should be viewed as risk-averse, since the relevant decision-makers in these firms are risk-averse. Making the assumption that corporations are risk neutral can lead to sub-optimal sanctions.

## I. AGENCY THEORY AND THE CRIMINAL CORPORATION

### A. *Agency Theory in General*

Lawyers and financial economists are quite familiar with the concept of agency. Within the context of corporate finance theory, an agency relationship arises in any contractual setting in which one or more persons (the principals) engage another person (the agent) to perform some service that requires the agent to make decisions on behalf of the principals.<sup>24</sup> Within the context of the publicly held corporation, financial economists consider shareholders to be principals and officers and directors to be their agents.

Michael Jensen and William Meckling made a seminal contribution to agency cost theory by developing a model that focuses attention on the moment a privately held firm goes public.<sup>25</sup> They argue that after the firm has sold shares to the public, one expects that the existing group of managers will continue to run the firm. But the public sale of shares creates an agency problem, because once a firm goes public, the interests of the firm's shareholders and its managers diverge. The shareholders want the managers to keep their collective noses to the grindstone, while managers may want to engage in leisure time activities, and divert portions of the firm's resources to their private use. Under this model, the agency problem can manifest itself in a number of ways. Wednesday afternoon golf outings, country club memberships for top executives, and corporate jets, for example, may all serve valid corporate purposes, but they may also represent a deviation between the interests of principals and agents.

Besides the somewhat obvious manifestations of the agency problem mentioned above, agency problems arise more subtly in firms' corporate financing decisions. Perhaps the most important way that the conflict between shareholder/principals and manager/agents manifests itself is in the different ways in which the two groups view risk. Shareholders can reduce the risk associated with individual stock holdings in particular firms by owning a fully diversified portfolio of securities. As a consequence, shareholders are in a position to benefit from risky investments undertaken by the firm. By contrast, firms' managers have invested their own "human capital" in the

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<sup>24</sup> Spence & Zeckhauser, *Insurance, Information and Individual Action*, 61 AM. ECON. REV. 119 (1971).

<sup>25</sup> Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

firms for which they work.<sup>26</sup> These managers hold undiversified investments in their firm in the form of their own human capital.

Because they hold undiversified investments, corporate managers are likely to be more risk averse than corporate shareholders. This divergence creates a form of agency cost. For example, some commentators have suggested that the conglomerate merger wave of the 1960's, in which many American corporations sought merger partners in wholly unrelated industries, could best be explained on the basis of agency theory.<sup>27</sup> The large conglomerate provided managers with the benefits of diversification, because even if some units within the conglomerate structure fared poorly, other units would fare well. Shareholders neither needed nor wanted to pay for this diversification because they could diversify their own portfolios.

Jensen and Meckling's insight was that, when a firm sells its shares to the public, rational investors will be unwilling to pay a price for the firm's shares that reflects its full value in the hands of a single owner-manager.<sup>28</sup> Rather, the public investor, anticipating future divergences of interest between himself and the firm's managers, will pay the full value less the amount of the anticipated agency costs.<sup>29</sup> The important point here is that the initial owners who sell the firm's shares to the public bear the entire cost associated with the agency relationship. The cost comes in the form of the discount that prospective shareholders take when they invest in a firm in which managers' behavior will possibly deviate from a strategy of maximizing shareholder wealth.

The implication of Jensen and Meckling's insight into who bears the costs of the agency relationship is that initial owners have strong incentives to make credible promises that they will refrain from taking actions that diverge from shareholders' interests in order to increase the value they receive when going public. Managers can agree to certain operating rules, to budget restrictions, or to incentive compensation policies that provide assurances to shareholders that they will maximize firm value.

Managers can also agree to such things as independent directors, audit committees composed of independent directors, and regular visits by outside directors in order to reassure investors. But all of these devices are costly. For that reason, eliminating agency costs entirely is not in anybody's interest. Rather, it will pay to reduce agency costs only up to the point at which the next dollar spent on agency cost reduction garners one additional dollar

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<sup>26</sup> "Human capital" simply refers to the process of investing in obtaining valuable skills. Economists consider the years one spends in law school to be investments in human capital. Some human capital skills are generic, in the sense that they easily can be transferred from one job to another. Certain other human capital skills are thought to be firm-specific because they are valuable only to one particular firm.

<sup>27</sup> Amihud & Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).

<sup>28</sup> Jensen & Meckling, *supra* note 25, at 313.

<sup>29</sup> *Id.*

in shareholder wealth. For example, it would not make sense to spend \$100,000 to assure that a manager will refrain from engaging in an activity that costs the firm only \$25,000.

Jensen and Meckling call the resources spent by managers to reduce agency costs "bonding expenditures."<sup>30</sup> These expenditures include such things as incentive compensation contracts and personal legal liability for violations of the fiduciary duties of care and loyalty. In addition, shareholders will expend resources to monitor the activities of corporate management. The costs of these monitoring and bonding expenditures reduce the value of the firm below what it would be in a perfect world. Putting all of this together, one can more precisely define the term "agency costs" as the sum of all monitoring expenditures by the principal and the bonding expenditures by the agent, plus the residual loss that exists because it is simply uneconomical to eliminate all agency costs completely through monitoring and bonding. The Jensen and Meckling agency cost analysis reveals finally that devising new ways of reducing agency costs leads to economic gains.

In this context, corporate criminal activity may have net benefits for public shareholders because any revenue obtained from the activity inures to the shareholders. Since public shareholders generally bear no responsibility for a manager's crime, "they will have every incentive to hire managers willing to commit crimes on the corporation's behalf."<sup>31</sup> Thus, viewed from an agency cost perspective, shareholders may not be as vigilant about policing corporate crime as one might hope. On the other hand, managers themselves have strong incentives to refrain from engaging in criminal activity.

### B. *Risk Aversion and Corporate Criminal Conduct*

One of the ways in which agency costs manifest themselves is in the form of excessive risk-aversion by corporate actors. Thus a very basic implication of agency theory is that criminal activity by corporations will be *exceedingly rare*. Even with the most generous managerial compensation scheme in place, corporate actors must share the gains associated with any corporate criminal activity with their shareholders. On the other hand, the corporate actors face extremely high personal costs if they are caught engaging in criminal activity.

Thus, the most interesting question associated with corporate criminal activity is not how harshly it should be punished, but rather why it ever takes place at all. Before answering this question it is important to note that corporate criminal misconduct is rare. A study of corporate crime that defined crime broadly enough to include any corporate action punished by the government in any way, revealed only 1,283 convictions for corporate

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<sup>30</sup> Jensen & Meckling, *supra* note 25, at 308.

<sup>31</sup> POSNER, *ECONOMIC ANALYSIS OF LAW* 398 (3d ed. 1986).



crimes between 1984 and 1987.<sup>32</sup> Indeed, the number of organizational prosecutions is so rare that an outside counsel to the U.S. Sentencing Commission expressed the view that "a predominantly empirical approach relying on past practice is unlikely to provide an adequate and consistent basis for organizational sentencing reform" because of the "relatively small number of organizational prosecutions."<sup>33</sup>

But corporate crime does occur at least occasionally. Agency theory can provide some insights into when such behavior is likely to take place. At the outset, it should be noted that deviations between the interests of managers and the interests of shareholders are likely to increase as the size of a firm's shareholding population goes up.<sup>34</sup> As the number of shareholders grows, the benefits to individual monitoring decline. Two shareholders who own fifty percent each of a firm's stock are likely to do substantially more monitoring than 50,000 shareholders who own only a minute fraction of a firm's stock. Each of the two fifty-percent shareholders will capture one-half of the gains from their monitoring activities. Each of the 50,000 shareholders will capture only an infinitesimal fraction of any gains associated with monitoring.

The amount of organizational crime will also decline as the size of a firm increases. This accords with the basic principles of agency theory discussed above. Managers of large, widely-held firms will not be monitored as assiduously as those in smaller, closely-held firms. The managers of these widely-held firms, therefore, have more latitude to give expression to their preference for avoiding risk. One way such managers can avoid risk is by refraining from engaging in criminal conduct.

In contrast, managers in smaller firms are more likely to engage in criminal activities than managers in larger firms because they are able to capture a larger share of any gains garnered by such activities. Managers of corporations bear a disproportionate share of the risks associated with criminal conduct because it is they, and not the outside shareholders, who will go to jail, or at least suffer stigma, if authorities discover the illegal conduct. But these managers must share the proceeds of their activities with the shareholders. In the case of a large firm with a widely dispersed shareholding population, the small share of the gains from a criminal enterprise that a manager keeps will rarely compensate the manager for the personal risks he incurs by engaging in a criminal enterprise for his firm.

Consistent with the implications of agency theory, of the 1,283 corporations convicted of federal crimes during the four-year period between 1984 and 1987, "only about 10 percent crossed the threshold of \$1 million in sales

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<sup>32</sup> Cohen, *Corporate Crime and Punishment: A Study of Social Harm and Sentencing Practice in the Federal Courts, 1984-1987*, 26 AM. CRIM. L. REV. 605, 606 (1989).

<sup>33</sup> Parker, *supra* note 23, at 516.

<sup>34</sup> More precisely, monitoring is likely to decline as the number of people owning large percentages of a firm's shares declines. Since the ownership stakes in larger firms is highly disaggregated, the statement in the text is generally correct.

and 50 employees; less than 3 percent had traded stock."<sup>35</sup> Thus, small firms comprise the vast majority of the firms engaged in criminal activity. Moreover, it would be wrong to suggest that these statistics are misleading because there are more small firms than large firms. The very size and scope of the activities of larger firms permits ample opportunity for them to engage in criminal activities. Large corporations engage in transactions at many levels and in many markets. Lower- and middle-level managers have ample independence, and ample opportunity to engage in criminal conduct. Significantly, however, there is little evidence that they actually do so. Consistent with an agency cost approach to corporate crime, the data suggests that managers of smaller firms, who are more closely monitored, and who are in a position to capture a large share of the gains associated with criminal conduct, are more likely to engage in criminal conduct.

### C. *The Self-Interest Assumption*

The fact remains, however, that even the largest corporations are, on occasion, subject to criminal prosecutions. In 1990, General Electric Company was convicted of defrauding the government of \$10 million for a battlefield computer system.<sup>36</sup> Boeing, Inc., pleaded guilty in November, 1988 to illegally obtaining two secret Pentagon documents,<sup>37</sup> and in February, 1990, RCA pleaded guilty to illegally obtaining secret budget defense reports.<sup>38</sup>

This section of the Article will attempt to reconcile the insights of agency theory with the reality of criminal misconduct in very large corporations. It may simply be the case that some managers have a positive taste for risk, or enjoy engaging in criminal activities. While it appears uncontroversial that most managers are risk averse, tastes vary widely among individuals, and it is at least plausible that some small fraction of corporate managers genuinely prefers criminal conduct. This explanation, however, does not adequately account for criminal behavior by large organizations, because it fails to explain why managers of large firms engage in criminal activities on behalf of their firms instead of on their own behalf. After all, if a corporate manager is going to steal, why should he steal for his shareholders and not for himself?

Judge Posner has suggested another possible explanation for corporate crime. He has observed that if shareholders "bear no responsibility for a manager's crime, they will have every incentive to hire managers willing to commit crimes on the corporation's behalf."<sup>39</sup> In other words, even if only a

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<sup>35</sup> Cohen, Ho, Jones & Schleich, *Organizations as Defendants in Federal Court: A Preliminary Analysis of Prosecutions, Convictions and Sanctions, 1984-1987*, 10 WHITTIER L. REV. 103, 112 (1988).

<sup>36</sup> Sugawara, *Criminal Indictments, Training Bigger Guns on Corporations*, Wash. Post, Mar. 2, 1990, at A1, col. 2.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> POSNER, *supra* note 31, at 398.

small fraction of the population of potential corporate managers consists of risk-preferring people willing to commit organizational crimes on the shareholders' behalf, shareholders will seek these people out and hire them. It is not clear, however, how shareholders will be able to *identify* managers with a predisposition for engaging in criminal acts. In addition, in the large, publicly held firm, most managers who are in a position to commit crimes are hired by other managers, not by the shareholders, or even the firm's board of directors. Put another way, the agency cost/risk aversion argument presented here applies not only to corporate decision-makers themselves, but also to those people who *select* the corporate decision-makers. In large, publicly held corporations, it seems highly implausible that managers are selected on the basis of their willingness to engage in criminal activity.

But even if we assume that Judge Posner is correct, and that shareholders do in fact select managers with a proclivity to engage in corporate crime, the case for imposing criminal sanctions on the corporation—as distinct from individual shareholders—is an uneasy one. Surely no one believes that all of the shareholders in a publicly held firm are equally culpable for the hiring decisions of the firm. Rather, it is far more likely that a single dominant shareholder or a small group of block holders would dominate a firm's decision to hire a crooked manager. Thus, even in those rare situations to which Posner's model of devious shareholders selecting criminal managers applies, the appropriate remedy would be to pierce the corporate veil and impose sanctions on those shareholders responsible for the hiring decisions. To impose blanket criminal liability on the firm as a whole would punish innocent shareholders for the misdeeds of their fellow shareholders.

But corporate crime does occur, even though financial and economic theory does not explain why. There are at least three plausible explanations for why at least some managers will engage in criminal activities on behalf of their firms. First, it may be the case that managers are forced to engage in illegal behavior simply in order to keep their firm or their division afloat. As will be seen, even firms that are not on the verge of bankruptcy may find themselves in a situation in which criminal activity is necessary for survival. Second, the corporate culture in a particular industry may promote criminal conduct. That is, it may be the case that engaging in a particular course of conduct, though illegal, is standard practice in an industry. Under these circumstances, managers who engage in criminal conduct may believe the conduct is not illegal, or may believe they will not be prosecuted if caught. And, where illegal activity represents a corporate norm, criminal behavior will not have a stigmatizing effect on a manager, at least within the industry itself. Finally, corporations may run afoul of the criminal laws because the firm's key actors simply make a mistake. The corporation may miscalculate the legality of a particular activity, or the likelihood of criminal prosecution once government officials discover the activity. A changing political climate can transform a seemingly benign act into a criminal event.

### 1. Criminal Activity, Managerial Shirking, and the Risk of Insolvency

While corporate management may be risk averse during the normal course of business, the normal incentive structure of these managers may change radically when their firm is on the verge of bankruptcy. Once again, the managers' own investment in firm-specific skills greatly affects the analysis. Since, by definition, managers cannot transfer their firm-specific skills to other firms, the managers lose their investment in these skills if their firm goes under. Moreover, high-level managers have a difficult time securing comparable positions at other firms.<sup>40</sup> Thus managers of firms on the brink of insolvency have a strong incentive to take great risks to protect these firm-specific investments.

In addition to their loss of firm-specific human capital investments, managers of insolvent firms may suffer stigma in the job market. Even managers who are in no way responsible for the firm's insolvency may be stigmatized if their firm becomes insolvent. Potential employers may simply assume that managers of insolvent firms are inept. Because of the costs associated with acquiring and analyzing information about individual workers, potential employers may find it efficient to invoke this assumption as a crude rule of thumb in order to economize on information costs.

All this gives managers of firms on the brink of insolvency strong incentives to take great risks to avoid insolvency. For these reasons, managers may be inclined to engage in criminal activities such as bribing government officials, price fixing, or defrauding consumers, in an effort to increase corporate revenues.

While managers' efforts to avoid bankruptcy by taking huge risks may benefit shareholders, often they do not. A conflict between managers' and shareholders' interests arises in these circumstances. If a firm goes bankrupt, managers often lose their jobs. On the other hand, shareholders in firms that undergo a bankruptcy reorganization often receive securities that will have value if the reorganized firm is successful. In contrast, firms convicted of a crime can lose their entire net worth. In particular, firms convicted of government procurement fraud or program fraud may lose their ability to obtain government contracts. A recent study showed that 6.6% of all corporate offenders were formally disbarred or suspended from doing business with the government.<sup>41</sup> Indeed, there is evidence that firms convicted of defrauding the government may lose their ability to do business with the government even when their sanctions do not contain a penalty of formal suspension or disbarment. Thus, the 6.6% figure probably underestimates the percentage of convicted firms facing government disbarment.<sup>42</sup>

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<sup>40</sup> Indeed, it is a truism at firms specializing in corporate relocations that the higher a manager's salary, the more time the manager needs to find another job. The rule of thumb is that finding a new job takes one additional month for each additional \$10,000 increment in salary previously earned by a manager.

<sup>41</sup> Cohen, *supra* note 32, at 613-14.

<sup>42</sup> *Id.*

Criminal conduct by organizations on the verge of bankruptcy is a likely a manifestation of this divergence of interests between managers and shareholders, rather than an example of corporate anti-social behavior undertaken in the shareholders' interests. Similarly, when managerial ineptitude causes a firm to perform poorly, the firm's managers may engage in criminal activity to compensate for a poor level of performance and to avoid being displaced. This type of behavior also contravenes shareholders' interests because the shareholders would prefer to obtain good corporate performance through legal means, since there is less risk associated with legal earnings than with illegal earnings.

Thus, managers who engage in criminal conduct do not necessarily act in the best interests of their shareholders. Illegal conduct exposes shareholders to risks that shareholders would prefer to avoid and for which they receive no compensation. Self-interested managers will engage in criminal conduct on behalf of their organizations not to benefit shareholders, but instead to retain their jobs.

Managers of firms faced with the prospect of a hostile takeover face incentives similar to those in firms on the brink of insolvency. Because successful hostile takeovers generally result in a turnover of the target firm's top management, target firm managers have incentives to resist takeovers—even those that are in the best interests of the shareholders. Indeed, commentators have criticized devices such as poison pills, designed to discourage hostile takeovers, as vehicles that simply transfer wealth from corporate shareholders to corporate managers.<sup>43</sup>

But the most effective way for a firm to avoid a hostile takeover is to show consistently high earnings. High earnings increase the cost of a firm's shares, in turn, driving up the acquisition cost to outside bidders. Conceivably, managers will cause their firms to engage in illegal activities in order to increase earnings and discourage outside bidders. This explanation for illegal corporate conduct is implausible, however, for three reasons. First, there are legal anti-takeover devices that can effectively deter hostile bidders, or force them to negotiate with incumbent management. In particular, corporate boards of directors can, without shareholder approval, adopt the poison pill, a device that provides target shareholders with a warrant that entitles them to obtain a premium for their shares from the acquiring firm. In addition, various states, particularly Pennsylvania, have enacted tough anti-takeover measures that make it extremely difficult for a corporation to be acquired without the incumbent management's approval.<sup>44</sup>

Second, golden parachute contracts, which guarantee generous severance

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<sup>43</sup> Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984) (offering empirical evidence tending to show that target firm shareholders suffer losses when tender offers are defeated). *But see* Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (offering evidence that target firm shareholders benefit from takeovers).

<sup>44</sup> *See, e.g.*, 70 PA. CONS. STAT. ANN. §§ 71-85 (Purdon 1991).

pay for managers of firms taken over by outside bidders, reduce managers' incentives to engage in illegal conduct as a means of avoiding their ouster in a hostile takeover. Indeed, golden parachutes generally reduce the incentives of managers to resist takeovers by any means, including illegal activities. Thus, in light of the presence of low-cost, legal alternatives to engaging in corporate crime, it is unlikely that any corporate manager would find it in his interest to resort to crime to avoid a takeover.

Finally, the incentive that outside bidders have to monitor the target firm's illegal activities further explains why managers will not resort to illegal activities to avoid hostile takeovers. An outside bidder who discovers that a firm is propping up its earnings through illegal activities has every incentive to publicize those activities. The resulting publicity will drive down the price of the target firm's shares and lower the acquisition cost to the outside bidder. Thus, target firms are not likely to succeed at using illegal means to avoid takeover since discovery virtually guarantees a transfer of control.

This aspect of the agency cost perspective suggests still another explanation for corporate crime: managerial shirking. Corporate managers may recognize that they will be displaced through discharge or ouster in a hostile takeover unless they keep their firms' earnings at or above a particular level.<sup>45</sup> Managers may accomplish their goal of "satisficing" or maintaining a particular level of earnings<sup>46</sup> either by hard work and competence, or by engaging in criminal activity. Even a risk-averse manager will engage in criminal activity if, in his view, the risks associated with criminal activity are less than the risks associated with *not* engaging in criminal activity and performing so poorly that he loses his job. Thus, the threat of sub-optimal performance can cause managers to become risk preferrers. Put another way, managers' criminal activity may operate as a *substitute* for diligent managerial performance undertaken in the shareholders' interest. Under these cir-

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<sup>45</sup> For a discussion of satisficing to avoid hostile takeover, see Brown, *In Defense of Management Buyouts*, 65 TUL. L. REV. 57, 72-73 (1990).

<sup>46</sup> Satisficing has been defined as the desire to "seek choices that satisfy at least minimum levels of aspiration with respect to their several objectives." F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 34 (2d ed. 1980); see also Simon, *Theories of Decision-Making in Economics and Behavioral Science*, 49 AM. ECON. REV. 253, 262-65 (1959).

Satisficing to avoid hostile takeover is possible so long as there are positive transactions costs associated with takeovers. See Brown, *supra* note 45, at 73 n.45. The massive federal and state regulatory apparatus governing hostile acquisitions has raised the costs of launching a hostile takeover considerably. See Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978); Macey & Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U.L.Q. 131 (1987). These regulatory costs thereby increase the efficacy of satisficing by corporate management by providing incumbent management with a wider range of latitude in which to operate without fear of market discipline in the form of a hostile takeover.

cumstances, organizational crime represents a form of shirking because managers self-interestedly expose shareholders to increased risks. Not only does this type of criminal activity expose shareholders to the normal risks of failure, it also exposes them to the costs of criminal sanctions.

Similarly, a link between criminal activity and insolvency exists where criminal activity is *essential* to the survival of an otherwise healthy firm. As discussed above, firms on the brink of insolvency have an incentive to act illegally. In addition, for some firms, illegal activity becomes necessary because it represents an industry norm. The liquor industry during prohibition and the illegal drug trade today are paradigmatic examples of industries in which illegal activities are the norm. Firms engaged in these businesses must resort to illegal conduct to survive. Similarly, firms that do business in certain countries may find that they can enter markets in those countries only if they make illegal payments to certain officials. Where access to a particular market is essential to a firm's survival, it is in managers' interest to make these payments despite their illegality.

Similarly, as capital markets become more efficient, securities firms may be unable to maintain profitability unless they engage in insider trading. Finally, managers of firms that bid for government contracts may feel compelled to engage in illegal activities either to obtain critical information necessary for bidding, or to make corporate planning decisions based on complete information.

The point is not that illegal corporate activity undertaken to avoid insolvency is *acceptable*, but rather that it may be *understandable*. The structure of the agency relationship within a firm powerfully deters management from acting illegally. On the other hand, the threat of bankruptcy, which could deprive corporate managers of their investments in firm-specific human capital, and may stigmatize them in the managerial labor market, explains this seemingly irrational behavior.

## 2. Criminal Activity and Corporate Culture

Even in the most competitive markets, firms' behavior is often highly imitative. Because only the fittest firms survive in a market economy, firms presumably act efficiently. Firms faced with considerable cost and uncertainty in formulating strategies act rationally by imitating the observed behavior of other, similarly situated firms. Imitation, however, can send false signals to corporate managers. That an industry commonly follows a particular custom or practice may suggest to corporate managers that the activity is legally acceptable even if it is not. Even when managers know that a particular practice violates the law, corporate executives may conclude that authorities have chosen to overlook the practice if it falls within certain bounds. For example, many drivers believe that authorities will not issue speeding tickets to motorists who exceed the 55 mile-per-hour speed limit by only one or two miles-per-hour. Drivers know that it is illegal to travel 57 miles-per-hour in a 55 mile-per-hour speed zone, but they believe

that authorities will not enforce the speeding laws within this range. Although this general belief stems from drivers' observation of the behavior of other drivers, rather than any official announcement by enforcement officials, drivers appear to be confident that they will not be sanctioned for exceeding the speed limit by a certain amount.

Similarly, even risk-averse managers may engage in illegal activity if their observation of rival firms' behavior leads them to conclude that there is virtually no risk that authorities will prosecute them. In addition, corporate managers may conclude that, even if authorities discover and punish their conduct, they will not be stigmatized in the managerial labor market for following an industry norm.

### 3. Organizational Crime and Mistake

A final explanation for corporate criminal conduct is mistake: where corporate officers and directors engage in an activity that they believe is legal, but that is in fact illegal. For example, during the seventies, Securities and Exchange Commission investigations into unreported corporate earnings revealed that over 450 firms had covered up the payment of illegal gratuities in foreign or domestic business transactions.<sup>47</sup> The information uncovered in these SEC investigations led to the passage in 1977 of the Foreign Corrupt Practices Act, which made certain types of corporate payments illegal and required public companies to keep sufficiently accurate books and records to reveal the nature of all such payments.<sup>48</sup> While it appears that many of these payments were illegal before the passage of the Foreign Corrupt Practices Act,<sup>49</sup> it also appears that the firms making these payments were unaware of their illegality.<sup>50</sup>

Corporate managers are probably likely to make mistakes about the legality of a particular corporate act only for crimes of a highly technical nature. By contrast, corporate managers will probably not mistakenly believe that price fixing is permissible. The hopelessly complex regulatory environment in which the modern corporation must operate, however, creates plenty of opportunity for individual criminal acts. Nevertheless, we should expect corporate officers and directors to comply with certain laws, such as prohibitions on hazardous emissions and toxic wastes, or laws relating to worker safety, despite their technicality.

There are some regulatory areas, most notably those involving the federal securities laws, in which a mistaken impression that one's conduct is legal can lead to criminal sanctions. Attorneys who specialize in securities regulation have noted that the recent insider trading scandals have led to "the

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<sup>47</sup> J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 449 (1982).

<sup>48</sup> H.R. CONF. REP. NO. 831, 95th Cong., 1st Sess., *reprinted in* 1977 U.S. CODE CONG. & ADMIN. NEWS 4121 (mandating detailed record-keeping for securities).

<sup>49</sup> See Pitt & Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 195 (1990).

<sup>50</sup> *Id.*



criminalization of things that up to now have been viewed as technical violations of the securities laws, such as 'net capital violations, Section 13(d) violations, parking . . . [and] books and records.'"<sup>51</sup> The dramatically heightened emphasis on pursuing criminal sanctions for violating the laws against insider trading marks this trend. Throughout much of the eighties, authorities and legal experts doubted whether the SEC had the statutory authority to impose even *civil* sanctions, beyond mere injunctive relief against future violations, for insider trading.<sup>52</sup> For example, when the SEC brought civil charges against Raymond Dirks for allegedly acting as a "tipper" to some of his investment banking clients,<sup>53</sup> the Justice Department affirmatively opposed the SEC's position. As two distinguished securities lawyers observed, it was not surprising that the Supreme Court sided with the Justice Department, since, after all, "[i]f the Justice Department could not agree with the SEC on what the laws against insider trading covered, how could Mr. Dirks be expected to comply with those laws?"<sup>54</sup>

Because managers are likely to be more risk averse than shareholders during the normal course of corporate life, the managers are likely to be extremely cautious to avoid the possibility of mistakenly violating some criminal law. Excessive risk avoidance, however, imposes costs on shareholders in the form of decreased innovation, excessive internal controls, and increased reliance on outside counsel at all levels of corporate decision-making. In addition, the probability of criminal prosecutions for purely political reasons also increases managers' proclivities toward risk-aversion. The recent criminal indictment of Exxon in connection with the Valdez oil spill provides an example. In connection with the indictment, Attorney General Richard Thornburgh held a press conference to say that pursuing criminal charges would send a " 'strong signal that environmental crimes will not be tolerated.' "<sup>55</sup> Exxon was indicted under the Dangerous Cargo Act<sup>56</sup> and the Ports and Waterways Safety Act,<sup>57</sup> which, respectively, regulate the transportation of dangerous materials and mandate that ships hire competent crews.<sup>58</sup> Exxon was also indicted under the Migratory Birds Treaty

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<sup>51</sup> *Insider Trading, Internationalization, Rule '144A' Discussed at ABA Conference*, 19 Sec. Reg. & L. Rep. (BNA) No. 33, at 1242-43 (Aug. 14, 1987).

<sup>52</sup> Pitt & Shapiro, *supra* note 49, at 202-03.

<sup>53</sup> *Dirks v. SEC*, 463 U.S. 646 (1983).

<sup>54</sup> Pitt & Shapiro, *supra*, note 49, at 218 n. 298.

<sup>55</sup> *Another Political Prosecution?*, Wall St. J., Mar. 5, 1990, at A14, col. 1 [hereinafter *Another Political Prosecution*].

<sup>56</sup> 46 U.S.C. § 170 (1958).

<sup>57</sup> 33 U.S.C. §§ 1221-1227, 1229, 1232(a) (1986).

<sup>58</sup> *Another Political Prosecution*, *supra* note 55.

Act<sup>59</sup> for killing migratory birds, and the Refuse Act<sup>60</sup> for discharging and depositing refuse matter without a permit.<sup>61</sup>

The indictment has been called "a political case to please the environmentalists."<sup>62</sup> Whatever the merits of the various counts in the indictment, the message to other firms is strong. Corporate management, in an effort to avoid the taint of a criminal indictment, may be far less willing to engage in the level of risk-taking that shareholders or society would prefer.

#### 4. The Interplay of the Factors Leading to Corporate Criminal Conduct

Each of the three factors detailed above—insolvency, corporate culture and mistake—can lead even rationally self-interested corporate executives to commit crimes on behalf of their firms. In some cases, all three factors can work together to create a situation in which corporate managers will find it in their interest to engage in corporate crime. For example, a particular illegal activity may become the norm in an industry because firms find it impossible to survive in that industry without engaging in the illegal activity.

The defense procurement industry, widely thought to be fraught with criminal activity, is a case in point. The recent convictions of General Electric, Boeing, and RCA, for example, all involved allegations of illegal activities in connection with these firms' involvement in the defense industry.<sup>63</sup> Despite the huge size of the firms involved in the defense industry, the prospects of bankruptcy are far from trivial for these firms because of the risks involved in the industry itself. For such firms, one or two successful contract awards can make the difference between astounding success and dismal failure. Unlike most other firms, the range of possible outcomes for firms in the defense business are extreme: firms are likely to be either very successful or very unsuccessful. Under the analysis developed above, such firms are particularly likely to engage in illegal activities because of the high stakes involved.

In addition, for a long time, there was little if any scrutiny of defense contracting activities.<sup>64</sup> During the past seven years, twenty of the 100 largest defense contractors have been convicted of defense procurement violations.<sup>65</sup> This high conviction rate contrasts sharply with the four decades prior to 1983, when not a single major defense contractor was convicted of any procurement violation.<sup>66</sup>

These data are consistent with the discussion of corporate culture above.

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<sup>59</sup> 16 U.S.C. §§ 703-708, 709a-711 (1985).

<sup>60</sup> 33 U.S.C. § 407 (1986).

<sup>61</sup> *Another Political Prosecution*, *supra* note 55.

<sup>62</sup> *Id.*

<sup>63</sup> *See* Sugawara, *supra* note 36.

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

Although there is no reason to believe that managers today have a greater incentive to engage in defense procurement fraud than they had in the past,<sup>67</sup> the unlikelihood of convictions for corporate fraud before 1983 created a corporate culture in which managers simply presumed that certain activities, though illegal, were *de facto* permissible.

Finally, because the defense procurement business is fraught with technicalities, the possibilities for mistakes and for technical violations of the law are great:

defense contractors have to worry about conflict of interest laws when they hire employees, whether the marketing documents are illegal, whether cost estimates are accurate, whether testing is done according to government directions and what their relationships are with government officials.<sup>68</sup>

Thus, the greater risks of insolvency in the industry, the corporate culture, and the likelihood of management mistake operate to overcome corporate managements' normal risk aversion, and induce legal violations.

#### D. *Corporate Criminality and Shareholder Welfare*

A prominent commentator has observed that "[a] distinctive feature of organizational crime is that it is committed by agents for the primary benefit of a principal."<sup>69</sup> The analysis presented above casts considerable doubt on the conventional assumption that corporate shareholders inevitably benefit from corporate crime. The conventional assumption, embraced by virtually all legal scholars including those with an understanding of economic theory,<sup>70</sup> is inconsistent with the basic assumption that corporate managers, like other economic actors, are rational, self-interested individuals. As such, their incentives often diverge from those of their principals.

While executive compensation plans that include stock options, bonuses, and opportunities for advancement serve to align the interests of managers and shareholders, such devices are costly. It is simply not efficient for firms to go to the expense of bringing the interests of managers and shareholders into perfect alignment. In fact, managers of large, publicly held firms may be *more* risk averse than shareholders would prefer. If the societal savings

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<sup>67</sup> Of course it is not possible to rule out completely the possibility that in fact there has been an increase in corporate crime in the defense procurement industry. Conceivably, the increasing federal budget deficit, coupled with a widespread perception that the government should cut its defense budget because of diminishing Cold War tensions, has signalled to firms in the defense industry that there is likely to be a major contraction in the amount of business available. If so, the increased criminal activity is consistent with the prediction made here that organizational crime will increase as the threat of bankruptcy increases.

<sup>68</sup> Sugawara, *supra* note 36.

<sup>69</sup> Coffee, *Corporate Crime and Punishment, A Non-Chicago View of the Economics of Criminal Sanctions*, 17 AM. CRIM. L. REV. 419, 456 (1980).

<sup>70</sup> See, e.g., POSNER, *supra* note 31, at 397-99.

from reducing some corporate crime, such as procurement fraud or price fixing, is less than the cost to society of effectuating the reduction, it is hardly worthwhile to expend the resources necessary to achieve the reduction.

While it is true that shareholders may benefit *ex post* if the criminal activity of their managers goes undetected, it is not at all clear that shareholders necessarily benefit *ex ante*. While shareholders can spread the firm-specific risk associated with the investments they make in particular firms, managers cannot. In fact, shareholders may prefer managers to take certain business risks. If those risks generate high returns, the shareholders reap the benefits. If the risks lead to catastrophe, the losses to diversified shareholders may be offset by gains in other securities. When managers substitute corporate crime for diligent, honest performance in order to obtain sufficient earnings to avoid their own displacement, however, shareholders will be worse off *even if* the conduct goes undetected, because the conduct exposes shareholders to risks for which they receive no compensation. This explanation of the managerial incentive to engage in organizational crime stands in sharp contrast to the standard explanations in which managers are assumed to be perfect agents of their shareholders and engage in corporate crime only on the shareholders' behalf.

Just as corporate managers may be more risk averse than shareholders during the normal course of corporate life, they may be more risk-preferring than shareholders during the waning days of corporate existence, because they have so much more to lose. As discussed above,<sup>71</sup> shareholders may prefer to allow a firm to undergo a bankruptcy reorganization rather than to engage in criminal activity to avoid such a reorganization, while managers might prefer to have the firm engage in criminal acts to avoid insolvency. Shareholders, unlike managers, may be able to recoup some of their losses in a successful reorganization, while the managers stand to lose everything, including their jobs and their reputations as good managers.<sup>72</sup>

Similarly, in large, multi-faceted firms in which criminal activity is isolated in a particular division or subsidiary, the managers of those divisions or subsidiaries may engage in illegal activities in order to avoid being discharged for poor performance. The firm's shareholders and high-level managers would prefer the employees to refrain from engaging in illegal conduct, but the costs of detecting the conduct may be greater than the benefits to shareholders, managers, or society. Once again, the point is not that shareholders never benefit from corporate crime, even from an *ex ante* perspective. Rather, they do not *necessarily* benefit from the criminal actions that corporate managers undertake on their behalf.

The previous section of this article identified three situations in which even managers of large, publicly held firms may engage in criminal conduct. In addition to committing crimes when their firm is on the verge on insol-

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<sup>71</sup> See *supra* text accompanying notes 40-41.

<sup>72</sup> Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991).

vency, managers may also engage in illegal acts when doing so is the norm in a particular industry, or when managers erroneously think that a particular practice is legal. The above discussion presented the argument that engaging in criminal conduct when a firm is on the brink of insolvency may not benefit shareholders. The same holds true when the criminal conduct is a result of mistake or a function of the corporate culture in a particular industry.

To see why this is so, we need to examine the assumptions about how shareholders gain from organizational crime. It is generally presumed that firms engage in organizational crime in order to provide shareholders with *abnormally* high returns.<sup>73</sup> That is, taking into account the possibility of detection and punishment, illegal activities supposedly provide firms with rates of return in excess of those that the firms would obtain under normal, competitive market conditions. By raising the penalties for organizational crime, or by increasing the probability of detection, presumably the incidence of organizational crime will decline because firms will no longer stand to gain from such conduct.

But the analysis here, which suggests that firms sometimes engage in illegal activity because it is the norm in the industry, or because of mistake on the part of corporate managers, indicates that shareholders do not stand to earn abnormal returns from corporate criminal conduct. When a particular criminal activity, such as paying bribes to government officials, is the norm in a certain industry, any abnormal returns will be competed away by other firms. Thus, shareholders will not benefit in any meaningful sense from this sort of activity.

It is also unlikely that criminal activity due to mistake will produce abnormal returns for shareholders. The probability of detection is high for crimes committed as a result of mistake because officers and directors will not ordinarily attempt to cover-up this sort of illegal activity because they do not think it is illegal. When the mistake is committed because corporate officers imitate the behavior of other firms, the likelihood of shareholders earning abnormal returns becomes even more remote because, as seen above, any gains will be competed away by the various firms. When, as in the case of mistake, the probability of detection is quite high, it is improbable that firms will earn abnormal rates of return from such activities.

Thus, it is not at all clear that shareholders benefit from corporate crime. Sometimes, as in the bankruptcy context, when managers take risks that are excessive from the shareholders' point of view, corporate crime will conflict directly with shareholder interests. At other times, as in the corporate culture and mistake examples, there is no evidence that crime permits shareholders to earn abnormal returns. Indeed, in the case of the corporate culture example, there is no reason to believe that shareholders will earn abnormal returns *even if the activity goes undetected*.

In this regard, even in the unlikely event that shareholders manage to

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<sup>73</sup> The term "abnormal returns" refers to returns to investors exceeding the amount necessary to compensate them for the risks associated with the firm's activities.

attract managers willing to engage in criminal activities on their behalf, there is no reason to believe that shareholders will benefit from the managers' criminal acts because shareholders will have to compensate their managers for the expected costs of punishment.<sup>74</sup> Thus, the gains that shareholders might receive from employing managers willing to engage in corporate crimes are likely to be returned to managers in the form of higher compensation.

Finally, in assessing the efficacy of imposing organizational sanctions on firms engaging in misconduct, it is important to recognize that such organizational sanctions will not necessarily lead to increased deterrence. The Sentencing Commission, however, has described deterrence as the main purpose of punishing corporations.<sup>75</sup> In particular, the Commission observed that organizational sanctions would provide a "strong incentive for owners and managers of organizations to strengthen internal mechanisms for preventing officers and employees from committing crimes and for detecting and punishing such crimes that are committed."<sup>76</sup> But when illegal behavior is the norm, or when a firm erroneously believes that a particular venture is legal, it is unlikely that internal monitoring and enforcement mechanisms will decrease the incidence of corporate crime.

In the bankruptcy context, internal control mechanisms may serve the intended purpose of deterring corporate crime. But it is also likely that the internal monitors in a firm on the verge of insolvency will find their incentives closely aligned with the parties whom they are supposed to monitor. After all, the monitors of insolvent firms will find themselves just as unemployed as the people they are monitoring.

#### E. *Agency Costs as a Source of Criminal Law*

The agency cost perspective also suggests another major insight: agency costs may lead, under certain circumstances, to developments in the criminal law itself. That is, often it may not be in a shareholder's best interest to have a particular corporate activity declared illegal. But a divergence of interests between a firm's managers and its shareholders may lead management to lobby to have a particular activity declared illegal even though that activity is in the best interests of the firm's shareholders.

The pursuit of criminal prosecutions for stock parking provides an example. Stock parking involves the practice of placing one's stock holdings in the hands of other firms in order to conceal the full extent of one's holdings. The securities laws make it illegal for shareholders to accumulate more than five percent of a public company's stock without publicly disclosing their identity and motives to the SEC.<sup>77</sup>

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<sup>74</sup> POSNER, *supra* note 31, at 398.

<sup>75</sup> See U.S. SENTENCING COMM'N, SENTENCING GUIDELINES FOR ORGANIZATIONAL DEFENDANTS (preliminary draft, Nov. 1989).

<sup>76</sup> *Id.*

<sup>77</sup> See *Wellman v. Dickenson*, 682 F.2d 355, 363-67 (2d Cir. 1982).

These provisions also include disclosure requirements under which bidding shareholders must reveal any valuable information that they discover about the target firm when the target firm's share price does not reflect that information. For example, a bidding firm may discover that a particular target firm is not taking full advantage of a certain asset, or that its overhead is too high, or that its management is inept.

By forcing bidding firms to disclose this information, the securities laws deter hostile bids for target companies by raising the cost of making such bids. Stock parking is the principal means by which bidding firms attempt to evade the reach of these disclosure provisions. By parking stock in friendly hands, bidding firms can make it appear that they own or control less stock than they actually do, thereby delaying the applicability of the disclosure obligation.

These disclosure rules benefit target firm management by making hostile takeovers less likely. On the other hand, the rules harm target firm shareholders by making it less likely that shareholders will be able to sell their shares at a premium to an outside bidder. In short, strict enforcement of the laws against stock parking benefit target-firm management but harm target-firm shareholders. Thus corporate managers who put political pressure on Congress and the SEC to encourage criminal sanctions against bidders engaged in stock parking do not act in the best interests of their shareholders. Instead, these corporate managers act to benefit themselves at the expense of their shareholders.<sup>78</sup> In other words, corporate criminal law itself, responding to management pressure to increase criminal penalties for stock parking and other laws that make takeovers more difficult, reflects the divergence in the agency relationship.

## II. AGENCY THEORY AND OPTIMAL PENALTY THEORY

Risk aversion plays a key role in the discussion of corporate crime above. The preceding section demonstrates, through the concept of risk aversion, that corporate managers often engage in corporate crime for self-interested reasons. When this is so, corporate criminal acts, though beneficial to a firm *ex post* if they go undetected, are harmful to shareholders *ex ante*.

Risk aversion also plays a key role in the economic analysis of optimal penalties for criminal acts. Optimal penalty theory begins with the basic observation that the penalty for a crime represents the social loss created by the offense adjusted to reflect the probability that the offender will escape detection. Suppose, for example, that a particular crime involves total social costs of \$1000. If the probability of detection is 100%, the offender will bear the total social costs of his crime if the penalty is set at \$1000. If the probability of detection is only ten percent, the fine must be set at \$10,000.

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<sup>78</sup> See *Bilzerian Sentenced, Parole Called 'Unlikely'*, NAT'L L.J., Oct. 9, 1989, at 6 (Bilzerian sentenced to six concurrent four-year jail terms and fined \$1.5 million for parking stock).

If the probability of detection is one in 1000, the fine should be \$1,000,000.<sup>79</sup> Each of these penalty schemes leads to an expected penalty, or certainty equivalent, of \$1000.<sup>80</sup>

If the costs of collecting fines are positive, but do not vary with the amount of the fine, the most efficient criminal sanction would impose extremely high fines, and would not concern itself with devoting large amounts of resources to detection in order to raise the probability of detection. Put another way, if we can achieve the optimal deterrence of crime by imposing any of a variety of penalties, we should select the enforcement scheme that imposes the lowest administrative cost. Because increasing the probability of detecting criminals is costly, the optimal deterrence scheme may involve keeping the probability of detection low and the penalties high.<sup>81</sup>

It is important to note that the preceding analysis applies only when the population of potential criminals is risk-neutral. While an assumption of risk-neutrality applies to corporate shareholders, who can diversify their investments, the assumption does not readily apply to corporate officers and directors, who are risk averse because they are unable to diversify their firm-specific human capital investments.<sup>82</sup>

When the relevant corporate decision-makers are risk averse, however, the analysis of optimal penalties changes dramatically. The relevant decision-makers, at least in the large, publicly-held corporation, are not the firm's shareholders, but its officers and directors. And when corporate managers are risk averse, they will refrain from engaging in criminal activity under the threat of stiff penalties even when the benefits of the activity are greater than the certainty equivalent of the fine. In such circumstances,

an increase in the fine will not be a costless transfer payment . . . . [F]or criminals who are risk averse, every reduction in the probability of apprehension and conviction, and corresponding increase in the fine for those who are apprehended and convicted, imposes a disutility not translated into revenue by the state. Thus the real social costs of fines increases for risk averse criminals as the fine increases.<sup>83</sup>

Because apprehension for criminal offenses inevitably imposes costs on corporate decision-makers and on corporate shareholders, raising the penalties for corporate crime can involve real social costs from the perspective of shareholders and society, because high penalties lead managers to be exces-

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<sup>79</sup> POSNER, *supra* note 31, at 207.

<sup>80</sup> If the probability of detection is 100%, setting the penalty at \$1000 produces an expected fine of \$1000 because  $1000 \times 1 = 1000$ . If the probability of detection is 10% , setting the fine at \$10,000 produces an expected penalty of \$1000 because  $10,000 \times .1 = 1000$ . If the probability of detection is only one in 1000, setting the fine at \$1,000,000 produces an expected penalty of \$1000 because  $1,000,000 \times .001 = 1000$ .

<sup>81</sup> A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 76 (1983).

<sup>82</sup> See *supra* text accompanying note 26.

<sup>83</sup> Posner, *supra* note 31, at 207-08.



sively risk averse. In other words, the agency cost approach to corporate sanctions suggests that it is inappropriate to base corporate fines on the assumption that corporations are risk neutral, and that, for that reason, we should impose stiff fines. Instead, increasing the penalties for corporate crime leads to a net reduction in social welfare because corporate managers will refrain from engaging in activities even when the expected benefits outweigh the expected societal costs.

Previous attempts to apply optimal penalty theory to corporate crime, even by sophisticated commentators, have assumed that it is appropriate to treat organizations as risk neutral.<sup>84</sup> But this assumption holds true only when interests between managers and shareholders do not diverge. In fact, it seems clear that managers will be significantly more risk averse than shareholders. We should formulate organizational sanctions with this fact in mind.

### CONCLUSION

This Article has applied an agency cost perspective to the subject of corporate crime. In this context, agency costs refer to the divergence of interests between corporate managers and shareholders, an inevitable consequence of the separation of ownership and management within the large, publicly held corporation. This divergence of interests manifests itself in the form of corporate officers' and directors' excessive risk aversion.

The agency cost approach to corporate crime taken in this Article suggests that the problem of corporate crime may not be as significant as popularly believed. The divergence of interest between shareholders and managers in terms of their relative proclivities for bearing risk creates a natural impediment to corporate crime. The data seem consistent with this implication. As one commentator has observed, "perhaps the most striking fact emerging from the data [on corporate crime] is the small volume of organizational prosecutions."<sup>85</sup> Thus, that corporate crime exists at all is rather surprising when we recognize that corporate crime appears to impose costs on corporate decisionmakers out of proportion to its potential benefits. The benefits of corporate crime, in any event, accrue mainly to shareholders.

Commentators too often treat corporate crime implicitly as a rare form of altruism, in which corporate managers risk heavy fines, social stigma, and even jail in order to increase shareholder wealth. This Article takes issue with these characterizations. It argues that, while we should expect that corporate officers and directors will engage in corporate crime only rarely, when they do so, their actions often further their own interests rather than those of their shareholders.

In particular, this Article has identified three situations in which we are

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<sup>84</sup> See, e.g., Parker, *supra* note 23, at 583 ("The underlying attitude of business organizations is likely to be risk neutral.").

<sup>85</sup> *Id.* at 521.

likely to observe corporate crime. First, when a firm is performing poorly, and managers face the prospect of a corporate reorganization or discharge for incompetence, they may be willing to take the risks of engaging in criminal acts even when criminal conduct does not serve the best interests of the firm's shareholders. Similarly, managers may engage in criminal conduct as a *substitute* for non-criminal conduct in order to raise earnings to a sufficient level that they avoid discharge or ouster in a hostile takeover. Finally, managers may engage in criminal activity because the risks associated with detection and punishment are less than the professional risks associated with a poor performance.

Thus, the threat of sub-optimal performance can induce managers to become risk preferrers relative to shareholders. For example, managers may engage in criminal acts because they fear imminent bankruptcy. The threat of sub-optimal performance can also lead managers to view criminal activity as the least risky alternative available at any given time. In either of these situations, corporate criminal conduct makes shareholders worse off, because, all else being equal, shareholders generally prefer the corporation to attain a particular level of earnings through honest, rather than dishonest conduct.

Second, corporate criminality can result from imitation within a particular corporate culture. That is, the general patterns of conduct of firms in a particular industry may signal to well-meaning, risk-averse officers and directors that their conduct is not illegal. Finally, organizational crime may arise from management mistake about either the applicability of certain laws or the relevant political landscape. These misjudgments can lead to heavy costs on corporate decisionmakers. It is unlikely that corporate criminality resulting from either imitative behavior or mistake provides abnormal returns to shareholders.

We should approach the subject of increased sanctions for organizational crime with caution. Increased organizational penalties may induce corporate managers to be excessively risk-averse. What ensues is a stifling of innovation and an increase in costly internal control systems—costs borne ultimately by consumers. Once we recognize that organizational crime only sometimes benefits the investors on whose behalf it ostensibly is undertaken, a case-by-case approach to corporate crime seems desirable. The politicization of the U.S. Sentencing Commission also suggests the desirability of a case-by-case approach. Politicization makes it unlikely that policymakers will consider the interests of innocent shareholders in formulating sentencing guidelines.