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## **SHOULD THE BEHAVIOR OF TOP MANAGEMENT MATTER?**

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## **SHOULD THE BEHAVIOR OF TOP MANAGEMENT MATTER?**

**By: Vikramaditya S. Khanna<sup>†</sup>**

### ***Abstract***

Recent events, such as the Enron, Worldcom, and Global Crossing debacles, have brought to the forefront the issue of corporate and organizational wrongdoing and the involvement of top management in it. To date, the law's response to the knowing or reckless involvement of top management in corporate wrongdoing has been primarily two-fold. First, it increases the sanction imposed on top management. Second, it increases the sanction imposed on the corporation (i.e., the shareholders). This paper examines the second response.

The second response can be examined in multiple ways depending on the analytical perspective being utilized. In this paper I consider the question from three perspectives. First, whether our current law can be justified under a deterrence-based approach to corporate criminal liability. This is the bulk of the paper as that has been where much of the literature in the corporate crime area has developed. Second, whether our current law can be justified under an expressive approach to corporate criminal liability. Third, whether our current law might reflect an attempt to place most of the risk of liability on the corporation, which is generally a better risk bearer than top management. My conclusions are that our current law is difficult to justify under any of these approaches and that it is likely imposing costs on society. This suggests that our current law is in need of reform.

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# SHOULD THE BEHAVIOR OF TOP MANAGEMENT MATTER?

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## I. INTRODUCTION.

It is well known that top managers play pivotal roles in guiding the behavior of their corporations.<sup>1</sup> However, as the recent Enron, Worldcom and Global Crossing debacles exemplify, top management may knowingly or recklessly take the corporation down a criminal or tortious path.<sup>2</sup> When this happens the law must decide how to respond. To date, the law's response to the involvement of top management in corporate wrongdoing has been primarily two-fold. First, top management may be sanctioned directly.<sup>3</sup> Second, the

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<sup>1</sup> Indeed, much scholarship and commentary has honed in on top management as being the crucial players in directing corporate or organizational activity. See e.g. Jayne W. Barnard, *Reintegrative Shaming in Corporate Sentencing*, 72 S. CAL. L. REV. 959, 976 (1999); Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 619 (2001); Eli Lederman, *Models for Imposing Corporate Criminal Liability: From Adaptation and Imitation Toward Aggregation and the Search for Self-Identity*, 4 BUFF. CRIM. L. REV. 641, 660 (2000); Craig LaChance, *Nature v. Nurture: Evolution, Path Dependence and Corporate Governance*, 18 ARIZ. J. INT'L & COMP. L. 279, 283 – 85 (2001).

<sup>2</sup> See William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1410- 1415 (1999); MARSHALL B. CLINARD, *CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT*, 71 (1983); Anthony J. Daboub et al., *Top Management Team Characteristics and Corporate Illegal Activity*, 20 ACAD. MGMT. REV. 138, 138-39 (1995); MARSHALL B. CLINARD, U.S. DEP'T OF JUSTICE, *ILLEGAL CORPORATE BEHAVIOR*, 7 (1979); Simeon M. Kriesberg, *Decisionmaking Models and the Control of Corporate Crime*, 85 YALE L.J. 1091 (1976). On Enron generally see Clifton Leaf, *White-Collar Criminals: They Lie, They Cheat, They Steal, and They've Been Getting Away With It For Far Too Long*, FORTUNE, March 18, 2002 at 60; Mike France, *Punishment for Corporate Fraud? How Radical*, BUSINESS WEEK, March 11, 2002 at 33; Carrie Johnson, *Enron Case Shapes Up As Tough Legal Fight*, WASH. POST, February 18, 2002 at A01; Peter Behr & David S. Hilzenrath, *Top Executives Blamed in Enron's Fall; Internal Investigation Details Failure to Supervise Partnerships*, WASH. POST, February 3, 2002 at A01; John R. Emshwiller & Rebecca Smith, *Joint Venture: A 1997 Enron Meeting Belies Officers' Claims They Were in the Dark*, WALL STREET JOURNAL, February 1, 2002 at A1; Joann S. Lublin & John R. Emshwiller, *Enron Board's Actions Raise Liability Questions*, WALL STREET JOURNAL, January 17, 2002 at C1.

<sup>3</sup> See RESTATEMENT (SECOND) OF AGENCY §§ 212-13, 215, 217B, 219 (1958); *Developments in the Law - Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247-51, 1260

corporation may be punished more severely when top management is involved in wrongdoing than when some other employee is similarly involved.<sup>4</sup> Although both responses are important and arise frequently together, legal commentary has focused almost exclusively on the first response.<sup>5</sup> The aim of this paper is to remedy this by examining the second response.

Examples of the second response include the provisions of the Organizational Sentencing Guidelines, the Model Penal Code's liability provisions, punitive damages assessments, and liability standards in numerous states and foreign jurisdictions.<sup>6</sup> The effect of these various provisions is that a corporation may suffer a greater sanction when top management is involved in wrongdoing holding all else equal. For example, if a non-top management employee is involved in wrongdoing then that employee would suffer a sanction of, say, \$1 Million and the corporation would also suffer a \$1 Million fine (a total of \$2 Million). However, if a member of top management engages in the *same* wrongdoing that person may suffer a sanction of \$1 Million and the corporation would suffer a greater sanction of, say, \$2 Million (a total of \$3 Million). Indeed, this practice is not unique to corporations – almost all organizations are punished more severely when their leaders are involved in wrongdoing compared to when non-leaders are involved.<sup>7</sup> This is so even if the harm caused by the leader and non-leader is the same.<sup>8</sup> In spite of the commonality of this pattern there is little

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– 1275 (1979); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J., 857, 859-61 (1984); A. Mitchell Polinsky & Steven Shavell, *Should Employees be Subject to Fines and Imprisonment given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 (1993); Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984); Richard A. Posner, *Optimal Sentences for White-Collar Criminals*, 17 AM. CRIM. L. REV. 409 (1980).

<sup>4</sup> See U.S. SENTENCING GUIDELINES MANUAL at §8C2.5(b); MODEL PENAL CODE § 2.07(1)(c); Pamela Bucy, *Organizational Sentencing Guidelines: The Cart Before the Horse*, 71 WASH. U.L.Q. 329 (1993); Laufer, *supra* note 2, at 1384-5 (discussing penalties under the United States Sentencing Guidelines); William S. Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647 (1994); William S. Laufer, *Culpability and the Sentencing of Corporations*, 71 NEB. L. REV. 1049 (1992); Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 785 – 787 (1992); Anthony Ragozino, *Replacing the Collective Knowledge Doctrine with a Better Theory for Establishing Corporate Mens Rea: The Duty Stratification Approach*, 24 Sw. U. L. Rev. 423, 449 (1995) (discussing penalties under the Model Penal Code).

One could also consider imposing greater sanctions on third parties (e.g., lawyers, accountants) when top management is involved in wrongdoing, but this paper will not engage in that discussion. See generally Kraakman, *infra* note 155.

<sup>5</sup> See Kraakman, *supra* note 3; Polinsky & Shavell, *supra* note 3; Posner, *supra* note 3; Sykes, *supra* note 3; *Developments*, *supra* note 3.

<sup>6</sup> See U.S. SENTENCING GUIDELINES MANUAL at §8C2.5(b); MODEL PENAL CODE § 2.07(1)(c); Laufer, *supra* note 2, at 1384-5 (discussing penalties under the United States Sentencing Guidelines); Ragozino, *supra*, note 4; Linda K. Hollander, *New 1996 Trend in New Mexico Law: 1994-95 TORT Law—New Mexico Holds Corporations Liable for Punitive Damages Based Upon the Actions of Managerial Agents: Albuquerque Concrete Coring Co. v. Pan Am World Services, Inc.*, 26 N.M. L. REV. 617, 619-620 (discussing punitive damages).

<sup>7</sup> See Laufer, *supra* note 2, at 1384 (discussing higher United States Organizational Sentencing Guidelines sanctions for organizations where wrongdoing was by high-level personnel); U.S. SENTENCING GUIDELINES MANUAL, ch. 8 (defining high level personnel). Note that non-profits have different liability rules. For charitable immunity, see 25 A.L.R. 4<sup>th</sup> 517, *Tort Immunity of Non-governmental Charities* (1983).

<sup>8</sup> See Laufer, *supra* note 2, at 1384.

functional analysis of *why* the involvement of top management (or a leader), as opposed to some other employee's involvement, should have such an impact on the sanction a *corporation* (or organization) suffers. This paper aims to examine this issue and thus does not discuss how much of a penalty should be imposed on top managers individually. In other words, this paper examines whether the knowing or reckless behavior of top management or leaders should matter in setting *corporate or organizational* sanctions.

This question can be addressed in multiple ways depending on one's analytical perspective. In this paper I consider the question from three perspectives. First, whether our current law can be justified under a deterrence-based approach to corporate criminal liability. This is the bulk of the paper as that has been where much of the literature in the corporate crime area has developed. Second, whether our current law can be justified under an expressive approach to corporate criminal liability. Third, whether our current law might reflect an attempt to place most of the risk of liability on the corporation, which is generally a better risk bearer than top management. My conclusions are that our current law is difficult to justify under any of these approaches and that it is likely imposing costs on society. This suggests that our current law is in need of reform – a matter I discuss later in the paper.

Part II begins by briefly setting out the principles of corporate liability and examining the various ways in which the behavior of top management can influence corporate sanctions.<sup>9</sup> With this background we can then examine whether our current law can be justified or explained by the approaches discussed above.

As the bulk of the analysis focuses on the deterrence-based approach to corporate criminal liability I begin by examining what factors should matter in setting corporate sanctions from that perspective (Part III). These factors are the harm caused, the likelihood of the firm being sanctioned, and the effectiveness of the firm's internal enforcement measures. I then ask whether the involvement of top management in wrongdoing correlates with movements in these factors (Part IV). If it does then we have some reason to adjust corporate sanctions in response to it. This then provides us with the potential benefits of increasing corporate sanctions when top management is involved in wrongdoing. I then examine some costs associated with increasing corporate sanctions when top management is involved in wrongdoing (Parts V and VI). By examining both the benefits and costs we can determine whether the law's current approach is socially desirable. My primary conclusions are that it is difficult to justify our

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<sup>9</sup> See V.S. Khanna, *Is the Notion of Corporate Fault a Faulty Notion?: The Case of Corporate Mens Rea*, 79 B.U. L. REV. 355, 369-370 (1999)(citing: RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING § 3.4.2, at 198-203, § 4.1-.2, at 263-84 (1994)); Laufer, *supra* note 2, at 1384-5.

current approach of *always* increasing corporate sanctions when top managers are involved in wrongdoing and that a much more contextual approach is warranted. This contextual approach would focus on when top management's involvement in wrongdoing operated as a desirable proxy for relevant sanctioning factors, such as the harm caused, the probability of the firm being sanctioned and the effectiveness of the firm's internal enforcement measures. The following paragraphs lay out the analysis in a little more detail.

Part III starts the discussion by asking how corporate sanctions should be set under a deterrence-based approach. This is examined in two parts. First, section A examines why corporate liability (in addition to liability for the individual wrongdoer) may be desirable. After all, corporations do not act – individuals do. The most commonly forwarded reason for corporate liability is that individual wrongdoers do not have sufficient assets to meet likely judgments.<sup>10</sup> If individuals are effectively judgment proof they are unlikely to take appropriate measures to avoid wrongdoing.<sup>11</sup> However, the corporation and the individual together may have sufficient assets to cover likely judgments and imposing liability on the corporation would induce it to take some measures, that individuals would not have the incentive to take, to avoid or reduce wrongdoing.<sup>12</sup> This then enhances deterrence. Second, assuming that corporate liability might be desirable, section B examines how one should set *corporate* sanctions. In many instances inquiry into the harm caused and the probability of the corporation being sanctioned may be sufficient to set the socially desirable sanction.<sup>13</sup> However, in a number of cases these two factors may not be sufficient and other factors, such as the effectiveness of the internal processes the corporation has in place to prevent or deter wrongdoing, become important.<sup>14</sup>

Part IV examines how the involvement of top management in wrongdoing might influence the sanctioning factors identified in Part III. If top management's involvement does influence these factors then we have a reason to adjust corporate sanctions in response to that involvement. This provides us with the potential benefits of increasing corporate sanctions when top

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<sup>10</sup> See Kraakman, *supra* note 3; Sykes, *supra* note 3; Posner, *supra* note 3; Lewis A. Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345, 1349 (1982).

<sup>11</sup> See Kraakman, *supra* note 3; Kornhauser, *supra* note 10; Sykes, *supra* note 3.

<sup>12</sup> See Kraakman, *supra* note 3; Kornhauser, *supra* note 10; Sykes, *supra* note 3; Vikramaditya S. Khanna, *Corporate Liability standards: When Should Corporations be held Criminally Liable?*, 37 AM. CRIM. L. REV. 1239, 1244-45 (2000)(citing: Sykes, *supra* note 3).

<sup>13</sup> See Kraakman, *supra* note 3; Kornhauser, *supra* note 10; Sykes, *supra* note 3; Khanna, *supra* note 12. I do not discuss the possibility that liability standards (such as mens rea or intent) may be methods of curtailing rent-seeking litigation. For greater discussion of that see Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S.CAL. L. REV. 657 (2001).

<sup>14</sup> See Khanna, *supra* note 12, Kraakman, *supra* note 3. Indirect measures for these factors (i.e., proxies) are important when direct inquiry is either too expensive or would not reveal sufficient information relative to indirect inquiry. See Khanna, *supra* note 9, at 383.

management is involved in wrongdoing. The analysis suggests that there may be *some* pockets of corporate wrongdoing where it is desirable to increase corporate sanctions when top management is involved in wrongdoing.<sup>15</sup> The critical inquiries are usually (i) how does the involvement of top management in wrongdoing work as a *proxy* for factors relevant to sanctioning and (ii) whether a proxy is *needed* for these factors or would direct inquiry be preferable. The answers to these questions will likely vary across the types and degrees of wrongs. Consequently, our current pattern of *consistently* increasing corporate sanctions because of top management involvement is difficult to justify.

Part V further develops the analysis by considering some social costs associated with increasing corporate sanctions when top management is involved in wrongdoing. In particular, such a sanctioning scheme might lead to management gathering less information about product risk (which increases the likelihood of harm and agency costs),<sup>16</sup> greater monitoring costs, and potentially too little production of certain goods and services. In light of the analysis in Parts IV and V, one might conclude that increasing corporate sanctions because top management is involved in wrongdoing is desirable in only some instances. This suggests that a contextual (i.e., fact-specific) approach to setting corporate sanctions is preferable, however our law does not adopt such an approach. Instead, the law consistently increases corporate sanctions when top management is involved in wrongdoing.

Part VI examines some reasons why the law might adopt an “across the board” sanction increase when a more contextual approach is desirable. One reason, discussed in Section A, is that the administrative and error costs associated with a contextual approach are quite high. In order to avoid these costs we might opt for a simple across the board rule. I discuss this argument and conclude that there is little evidence to think that this is a viable justification today. This is because courts already engage in this kind of contextual analysis, for other reasons, and asking them to rely on it when assessing the impact of top management’s involvement on corporate sanctions should not add appreciably to the costs of adjudication. Section B then considers another reason – that top management’s involvement in corporate wrongdoing weakens the informal sanctions or norms within the corporation against wrongdoing and that this may provide a reason to increase corporate sanctions even if the other sanction setting arguments do not.<sup>17</sup> I discuss this possibility and conclude that although top management’s behavior is important in setting informal sanctions within the

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<sup>15</sup> See *infra* Parts IV & V.

<sup>16</sup> See Khanna, *supra* note 9, at 369-370 (citing RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING § 3.4.2, at 198-203, § 4.1-.2, at 263-84 (1994)).

<sup>17</sup> See *infra* Part VI.B; Ellickson, *infra* note 140; Posner, *infra* note 140; Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 37 J. LEGAL STUD. 765 (1998).

corporation, this may not provide a reason, independent from those in Parts IV and V, for increasing corporate sanctions. Thus, it is difficult to justify our current law under a deterrence-based approach.

Part VII considers alternative justifications and explanations for our current law. Section A discusses expressive considerations. For example, that members of society might obtain some utility or psychic gain by imposing greater corporate sanctions when top management is involved in wrongdoing and that we may wish to shape behavior by sending messages to society through corporate liability.<sup>18</sup> The current state of scholarship developing these arguments is somewhat nascent, nonetheless one cannot dismiss the arguments out of hand.<sup>19</sup> My analysis suggests that the expressive considerations can be furthered by other, socially less costly, forms of liability. In any event, these expressive considerations come at the expense of otherwise unjustified (and hence costly) impositions of higher corporate sanctions and these costs should be recognized when determining whether to pursue such expressive considerations. This pushes us toward a contextualized inquiry. Section B then discusses whether shifting the risk of liability on to the corporation might be desirable because it is generally the better risk-bearer than top management. My analysis suggests that this argument is fairly weak in the context of knowing or reckless wrongdoing by top management.<sup>20</sup> Indeed, shifting liability away from top management when it is knowingly or recklessly involved in corporate wrongdoing is dangerous. This is because if the corporation cannot shift this liability back to top management, which is likely because bargaining between them is less than “arm’s length”, then a weakening in deterrence is likely.

The overall results of my analysis are discussed in Part VIII. They show that, although top management’s behavior matters a great deal in influencing the behavior of other corporate agents and the corporation itself, there are only some instances where the involvement of top management in corporate wrongdoing should result in greater corporate sanctions. This suggests that we need to contextualize our law more. Further, if one potential *explanation* for our current approach is that it serves to deflect liability away from managers and on to the corporation then that is undesirable. This may often generate socially costly outcomes and suggests serious reconsideration of our current law.

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<sup>18</sup> See *infra* Part VI.C. See Kaplow & Shavell, *infra* note 145. The intuition is that leaders of the corporation set the norms and in some senses the expectations that other employees have when working for the corporation. See Peter H. Huang & Ho-Mou Wu, *More Order without More Law: A Theory of Social Norms and Organizational Cultures*, 10 J.L.ECON. & ORG’N 390 (1994). If the leaders are themselves involved in wrongdoing, the likelihood that other employees will be law-abiding might be reduced. See *id.*, at 397.

<sup>19</sup> See Kaplow & Shavell, *infra* note 145.

<sup>20</sup> See Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002); John C. Coates IV & V.S. Khanna, *An Analysis of Directorial Liability: Of Enron & Caremark*, (Draft paper 2002) discussing this and related issues.

## II. THE LEGAL TREATMENT OF TOP MANAGEMENT'S INVOLVEMENT IN CORPORATE WRONGDOING.

When the top managers of an organization (e.g., the chief executive officer, chief financial officer, president, vice-president, chief technical officer) are involved in wrongdoing, their actions could have numerous effects on the sanctions imposed on the corporation and those associated with it. For the sake of clarity, the phrase “involved in wrongdoing” and similar terms in this paper refer roughly to those instances where top managers have participated in some aspect of the wrongdoing with at least a reckless or knowing state of mind.<sup>21</sup>

### A. *Basic Corporate Liability and Respondeat Superior.*

In the US and elsewhere there are roughly speaking two methods of holding corporations liable for the behavior of their agents – *respondeat superior* and the “alter ego” approach. At the Federal level and in many states the doctrine of *respondeat superior* holds corporations liable for the behavior of their agents.<sup>22</sup> This requires that the agent be acting “within the scope of employment” and with some intent to benefit the corporation.<sup>23</sup> Liability attaches regardless of whether the agent was a line employee or the chief executive officer and applies to both civil and criminal liability for corporations in the US.<sup>24</sup> Thus, any corporate agent’s behavior could trigger liability for the corporation and for that agent.

If, however, the agent happens to be a member of “top management” then the liability consequences may be more serious. Corporate liability and liability for the top manager may already exist, but often there is an additional sanction on the corporation because of the involvement of top management. To simplify assume that when any non-top management agent engages in wrongdoing the corporation faces a sanction of X and the individual agent faces a sanction of Y.

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<sup>21</sup> See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 819-822 (2001) (noting that participation in “wrongdoing”, scienter: knowledge or recklessness are sufficient for 10(b) securities violation); Scott H. Moss, *The Private Securities Litigation Reform Act: The Scienter Debacle*, 30 SETON HALL L. REV. 1279, 1283 (2000) (stating that scienter: knowledge or recklessness sufficient for PSLRA violation). This approach excludes cases involved negligent supervision.

<sup>22</sup> See RESTATEMENT (THIRD) OF AGENCY §2.04 (2000), Khanna, *supra* note 9, at 369-370 (citing: RICHARD S. GRUNER, CORPORATE CRIME AND SENTENCING § 3.4.2, at 198-203, § 4.1-.2, at 263-84 (1994)).

<sup>23</sup> See Khanna, *supra* note 9, at 370 (citing: *Developments in the Law-- Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1247 (1979)); Kornhauser, *supra* note 10, at 1349.

<sup>24</sup> See *Developments*, *supra* note 3, at 1247. Note that Respondeat Superior liability is in addition to any personal liability that may attach to the agent. See RESTATEMENT (THIRD) OF AGENCY Ch. 11 To. 3 Gen. Matls. (1958 App.) Appendix Court Citations (Respondeat Superior does not defeat agent liability; Khanna, *supra* note 9, at 370 (citing: BRICKEY §401 at 130; GRUNER §3.4.2 at 199-200)).

However, when the agent is a member of top management the corporation suffers a sanction greater than  $X$  – say  $X + TM$ . Now the sanctions faced are  $X + TM$  on the corporation and  $Y$  on the agent (i.e., a member of top management).<sup>25</sup> Thus, the total sanctions faced by the corporation and those associated with it are usually greater when the agent wrongdoer is a member of top management than when the wrongdoer is not. This is so even if we hold all else constant (e.g., the harm caused is the same regardless of the agent who engaged in wrongdoing).<sup>26</sup> Thus, under *respondeat superior* top management’s involvement does not influence *whether* the corporation will be liable, but does influence for *how much* the corporation will be liable.

This can be seen in at least three areas of law. First, at the Federal level in the US the involvement of someone who is in a position of “substantial authority” leads to increased corporate sanctions under the Organizational Sentencing Guidelines.<sup>27</sup> The term “substantial authority” is roughly co-existent with people in top management and in fact is even broader.<sup>28</sup> Corporate sanctions may increase because top management involvement (or the involvement of someone with substantial authority) increases the corporation’s “culpability” score and a higher culpability score results in a higher sanction.<sup>29</sup> Further, under the Organizational Sentencing Guidelines a corporation can reduce or mitigate its sanction if it has a “reasonable” compliance program in place.<sup>30</sup> This potential sanction reduction or mitigation is lost if top management is involved in wrongdoing as that counts against the “reasonableness” of the compliance program.<sup>31</sup> This makes top management’s involvement in wrongdoing one of the most important factors in determining a corporation’s culpability score and hence its sanction.

Second, sometimes punitive damages are awarded when top management is involved in wrongdoing.<sup>32</sup> For example, in many states punitive damages may

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<sup>25</sup> See U.S. SENTENCING GUIDELINES MANUAL at §8C2.5(b); Laufer, *supra* note 2, at 1384-5.

<sup>26</sup> See *id.*

<sup>27</sup> See *id.*

<sup>28</sup> See *id.*, at § 8A1.2 cmt. 3(b) (stating that “Substantial authority personnel” means individuals who, within the scope of their authority, exercise a substantial measure of discretion in acting on behalf of an organization. The term includes high-level personnel, individuals who exercise substantial supervisory authority (e.g., a plant manager, a sales manager), and any other individuals who, although not a part of an organization’s management, nevertheless exercise substantial discretion when acting within the scope of their authority (e.g., an individual with authority in an organization to negotiate or set price levels or an individual authorized to negotiate or approve significant contracts”).

<sup>29</sup> See *id.*, at §8C2.5(b).

<sup>30</sup> See *id.*, at §8C2.5(f).

<sup>31</sup> See *id.* See Laufer, *supra* note 2, at 1385.

<sup>32</sup> See Holander, *supra* note 6, at 617 (discussing: Albuquerque Concrete Coring Co. v. Pan Am World Services, Inc., 118 N.M. 140, 879 P.2d 772 (1994) that states “the New Mexico Supreme Court held a corporation liable for punitive damages based on an employee’s misconduct when the employee was acting in his “managerial capacity”).

be awarded if the defendant (in our case the corporation) is found to act in a knowing or intentional manner.<sup>33</sup> Corporate knowledge or intent in this context is usually assessed by what members of top management knew or intended.<sup>34</sup>

Third, in some areas the behavior of top management will trigger liability for the corporation for regulatory violations, whereas the same behavior undertaken by lower level employees would not trigger any liability. Consider the recently promulgated Regulation F-D, which holds that it is illegal for a corporation to engage in selective disclosure of information to the market.<sup>35</sup> It was designed to reduce the pattern of corporations informing a select few market participants of their operating results.<sup>36</sup> Regulation F-D prohibits top managers from engaging in such selective disclosure to the market, but provides an exception for when middle or lower level managers engage in the same activity.<sup>37</sup> Thus, the involvement of top management in wrongdoing also increases the prospect of liability for regulatory violations.

These three areas provide examples of how top management's involvement in corporate wrongdoing increases corporate sanctions under *respondeat superior*. This, however, is not the only method of attributing liability to the corporation.

#### B. The "Alter Ego" Approach.

In those jurisdictions that do not follow *respondeat superior*, they often still take the involvement of top management into account. In states that follow the Model Penal Code, corporate responsibility for mens rea offenses requires the

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<sup>33</sup> See *id.* See also *Fotiades v. Hi-Tech Auto Collision Painting Services, Inc.*, slip op. at 16 (Cal.App. 4 Dist., Oct. 17, 2001) (noting that "[u]nder Cal. Civil Code section 3294, subdivision (b), a corporation cannot be held liable for punitive damages based on the acts of an employee unless a director, officer, or managing agent of the corporation either: (1) had advance knowledge of the unfitness of the employee and employed him or her with a conscious disregard of the rights or safety of others, (2) authorized or ratified the employee's wrongful conduct, or (3) was personally guilty of oppression, fraud, or malice"); *Schropp v. Crown Eurocars, Inc.*, 654 So. 2d, 1158, 1159 (Fla. 1995) (stating that "[i]n order to impose direct liability for punitive damages on a corporation, there must be a showing of willful and malicious action on the part of a managing agent of the corporation"); K.S.A. § 60-3701(d)(1) (stating that punitive damages may be awarded for corporate liability where the questioned conduct was authorized or ratified by a person expressly empowered to do so on behalf of the employer).

<sup>34</sup> See Henry J. Amoroso, *Organization Ethos and Corporate Criminal Liability*, 17 CAMPBELL L. REV. 47, 52 (1995) (stating that "[t]he guilty intent of corporate officers may be imputed to the corporation, so that a corporation may be liable for certain offenses of which specific intent is a necessary element. Such instances occur where the crime consists of purposely doing the things prohibited by statute, or where the crime involves knowledge and willfulness").

<sup>35</sup> See Regulation F-D, \_\_\_\_\_. See also Stephen Choi, *Selective Disclosure in the Public Capital Markets*, 35 U.C. DAVIS L.REV. 533 (2002) (discussing the efficiency consequences of Reg. F-D).

<sup>36</sup> See Choi, *supra* note 35.

<sup>37</sup> See 17 C.F.R. § 243.101(c).

involvement of a member of top management, not simply any agent.<sup>38</sup> Similarly, in some overseas jurisdictions corporate criminal liability can only be imposed if the “alter ego” or some group (or person) of considerable importance in the corporate hierarchy was involved in the wrongdoing.<sup>39</sup> This has usually been interpreted to mean someone in top management.<sup>40</sup> Thus, the involvement of top management in wrongdoing may trigger corporate criminal liability in some jurisdictions following this “alter ego” approach whereas the involvement of a non-top management agent would be insufficient to do so. The presence of corporate criminal liability works as an additional sanction for the corporation on top of any civil sanction. In other words, in *non-respondere superior* jurisdictions, top management’s involvement in wrongdoing influences whether the corporation will be held criminally liable for certain wrongs and thereby influences the corporation’s total sanction.

To summarize, in *respondere superior* contexts the involvement of top management results in a greater sanction for corporations and in *non-respondere superior* contexts the involvement of top management results in extra liability (e.g., corporate criminal sanctions) on the corporation. In both cases the corporation’s total sanction will increase. The issue is then whether such a sanctioning and liability system can be justified or explained. I begin with looking to a deterrence-based approach to corporate criminal liability for a justification.

### III. SETTING CORPORATE SANCTIONS.

Setting corporate sanctions when top management is involved in wrongdoing is a complicated matter under a deterrence-based approach to corporate criminal liability. In this Part I address the issue in two broad sections. Section A examines why we have corporate liability. After all, corporations do not act, their agents do. Yet, we impose liability on the corporation (i.e., shareholders). What might explain this liability structure? Next, in section B, I address how we should set corporate sanctions assuming imposing corporate liability is desirable. Part IV then takes this analysis and considers how the involvement of top management might be relevant to it.

#### A. *Why Have Corporate Liability?*

As a preliminary matter it is worth asking why do we impose liability on a

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<sup>38</sup> See MODEL PENAL CODE § 2.07(1)(c); Ragozino, *supra* note 4, at 449.

<sup>39</sup> See V.S. Khanna, *Corporate Criminal Liability: What Purpose Does it Serve?*, 109 HARV. L. REV. 1477, 1490 (1996).

<sup>40</sup> See Laufer, *supra* note 2, at 1384-85 (discussing “substantial authority” under the Model Penal Code); Khanna, *supra* note 39, at 1490 (citing John C. Coffee, Jr., *Emerging Issues in Corporate Criminal Policy*, *Foreword to GRUNER* at xix).

corporation? After all, it does not act only its agents do. Further, imposing corporate liability seems, on some level, unfair because it reduces shareholders' wealth and they rarely would have done anything wrong directly. Thus, it becomes important to discuss why we should impose liability on corporations (i.e., shareholders) when someone else (agents) commits wrongs.

As a general matter liability against the individual agent is the first course of action. However, direct individual liability may prove ineffective (or fail) in some instances and hence provide some scope for considering the imposition of liability on other parties, such as the corporation.<sup>41</sup> The most common reason for direct liability failing is that agents often do not have sufficient assets to pay for the total social costs of wrongdoing and hence would have insufficient incentives to undertake precautionary measures.<sup>42</sup> This would lead to a reduction in deterrence.<sup>43</sup> In such instances corporate liability may enhance deterrence relative to where we rely only on agent liability.<sup>44</sup>

Corporate liability improves deterrence when agents are judgment proof because it places corporate assets at risk and thereby forces the corporation to internalize the social costs of wrongdoing.<sup>45</sup> If the corporation bears these costs then it would generally have a stronger incentive to monitor its agents and

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<sup>41</sup> See Sykes, *supra* note 3, at 1236-39; Kornhauser, *supra* note 10; Kraakman, *supra* note 3; Khanna, *supra* note 39, at 1495.

<sup>42</sup> See Sykes, *supra* note 3, at 1244; Khanna, *supra* note 39, at 1496. Another reason for corporate liability is that even if agents are not judgment proof they may not be deterred by direct liability because they may not respond in informed and rational ways to the liability that is imposed on them. See Arlen & Kraakman, *infra* note 46, at 696 n.23 (noting that "it appears that, holding the expected sanction constant, individuals are deterred more by a high probability of paying a relatively low fine than the relatively low probability of paying a high fine... This might justify imposing corporate liability to induce firms to raise the probability of detection, even if it would not be justifiable were individuals risk neutral and utility maximizers"). Corporations, on the other hand, are more likely to respond in a rational and informed manner. See *id.*

In a sense we are also deputizing the corporation to act as an enforcer. This may also reduce enforcement costs for the government. See *id.*; Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 7 RUTGERS L. REV. 605, 681-5 (1995).

<sup>43</sup> To elaborate upon this rationale let us consider the following example. Assume X (the agent) can engage in an activity that causes certain social harm of \$100 and generates social and private benefits of \$40, but is caught only 50% of the time. Let us assume that X has only \$50 in attachable assets which means X faces an expected sanction of \$25 only (\$50 times 50%) and hence will engage in the act (which benefits X by \$40 each time). See Sykes, *supra* note 3, at 1244. One may wonder why not simply take away the \$40 X gains each time. There may be reasons why this is not possible or too difficult. For example, if part of the \$40 can be consumed (e.g., X used some of the money for a trip to Paris) then this will be difficult to recover from X. Cf. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

<sup>44</sup> See Sykes, *supra* note 3 at 1250-6; Kornhauser, *supra* note 10; Kraakman, *supra* note 3, at 858 - 67. To enhance deterrence we may need to impose liability on another person who has more assets and might be able to influence the behavior of X, such as X's corporate employer. See Kraakman, *supra* note 3, at 858 - 67; Sykes, *supra* note 3, at 1244 - 56; A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 (1993).

<sup>45</sup> See Sykes, *supra* note 3, at 1244 - 56 (arguing that the primary rationale for vicarious liability is when agents are judgment proof); Kornhauser, *supra* note 10, at 1349 - 52, 1362 - 66 (same); Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1 *passim* (1980)(same).

prevent or deter them from engaging in wrongdoing.<sup>46</sup> There might be other benefits as well, but for now this provides a sufficient starting point for seeing why corporate liability might be desirable.<sup>47</sup>

*B. Factors Relevant in Setting Corporate Sanctions.*

Assuming that corporate liability might often be desirable, then how much of a sanction should the corporation suffer? As a general matter the magnitude of corporate sanctions (and what factors matter in setting corporate sanctions) depends in large measure on the liability standard used to assess corporate liability.

There are many liability standards one could choose from including strict liability, negligence, *mens rea* and combinations of these standards. Strict liability imposes liability whenever harm is caused regardless of whether the actor exercised due care or acted with the most noble of motives.<sup>48</sup> The factors that are important in setting optimal sanctions under strict liability are the harm caused and the likelihood that the corporation will be sanctioned.<sup>49</sup> Negligence imposes liability whenever harm is caused and the standard of due care is not met.<sup>50</sup> Thus, if harm is caused but the due care standard is met then there is no liability. The factors of importance in setting the optimal sanction here are the harm caused, the likelihood of the corporation being sanctioned, and some method of assessing whether the corporation was negligent (e.g., the effectiveness of internal enforcement measures). *Mens rea* imposes liability whenever an actor acts with the required state of mind.<sup>51</sup> If the actor causes harm and does not act with the required state of mind then there is no liability under *mens rea*. The factors relevant for sanctioning here are the harm caused, the likelihood of the

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<sup>46</sup> See Jennifer Arlen & Reinier Kraakman, *Controlling Corporate misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U.L.REV. 687, 692 – 95; Sykes, *supra* note 3, at 1244 - 56. Note, corporations may also be judgment proof with respect to certain sanctions and that raises another host of difficult issues. For greater discussion, see Kyle D. Logue, *Solving the Judgment-Proof Problem*, 72 TEX. L. REV. 1375 *passim* (1994) (discussing the concerns for deterrence arising from the judgment proof problem); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 *passim* (1997) (discussing the plethora of ways that a corporation can make itself judgment proof to avoid liability); Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45 *passim* (1986) (discussing problems arising when wrongdoers are judgment proof and potential solutions).

<sup>47</sup> For example, internalizing the total social costs of a product would lead the corporation to price its products to reflect their true social costs (since the corporation now bears these costs) which leads to the optimal amount of the product being produced and purchased. See Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 2-3 (1980); Sykes, *supra* note 3, at 1246. We will discuss this further at *infra text accompanying notes* 53 to 58.

<sup>48</sup> See Khanna, *supra* note 12, at 1246; Shavell, *supra* note 47, at 2 – 3 (describing strict liability as no fault necessary).

<sup>49</sup> See Polinsky & Shavell, *supra* note 44, at 721; Arlen & Kraakman, *supra* note 46, at 703.

<sup>50</sup> See Khanna, *supra* note 12, at 1246.

<sup>51</sup> See *id.*, at 1246-7.

corporation being sanctioned, and some measure of “corporate mens rea” (e.g., the corporation’s internal processes).

The next issue is then when will each liability standard be desirable as that will determine all the factors relevant for sanctioning. The next few paragraphs address this issue. For ease of exposition I shall compare strict liability to negligence and mention where *mens rea* and other liability standards fit in as we progress through the discussion. Then, in Part IV, I discuss how the involvement of top management in corporate wrongdoing could, arguably, be a relevant factor in setting corporate sanctions when strict liability is desirable and when negligence (or some other liability regime) is desirable. To begin, however, we need to determine when each liability standard is desirable.

As a general matter we are interested in the effects of liability standards on two different fronts. First, we want liability standards to induce firms to produce the socially appropriate amount of their goods (the activity level goal) and second we want to induce firms to put in place internal enforcement measures that reduce the incidence of wrongdoing or the magnitude of harm caused or more generally minimize the social costs associated with wrongdoing (the enforcement goal).<sup>52</sup>

### 1. Activity Level

Let us begin with the activity level goal. For the socially appropriate amount of a good to be produced we need the price of the good to reflect its true social costs, which includes the cost of making the good as well as the harm it may cause to others.<sup>53</sup> If the price understates the true social costs then too much of the good will be produced and purchased relative to the social ideal, whereas if the price overstates the true social costs then not enough of the good will be produced and purchased.<sup>54</sup> This means that the corporation should bear the full social costs of its products so that its products are priced appropriately.

This can be achieved under strict liability, with the optimal sanction, where the firm is forced to internalize all the costs of its products. The optimal sanction under strict liability is the harm caused divided by the probability of the firm bearing a sanction.<sup>55</sup> For example, if a firm’s product causes certain harm of \$200, but the firm is sanctioned only 50% of the time harm is caused then the

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<sup>52</sup> See Arlen & Kraakman, *supra* note 46, at 692. I do not discuss the possibility that liability standards (such as *mens rea* or intent) may be methods of curtailing rent-seeking litigation. For greater discussion of that see Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S.CAL. L. REV. 657 (2001).

<sup>53</sup> See ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 302 – 13 (3d ed., 2000) (comparing strict liability and negligence); Shavell, *supra* note 47, *passim* (same).

<sup>54</sup> See Shavell, *supra* note 47, at 2 – 3.

<sup>55</sup> See Polinsky & Shavell, *supra* note 44, at 721; Arlen & Kraakman, *supra* note 46, at 703.

optimal sanction should be \$400 each time the firm is sanctioned. This is because the firm will then face an expected sanction of \$200 (i.e., \$400 times 50%) each time it acts and hence will bear the full social costs of its activities. If we sanctioned the firm only \$200 each time it was caught then for every \$400 of harm it caused it would only bear \$200 of it.<sup>56</sup> This leads to less than full internalization of the social costs of a product, over-production of it, and too much harm relative to the social ideal.<sup>57</sup> This can be a serious concern when the product is something that causes significant social harm like environmental pollution. Of course, the opposite extreme is possible too – if the corporation is penalized too severely for its products then there will be under-production of the good and this might be socially troubling for goods like pharmaceuticals used to treat various diseases and medical conditions. However, under strict liability, with the optimal sanction, the firm bears the full social costs of its activities, thereby causing its goods to be priced appropriately, resulting in the socially appropriate amount of production.<sup>58</sup>

Negligence standards tend to fail on the activity level front because they do not force the firm to bear the full social costs of its products. Under a negligence standard the firm is liable for the harm caused *only* if it is negligent. Thus, if there is any harm caused when the firm is not negligent (i.e., taking due care) the firm will not be liable for it.<sup>59</sup> Of course, taking due care *does not* mean that harm *never* occurs, but simply that all cost justified precautions have been taken.<sup>60</sup> Thus, we might expect some harm to occur even when the firm is taking due care and I refer to this harm as the residual harm. Because the firm does not bear this residual harm it does not bear the full social costs of its products and it will produce too much of the product.<sup>61</sup> This product would then be purchased in a supra-optimal amount by society (because its price is lower than it should be).<sup>62</sup> *Mens rea* standards raise similar concerns because they impose no liability on unintentional actors (the analog to “not negligent” actors) even if these actors

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<sup>56</sup> See Arlen & Kraakman, *supra* note 46, at 703.

<sup>57</sup> See *id.*, at 698.

<sup>58</sup> See *id.*

<sup>59</sup> See Shavell, *supra* note 47, at 2.

<sup>60</sup> I am assuming that even if all appropriate precautions are taken there is still some chance of harm. This simply acknowledges that a non-negligent system is not necessarily perfect or that it would reduce wrongdoing to zero. See Arlen & Kraakman, *supra* note 46, at 705.

<sup>61</sup> See *id.* The total social costs of a good include the costs of making it, the costs of taking precautionary measures, and the residual harm even when due care is taken. Negligence regimes induce the corporation to take into account the costs of making a good and the costs of taking precautionary measures, but not the residual harm (as corporations are not liable for this amount under negligence). See *id.* Because this cost is not borne by the corporation the price of the good is too low. See *id.* This may result in too much of the good being produced and purchased relative to the social ideal. See *id.*

<sup>62</sup> See Shavell, *supra* note 47, at 4.

have caused harm.<sup>63</sup> This once again induces the actors to overproduce their goods or engage in too much activity.

Thus, strict liability is generally preferable to negligence (and *mens rea*) when considering the activity level goal. That leaves for consideration how liability standards affect the implementation of optimal enforcement measures. On this front the analysis is somewhat more nuanced and depends on context more so than activity level analysis.<sup>64</sup> Let us, however, start with the standard case to provide a baseline.<sup>65</sup>

## 2. *Internal Enforcement Measures*

We know that strict liability forces the firm to bear the full social costs of its activities (if the sanction is set optimally). Because the firm bears both the social costs of harm (through the sanction) and the social costs of the internal enforcement measures it has an incentive to try to minimize the sum of these costs and hence should take all the enforcement measures necessary to minimize its (and society's) costs.<sup>66</sup> This should result in the socially desirable level of most internal enforcement measures.

Negligence standards could, in theory, induce the socially desirable level of enforcement measures (with an optimally set sanction), but are unlikely to be as effective as strict liability. This is because negligence determinations are subject to multiple types of errors that render them unable, normally, to achieve optimality on this front.<sup>67</sup> For example, when considering what enforcement measures must be implemented to meet the negligence standard, authorities may be either over-inclusive (include too many measures) or under-inclusive (exclude certain measures).<sup>68</sup> This problem stems from the fact that the authorities

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<sup>63</sup> See Khanna, *supra* note 9, at 369 (discussing liability dynamic under a strict liability, negligence, and *mens rea* standards).

<sup>64</sup> See Arlen & Kraakman, *supra* note 46, at 692 – 95, 700 – 18; Shavell, *supra* note 47, at 2 - 3 (discussing the level of care exercised under strict liability and negligence). For discussion of why firms engage in extensive monitoring of employees rather than simply increasing the penalty imposed on employees to a very high level see William T. Dickens, Lawrence F. Katz, Kevin Lang & Lawrence H Summers, *Employee Crime and the Monitoring Puzzle*, 7 J. LAB. ECON. 331 (1989).

<sup>65</sup> See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 172-74 (1987); Arlen & Kraakman, *supra* note 46, at 696. See also *id.*, at 701 - 05 (noting that preventive measures come in two varieties – ex ante and ex post in relation to when the wrong occurs. Some examples of ex ante measures are “strict accounting for chemical wastes to tighter security at pharmaceutical warehouses, strict controls over cash disbursements, and careful screening of new employees” and of ex post “basing employees' compensation and promotion on .... the firm's long-run profits, however, because the firm's long-run profits will be net of any expected entity-level sanctions resulting from the wrongdoing”).

<sup>66</sup> See Arlen & Kraakman, *supra* note 46, at 703.

<sup>67</sup> See Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1539 – 40 (1984) (noting that if it is difficult to determine when a party is not negligent it may prove better to rely on strict liability); Arlen & Kraakman, *supra* note 46, at 713 - 714.

<sup>68</sup> See *id.*

probably do not possess the detailed information necessary to make assessments about what measures are desirable and even if they did courts might err in applying them to specific facts.<sup>69</sup> Both of these errors make negligence standards generally less efficient than strict liability in inducing socially desirable enforcement measures.<sup>70</sup> Thus, on this front we would prefer strict liability over negligence (and similarly *mens rea* where courts may err when deciding if someone acted with a particular state of mind).

This analysis holds for the standard kinds of enforcement measures. However, there are some enforcement measures for which strict liability may perform worse than negligence. Some enforcement measures, referred to as policing measures, affect the likelihood of the corporation being sanctioned.<sup>71</sup> Examples would include internal audits of activity, on-going monitoring programs (e.g., tapping phone lines of securities traders), and so forth.<sup>72</sup>

Strict liability may not result in the socially desirable level of policing measures. This is because policing measures have two effects on the firm under strict liability.<sup>73</sup> First, policing measures may deter some agent misbehavior by letting agents know “they are being watched” and hence should reduce the firm’s overall liability.<sup>74</sup> Second, policing measures, by definition, increase the likelihood that the firm will be sanctioned for the harms that still occur.<sup>75</sup> This is because policing measures “increase the firm's expected liability if either the firm or its agents report detected wrongdoing to the government or if the government independently suspects a wrong and uses its broad search and subpoena powers to obtain the information about wrongdoing from the firm for use against it.”<sup>76</sup> Consequently, policing measures impose an additional cost on firms under strict

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<sup>69</sup> See COOTER & ULEN, *supra* note 53, at 316 – 19 (discussing the effects of error on the analysis); Arlen & Kraakman, *supra* note 46, at 705; Khanna, *supra* note 9, at 379 - 82.

<sup>70</sup> See Arlen & Kraakman, *supra* note 46, at 705. This would be true even if courts were very skilled at defining and applying enforcement measures because strict liability is probably still better as it uses the firm’s own knowledge in defining what standards are best. *See id.*

<sup>71</sup> See Arlen & Kraakman, *supra* note 46, at 706 (noting that “policing measures can be either *ex ante* or *ex post*, according to whether they function before--or only after--the wrong occurs. *Ex ante* policing generally assumes the form of continuous monitoring under an ongoing compliance program [such as random drug testing, and *ex post* measures include] episodic auditing... and measures, such as investigation and reporting”).

<sup>72</sup> *See id.*, at 706 – 07.

<sup>73</sup> *See id.*, at 707.

<sup>74</sup> See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 840 *passim* (1994).

<sup>75</sup> *See id.*

<sup>76</sup> Arlen & Kraakman, *supra* note 46, at 708. *See also id.*, at 708 - 09 (discussing, as an example, “a securities firm’s ongoing program of recording broker phone calls to monitor for securities fraud. Under a strict liability regime, such a program will deter some potential fraud, but it will also increase the detection of actual fraud for which the firm will be strictly liable. Strict liability will induce the firm to forego a recording program if the expected increased liability from enhanced detection exceeds the reduction in liability from enhanced deterrence”).

liability (i.e., a greater chance of liability). This extra cost may cause firms to engage in too little of the policing measures relative to the social ideal. This is because from society's perspective the choice about which policing measures to adopt should be based on their deterrent advantages compared to the costs of implementing these policing measures.<sup>77</sup> However, under strict liability the firm bears these costs and benefits plus an additional cost – the increased likelihood of being sanctioned.<sup>78</sup> This extra cost distorts the firm's choice away from what would be socially desirable. An example may prove illustrative.

Assume that when firm ABC takes no policing measures its agents commit 16 crimes and ABC's probability of being sanctioned is 25%– so ABC is sanctioned 4 times in total. If ABC spends \$200 to police its agents then the number of agent crimes drops to 8 (because some agents are deterred or interdicted), but the likelihood of ABC being sanctioned increases to 50%. The likelihood may increase because of corporate self-reporting or the greater information a government subpoena is likely to garner when corporations increase their own internal policing (i.e., create a document trail of evidence).<sup>79</sup> If so then corporations will be held liable 4 times (the same as when no resources were spent on policing measures), but they are worse off by the cost of the policing measures and will not police due to this.<sup>80</sup>

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<sup>77</sup> See Arlen & Kraakman, *supra* note 46, at 691; Arlen, *supra* note 74, at 848; David A. Dana, *The Pervasive Incentives of Environmental Audit Immunity*, 81 IOWA L. REV. 969 (1996).

<sup>78</sup> See Arlen & Kraakman, *supra* note 46, at 714.

<sup>79</sup> See Arlen, *supra* note 74, at 850 – 58.

<sup>80</sup> See *id.* Of course, one can generate an example where the corporation will still have an incentive to monitor as well (e.g., where the drop in wrongs is to 4, rather than 8, and if everything else is the same then the corporation is sanctioned only 2 times rather than 4 times – this might be sufficient to induce the corporation to monitor). Here however there are other problems that can arise that are discussed in depth elsewhere, but for our purposes are well beyond our discussion. See Arlen, *supra* note 74, at 850 – 57. See also Arlen & Kraakman, *supra* note 46, at 709 (noting that “the sanction that induces efficient policing under traditional strict liability exceeds the sanction that induces optimal activity levels, sanctioning, and prevention measures. Thus, even in the best circumstances, traditional strict liability cannot simultaneously induce optimal policing and serve the other objectives of entity-level liability”).

Note that other enforcement measures are not subject to this critique because they do not increase the likelihood of ABC being sanctioned. Thus, assuming the enforcement measures would generate the same numbers as used in the above example then ABC's employees would commit only 8 crimes with non-policing measures in place and ABC would be sanctioned 25% of the time (the same as before the measures were undertaken). Thus, ABC would be sanctioned 2 times with enforcement measures and 4 times without them. If the sanctions avoided exceed the costs of the enforcement measures then firms will undertake these measures.

This is exactly when society would want the firm to take these measures. See Arlen, *supra* note 74, at 850. Continuing with the example assume that the cost of each crime is \$300. Thus, without enforcement measures the firm is sanctioned 4 times. Each time the firm bears a sanction of \$1200 (i.e.,  $h/p$  or  $\$300/0.25$ ) which makes a total sanction of \$4800 (i.e., \$1200 each of the 4 times it is sanctioned). With enforcement measures the firm is sanctioned twice and bears a sanction of \$1200 each time (i.e.,  $h/p$  or  $\$300/0.25$ ) or a total sanction of \$2400. Add to this the cost of the enforcement measure (say \$200) then the firm's losses are \$2600 or less than the losses if no enforcement measures were taken (i.e., \$4,800). This will be true whenever the enforcement measures cost less than \$2400 (the difference in the sanction suffered - \$4,800 less \$2,400). Note that on the example the measures reduced crime by 8 units (each costing \$300). Thus, the total advantage of the enforcement measure is \$2400 and whenever these measures cost less than \$2400 the firm

A negligence standard, although still subject to errors in application, avoids the problem associated with strict liability discussed in the above paragraphs. This is because if the corporation takes sufficient policing measures then it cannot be held liable (there is no negligence). If the corporation cannot be held liable for taking appropriate measures then the second effect associated with strict liability (increasing the likelihood of being sanctioned due to taking these measures) is missing.<sup>81</sup> Thus, if courts could ascertain the optimal level of policing measures and apply them, then the negligence standard would lead the corporation to take optimal policing measures when strict liability may not.<sup>82</sup> Of course, courts may not perfectly assess policing measures, but even then that might still be an improvement over strict liability.<sup>83</sup>

Another area where strict liability may sometimes be inferior to negligence is the effect of each on the credibility of the firm's threats to its employees to self-enforce. If a corporation decides to implement internal enforcement measures the corporation's agents must believe that these measures have some real bite for the measures to have a significant deterrent effect.<sup>84</sup> However, under strict liability some of these enforcement measures will not be credible, whereas under a negligence standard they might be.<sup>85</sup> An example may prove illustrative.

Assume that a corporation wants to reduce the amount of employee wrongdoing by instituting a new internal oversight system that keeps detailed records of what employees do and promises to report suspected instances of wrongdoing to the authorities.<sup>86</sup> Under strict liability an employee might not believe that the corporation would report employee wrongdoing to authorities or keep detailed records because if the corporation did it would be increasing the likelihood of bearing a sanction itself.<sup>87</sup> Strict liability means that the corporation would be sanctioned *even if* it reported its employees' wrongdoing to authorities.<sup>88</sup> Thus, strict liability makes the firm's threat to "rat out" the employee less credible because the corporation would be increasing the chances

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will undertake it under strict liability – the socially desirable result. I have assumed that the sanctions are set optimally under strict liability (i.e., harm divided by the probability of being sanctioned).

<sup>81</sup> See Arlen & Kraakman, *supra* note 46, at 710 – 11.

<sup>82</sup> See COOTER & ULEN, *supra* note 53, at 316 – 20 (discussing some consequences of errors and uncertainty in liability).

<sup>83</sup> See Arlen, *supra* note 74, at 847.

<sup>84</sup> See Arlen & Kraakman, *supra* note 46, at 714.

<sup>85</sup> See Arlen & Kraakman, *supra* note 46, at 712 – 17 (noting that such threats' credibility depends on the observability of such threats).

<sup>86</sup> See *id.*, at 713.

<sup>87</sup> See *id.*, at 714.

<sup>88</sup> See *id.*, at 714 – 15.

of facing a sanction itself.<sup>89</sup> If the measures do not deter employees then the corporation, anticipating this, would probably not implement them or would announce that they would implement them and then not actually do so (e.g., “window dressing” measures) as doing otherwise could increase corporate liability and sanctions.<sup>90</sup> Thus, certain enforcement measures would probably unravel under strict liability.

Negligence standards can overcome this problem because the corporation would still want to report the employee if he engages in wrongdoing or to monitor him as this would make the corporation “not negligent” and hence help it to avoid (or lessen) a sanction even if the employee engages in wrongdoing.<sup>91</sup> The avoidance of a sanction makes the corporation’s threats to take enforcement measures credible.<sup>92</sup> If these measures are credible then employees know that if the corporation detects their wrongdoing the corporation will probably report it to authorities (so the firm would be considered not negligent) and thereby increase the employee’s expected sanction. Increases in an employee’s expected sanction should, all else equal, reduce an employee’s incentive to engage in wrongdoing and hence result in greater deterrence.<sup>93</sup>

In summary, the analysis in this Part suggests that negligence-like standards may not operate too well on activity level issues and certain enforcement measures. However, strict liability may not operate perfectly when the probability of the firm being sanctioned is increased by the enforcement measure in question as this both reduces the firm’s incentive to undertake policing measures and reduces the credibility of corporate threats to self-enforce. Thus, neither liability standard appears likely to be desirable, by itself, over the full range of corporate wrongdoing. However, we might be able to aid in the analysis by identifying when each standard is likely to be preferable.

The problems with strict liability are generated because of effects on the probability of the firm being sanctioned. Both the harmful effects on policing measures and credibility of self-enforcement measures occur because the firm by

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<sup>89</sup> See *id.*

<sup>90</sup> See Laufer, *supra* note 2, at 1372-73; John C. Coffee, Jr., *Does “Unlawful” Mean “Criminal”?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 229 (1991).

<sup>91</sup> See Arlen & Kraakman, *supra* note 46, at 716 (noting that the “credibility of the court- threatened sanctions, in other words, will serve to enhance the credibility of the firm’s policing efforts”).

<sup>92</sup> See *id.*

<sup>93</sup> See *id.*, at 716 – 17 (noting that the firm’s enforcement measures must be “ex post observable to the court, even though they are not ex ante observable to agents. [This] judicial observableness requirement [may] be met in most-but not all--circumstances where credibility is a serious issue”). Note also that “a firm operating under a duty-based regime [e.g., negligence] might well monitor, report, or sanction misconduct even if doing so had no impact on the behavior of its agents as long as the penalty for failing to do so was sufficiently large. Thus, under a properly designed duty-based regime, agents will expect firms to carry out threats to monitor or report misconduct.” *Id.*, at 716.

undertaking these measures would increase the chances of its being sanctioned under strict liability. This is presumably a larger problem the lower the initial probability of being sanctioned. For example, if the probability of being sanctioned (before considering any enforcement measures) was 95% then a policing measure is probably not going to have a significant negative effect on the firm's behavior (it can only increase the likelihood of being sanctioned by 5% at most which might often be outweighed by the deterrent advantages of the measure). However, if the initial probability was 30% and the enforcement measure could increase the probability to 60% then we might find some of the undesirable effects discussed earlier. Thus, if the probability of being sanctioned is fairly high (before considering enforcement measures) one expects that strict liability would be the preferred liability standard. In such a case we need to know the harm caused and the likelihood of the firm being sanctioned to set optimal sanctions. However, if the probability of being sanctioned is low and certain enforcement measures could significantly increase this probability then we might be cautious in applying strict liability.<sup>94</sup> In this case we need to know not only the harm caused and the likelihood of the firm being sanctioned, but also the effectiveness of internal enforcement measures the firm has undertaken (to assess negligence) to set optimal sanctions.

This creates two sets of situations in which the role of top management in wrongdoing can be analyzed – when strict liability by itself is desirable and when it is not. The next part examines the role of top management's involvement in wrongdoing in setting corporate sanctions in both cases.

Before beginning that inquiry just a word on liability regimes. In those cases where strict liability may fail we may not want to opt for simply a negligence system. The reason is that although negligence may improve upon policing measures and credibility issues it hurts activity level concerns and other enforcement measures. Thus, one alternative would be to opt for a composite liability regime. These are regimes that meld elements of both strict liability and negligence or *mens rea*.<sup>95</sup> For example, we could have a sanctioning system where if the corporation were not negligent it would receive a penalty of Y and if it were negligent then it would receive a penalty of Y+Z. Y is then the strict liability penalty and should be set to equal the amount of harm divided by the probability of being sanctioned. Z is the extra amount a corporation would suffer if it did not take optimal policing measures and not make its threats to self-enforce credible to its employees. In broad brushstrokes our current sentencing

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<sup>94</sup> See *id.*, at 717 – 18 (noting that if wrongdoing could be avoided through utilizing optimal preventive measures then our concern with strict liability would be reduced). Also, negligence regimes would be efficient if we thought “market forces [caused] the firm to bear the full social cost of any wrongdoing, thereby ensuring that the firm undertakes optimal activity levels, sanctioning, and prevention.” *Id.*, at 718.

<sup>95</sup> See Arlen & Kraakman, *supra* note 46, at 717.

system for corporations seems to reflect this kind of a composite regime.<sup>96</sup> It is still open to much criticism, but it does seem to reflect an attempt to devise a composite regime.<sup>97</sup> Whether composite regimes are generally desirable is, however, not the primary matter of my inquiry. My concern is whether top management's involvement in corporate wrongdoing should play any role in determining corporate sanctions – whether in a strict liability regime, a negligence regime or a composite regime. For ease of exposition I treat all liability regimes that are not purely strict liability as being in one category. If within that category further divisions are necessary with respect to the role of top management's involvement in setting sanctions, they will be highlighted in the text or the notes.

#### **IV. WHY SHOULD THE INVOLVEMENT OF TOP MANAGEMENT LEAD TO INCREASED CORPORATE SANCTIONS?**

In the last Part I discussed how one should set corporate sanctions. The features that are relevant in determining corporate sanctions vary depending on whether we are in an area where pure strict liability is desirable (e.g., high probability of being sanctioned) or whether we are in an area where either a negligence or a composite regime is desirable (e.g., a lower probability of being sanctioned). This Part examines how the involvement of top management in corporate wrongdoing might affect the factors relevant for setting corporate sanctions in both contexts.

The forthcoming analysis indicates that two matters are important. First, does the involvement of top management in wrongdoing work as a *proxy* for a factor relevant for sanctioning in either context and second, do we *need* a proxy for this factor or would direct inquiry into it be sufficient? These inquiries will provide us with the potential benefits of using top management's involvement as a factor to increase corporate sanctions. Part V then considers some costs associated with using top management's involvement as a sanctioning factor. The analysis from both Parts suggests that reliance on top management's involvement in wrongdoing to increase corporate sanctions is something that should be undertaken on a much more contextual basis than the current “across the board” rule we use.

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<sup>96</sup> See *id.*, at 689-690 (noting that “In many areas, particularly in the criminal law, lawmakers are replacing strict vicarious liability with regimes that reduce or eliminate liability when principals act to deter wrongdoing. The United States Sentencing Commission's Sentencing Guidelines for corporate defendants, enacted in 1991, replace the traditional rule imposing strict vicarious liability on the firm for its agents' wrongdoing with a “composite” regime in which the firm incurs a reduced penalty if it has discharged certain compliance-related duties”).

<sup>97</sup> See *id.*, at 751-752 (stating that “although the Sentencing Guidelines erect a composite liability regime, as we recommend, this regime needs significant reform if it is to become an efficient enforcement tool”).

A. *Top Management's Involvement When Pure Strict Liability Is Desirable.*

When pure strict liability is desirable the optimal sanction is set by taking the harm caused and dividing it by the probability of the firm bearing a sanction. Thus, top management's involvement in wrongdoing could be used to increase corporate sanctions if that involvement is associated with increases in the amount of actual harm suffered or decreases in the probability of the firm being sanctioned.

1. *Effect on level of harm.*

Might top management's involvement in wrongdoing increase the amount of harm actually suffered? This depends largely on what kind of wrong we are considering. If the wrong involves a one-on-one injury, such as running someone over with a garbage truck, then the amount of harm is probably the same whether the agent who ran over the victim was a line employee or the Chief Executive Officer (CEO).<sup>98</sup> However, for other kinds of wrongs we might think differently.

For example, if the wrong involves telling someone to do something illegal then one can imagine that a line employee's "order" may only influence some people, whereas a CEO giving such an "order" may influence many others.<sup>99</sup> Another example might be to compare the harm from when a line employee profits from securities trading based on fraud and when the CEO does. The CEO's trading is seen by the market as a signal of the corporation's value and hence is likely to influence more traders than a line employee's trading (because the CEO is presumed to have greater knowledge about the corporation than the line employee).<sup>100</sup> As the CEO's trading influences more of the market it

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<sup>98</sup> See, e.g., *Davis v. Pak-Mor Mfg. Co.*, 284 Ill.App.3d 214, 216 (Ill. App. Ct. 1996). See also Laufer, *supra* note 2, at 1384-86.

<sup>99</sup> See *Allen v. Powell*, 989 S.W.2d 776, 777 (Tex. Ct. App. 1998).

<sup>100</sup> See F.H. Buckley, *When the Medium is the Message: Corporate Buybacks as Signals*, 65 IND. L. J. 493 (1990) (discussing how buybacks can be signals of firm value); Michael J. Chmiel, Note, *The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action*, 1990 U. ILL. L. REV. 645, 648-650 (noting that "when the CEO buys stock to strengthen the company stock, people see this transaction as a sign the company will be doing better in the future and cause the price to rise further; however, then the CEO can take the profits of the stock seemingly contradicting the duties to the shareholder"); Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 441 - 453 (2000) (discussing the potential signaling explanation for repurchase tender offers).

Having more wealth and access to important information, executives are likely to benefit more from inside trading and securities fraud than regular employees. See Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1 (1993).

is likely to cause greater harm than the line employee's trading.<sup>101</sup> In other words, for some wrongs the CEO's activities may result in greater harm relative to when those activities were carried out by a line employee. Thus, top management's involvement in wrongdoing may work as a proxy for greater harm in some cases.

The issue is then when do we need this proxy? First, if direct inquiry into the level of harm caused is possible, it is unclear why we would need/want to use a proxy.<sup>102</sup> In many instances we might be able to estimate the amount of harm caused directly.<sup>103</sup> For example, if more traders respond to the CEO's trading then that will be picked up in the things that track securities trades and in the suits by those who lost as a result of the CEO's trading. These would provide direct measures of harm. If direct measures are available, the use of proxies (indirect measures) cannot, by assumption, add any greater accuracy and may only increase costs or worse yet mislead us in setting sanctions. For example, if direct measures indicate no increase in harm then relying on a proxy to increase the sanction would lead to a supra-optimal penalty. Such a penalty would probably lead to overdeterrence and a host of other problems (which I will discuss in greater detail in Part V). Thus, in cases where the quantum of harm is reasonably ascertainable it may not be desirable to rely on a proxy (such as top management's involvement), but rather to rely on direct measures of harm.<sup>104</sup> If, however, we are dealing with a situation where we do not have terribly good estimates of harm then we might want to rely on a proxy to increase the sanction a corporation suffers.<sup>105</sup> This suggests that the involvement of top management could be a useful sanctioning factor in some, but probably not all, cases.

## 2. *Effect on the probability of being sanctioned.*

Another factor to consider under a pure strict liability regime is the effect on the probability of the firm being sanctioned when top management is involved in wrongdoing. If the probability of the corporation being sanctioned drops when top management is involved in wrongdoing then that might be a reason to increase the corporate sanction.

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<sup>101</sup> This would be true even if both the CEO and the line employee were required to disclose their trading activities. See section 16(a) of the Securities & Exchange Act 1934 for rules requiring disclosure of "insider" trades.

<sup>102</sup> See Khanna, *supra* note 9, at 385.

<sup>103</sup> See *id.*

<sup>104</sup> See Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1247 - 49 (1985).

<sup>105</sup> See *id.*

This once again is likely to depend on the kind of wrong at issue. If we are dealing with wrongs where the probability of the corporation being sanctioned is high (e.g., gigantic oil spills) then there is little reason to believe that top management's involvement in wrongdoing is likely to reduce the probability of the corporation being sanctioned relative to another employee's involvement.<sup>106</sup> However, some wrongs may be of a nature where the probability of being sanctioned might actually drop with the involvement of top management in wrongdoing. For example, top managers may have greater opportunities and influence in fabricating documents, moving evidence, and orchestrating a cover up than a lower level employee.<sup>107</sup> This means when a higher level employee is involved in a knowing or reckless manner in corporate wrongdoing the likelihood of being sanctioned for the corporation may be less than when a lower level employee is involved. Examples of this abound in the literature on white-collar crime and these examples present one reason for increasing corporate sanctions.<sup>108</sup>

However, there are also reasons for why the probability may not drop and indeed may increase if top management is involved. This is because top management gets much of its information from within the corporation. Thus, in most corporations of any significant size top management's involvement will usually be documented by a paper trail.<sup>109</sup> If there is a significant paper trail then even if top management can cover up the occurrence of the wrong, once it is discovered the chance of conviction, relative to where lower level employees are involved, is high because most of the information will be documented.<sup>110</sup>

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<sup>106</sup> See Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, at 342 – 343 (discussing the Exxon oil spill “the probability that a large oil spill will be detected is one”) (1996). See also Arlen & Kraakman, *supra* note 39, at 722.

<sup>107</sup> See M. DALTON, *MEN WHO MANAGE* (1959); M. CROZIER, *THE BUREAUCRATIC PHENOMENON*. See John Reed Stark, *Securities Regulation and the Internet*, 520 PLI/Pat 793, 854 (1998). Practising Law Institute PLI Order No. G0-0001 New York City June 8-9, 1998 San Francisco, July 20-21, 1998 Second Annual Internet Law Institute. For example in *Feldman v. Motorola, Inc.*, 1992 WL 415382, Fed. Sec. L. Rep. P 97,221 N.D.Ill. Nov 05, 1992 page 2, the court thought that superiors could take steps to insure that certain information is not forwarded to headquarters.

<sup>108</sup> See, e.g., DALTON, *supra* note 107; CROZIER, *supra* note 107; Jennifer H. Arlen & William H. Carney, *Vicarious Liability for fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, at 711 (noting that the “board can weigh the costs to the firm resulting from the fraud against the advantages of retaining a manager. Moreover, some observers suggest that structural bias in favor of colleagues may influence many board members to go easy on top managers. The problem is exacerbated when a majority of the directors are either insiders of the firm or outside directors who owe their positions on the board to the senior managers implicated in the fraud. Inside directors also may be inclined to go easy on the obvious wrongdoer in exchange for his not implicating them”). See also Kimberly D. Krawiec, *More Than Just “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 IOWA J. CORP. L. 1 (1997) (discussing Daiwa scandal, wherein Daiwa senior management concealed losses from regulators and covered up to avoid detection by regulators).

<sup>109</sup> See Pamela H. Bucy, *Indemnification of Corporate Executives Who Have Been Convicted of Crimes: an Assessment and Proposal*, 24 IND. L. REV. 279, 302 (1991); Arlen & Kraakman, *supra* note 46, at 722.

<sup>110</sup> See Laufer, *supra* note 2, at 1384-88.

Thus, top management's involvement in wrongdoing might operate as a proxy for decreases in the probability of being sanctioned for certain kinds of wrongs and only when there is not a significant paper trail created. These conditions provide indicia of when top management's involvement would act as a proxy for a decrease in the probability of being sanctioned, but they do not say anything about whether we *need* a proxy.

In some instances there may be direct evidence of changes in the probability of being sanctioned for the firm. For example, if documents were destroyed or fabricated (or shredded ala Enron) then that would provide direct evidence of a drop in the probability of being sanctioned. There is no need to rely on a proxy in this case. In fact, sometimes the method of ascertaining if top management is involved in wrongdoing is to look to see if documents have been destroyed and so forth and from that to imply that top management must have known about it.<sup>111</sup> In such cases, relying on top management's involvement could sometimes lead to erroneous results. For example, if top management did know about some wrongdoing, but the firm is certain to be sanctioned (e.g., a gigantic oil spill) under strict liability then there is no change in the probability of being sanctioned.<sup>112</sup> Increasing corporate sanctions in this case would lead to overdeterrence and a host of other problems (some of which are discussed in Part V).

Thus, if the probability of being sanctioned can be directly ascertained then there is no need to rely on a proxy. If, however, this direct evidence is missing then reliance on a proxy may prove desirable under some circumstances. Once again the analysis here suggests a fact specific approach to increasing corporate sanctions when top management is involved rather than an across-the-board rule.

In summary, when pure strict liability is desirable we may have an argument, in some cases, that the involvement of top management in wrongdoing might be a factor to consider in increasing corporate sanctions. However, this is a contextual claim and does not match our current treatment of the issue. Indeed, it would call for a much more case specific analysis on its own.

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<sup>111</sup> See Dale A. Oesterle, *A Private Litigants Remedies for an Opponent's Inappropriate Destruction of Relevant Documents*, 61 TEX. L. REV. 1185, 1186 (1983). Cf. *Trigon Ins. Co. v. U.S.*, 204 F.R.D. 277, 288 88 A.F.T.R.2d 2001-6883, 51 Fed.R.Serv.3d 378, 57 Fed. R. Evid. Serv. 664 E.D.Va. Nov 09, 2001 (noting that "[t]he United States also was obliged to produce the materials pursuant to various document requests made by Trigon from December 2000 through March 2001. Though the majority of the requests were informal, they certainly gave the United States ample notice that the allegedly spoiled evidence was sought after. Finally, the Court itself advised the United States that it was "playing with fire" in its hesitation to produce documents").

<sup>112</sup> See Fischel & Sykes, *supra* note 106; Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 889 (1984).

B. *Top Management's Involvement When A Non-Strict Liability Regime Is Desirable.*

Some instances of corporate wrongdoing are such that pure strict liability may not be desirable. This might be the case where the probability of being sanctioned before considering any enforcement measures is not very high. This is because the deleterious effects on policing measures (and concerns with credibility) may gain greater import in this situation. In such situations the issue is whether the involvement of top management in corporate wrongdoing influences factors of relevance in setting corporate sanctions such as the harm caused, the probability of the firm being sanctioned, and the effectiveness of internal enforcement measures. As I have discussed the first two factors already (i.e., harm and probability of being sanctioned) the discussion in this section will focus only on the effectiveness of internal enforcement measures.

One might think that the effectiveness of internal enforcement measures might be compromised in some way if top management were involved in wrongdoing. When top management is involved we might witness few internal enforcement measures, or the enforcement measures might be “window dressing”, or employees may not believe management will follow through on the enforcement measures.<sup>113</sup> If so then this would provide a reason to increase corporate sanctions under a negligence/composite liability regime because top management's involvement might be correlated with ineffectual internal enforcement measures. Let us examine these contentions in some greater detail.

This reasoning assumes that top management's involvement is operating as a *proxy* for the absence or ineffectiveness of internal enforcement measures. The absence of internal enforcement measures is something on which direct evidence is probably quite easily available – simply look to see what measures are in place.<sup>114</sup> If the measures that are in place do not appear to meet the due care standard then the corporation should be sanctioned more severely under a composite or negligence liability regime. This, however, does not require us to inquire into whether top management was involved in wrongdoing or not. Simply put, the situation does not call for a proxy.

One could also argue that although the corporation may have enforcement measures in place they may not be effective – that is, they may simply be “window dressing”.<sup>115</sup> Further, the likelihood of internal enforcement

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<sup>113</sup> See Laufer, *supra* note 2, at 1407; Khanna, *supra* note 12, at 1270.

<sup>114</sup> See Richard Gruner, *To Let the Punishment Fit the Organization: Sanctioning Corporate Offenders Through Corporate Probation*, 16 AM. J. CRIM. L. 1, 100 (1988).

<sup>115</sup> See William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1372 – 1373, 1407 (1999).

measures being window dressing is probably strongly correlated with the involvement of top management in wrongdoing. Although one can intuitively understand this argument, it comes with constraints.

The “window dressing” argument has bite only if (i) the involvement of top management in corporate wrongdoing is correlated with ineffectual internal enforcement measures (i.e., it serves as a proxy) and (ii) prosecutors and courts could not tell the difference between a well functioning system and “window dressing” without reference to the involvement of top management in wrongdoing (i.e., we need a proxy). There are reasons to be somewhat skeptical on both grounds.

First and foremost, in many corporations top management is not the final enforcement authority – often there is a compliance officer in charge of the internal processes who is not subject to the kind of control by top management that other employees might be.<sup>116</sup> If the compliance officer is really independent of top management then the internal enforcement measures would be maintained and enforced by someone who has little reason to be swayed by the fact that top managers are involved in wrongdoing.<sup>117</sup> Such situations are not likely to be instances of “window dressing” measures.<sup>118</sup>

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<sup>116</sup> For example, audit committees and a committee of outside directors may be utilized to review company-wide compliance. See Cynthia E. Carrasco and Michael K. Dupee, *Corporate Criminal Liability*, 36 AM. CRIM. L. REV. 445 (1999). See also Laufer, *supra* note 2, at 1382, 1386-92, 1405-10. *But see id.*, at 1413 (noting how top management charts and enforces the “legal and ethical compliance” in some corporations). See Richard Gruner, *To Let the Punishment Fit the Organization: Sanctioning Corporate Offenders Through Corporate Probation*, 16 AM. J. CRIM. L. 1, 85 (1988).

Also, all financial companies seem to have fairly independent compliance officers. Depository financial institutions typically set strict compliance standards for themselves. 85% of commercial banks have a full-time chief compliance officer – higher than any other industry. Compliance officers are particularly important to banks because of the complexity of the regulations they are subject to. Violation of these regulations could lead to license revocation and the bank would lose the ability to operate. See Deborah R. Strour & Carole L. Basri, *What Every In-House Banking Counsel Needs to Know to Update His or Her Compliance Program*, 1317 PLI/Corp 273 (June-July 2002).

Non-depository financial institutions have recently come under increased scrutiny and, therefore, are making compliance programs a priority. Larger financial institutions employ teams of full-time compliance officers in their headquarters. For example, Merrill Lynch employs 100 people in its compliance office in New York. See Charles Gasparino & Susan Craig, *Broker Watchdogs Face Scrutiny As Investor Complaints Mount*, WALL ST. J., May 23, 2002, at A1.

<sup>117</sup> Following the recent series of corporate debacles one expects that compliance may be even more vigilant with top management.

<sup>118</sup> Also one could argue that the internal system was deliberately set up with loopholes in it so that it would appear effective, but in reality be ineffective. Although this might be true in some instances, one doubts it is true for most corporations. See Gruner, *supra* note 114 (noting that “Regulatory scholars Ian Ayres and John Braithwaite insist that corporate actors are ‘often concerned to do what is right, to be faithful to their identity as a law abiding citizen, and to sustain a self-concept of social responsibility’”); Clifford Rechtschaffen, *Deterrence vs. Cooperation and the Evolving Theory of Environmental Enforcement*, 71 S. CAL. L. REV. 1181, 1191-92 (1998) (*quoting* IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* 22 (1992)). See generally, Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034 (1993) (discussing the role of independent directors in monitoring and governing corporate management).

Second, it is noteworthy that just because “a” member of top management is involved in wrongdoing does not mean that the entire enforcement system is corrupt or ineffectual.<sup>119</sup> It is possible that a system can work well even if some members of top management engage in wrongdoing. This is because most reasonable enforcement systems encompass cost justified measures to reduce (but rarely eliminate) corporate wrongdoing.<sup>120</sup> Thus, just because someone in top management engaged in wrongdoing is not a reason, by itself, to *conclusively assume* that the enforcement system is tantamount to “window dressing”. In some cases it may be, in others it may not. This suggests that sometimes the involvement of “a” member of top management does not work as a proxy for the effectiveness of internal enforcement measures.

Third, there is some evidence that prosecutors and courts are actually fairly good at telling the difference between a functioning system and “window dressing” independent of the involvement of top management in wrongdoing.<sup>121</sup>

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If the internal systems were not started with a view to commit wrongs then top managers who would like to engage in wrongdoing may have to tinker with a well functioning system. Such “tinkering” might alert others to the behavior of top management which would increase the likelihood of sanctions. See Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV., Mar.-Apr. 1994, at 106 (noting that the main reason for companies to implement compliance program is the prospect of leniency and reduced fines).

One could argue that law firms and consulting agencies might work with management to draft compliance programs that looked “good”, but were ineffectual. See Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 BROOKLYN L. REV. 629, 650 (1997) (advancing the argument that a lawyer is “motivated to believe what the client’s *management* group believes, and the tendency to conform will occur subconsciously”). Although some law firms and consulting agencies may be complicit in wrongdoing one doubts that all of them are and the ones that have better reputations will be able to attract more business and charge more – an incentive to behave well. Cf. Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995) (discussing an analogous concept for lawyers). This urges for a more contextual inquiry as well.

<sup>119</sup> See Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save Its Soul?*, 47 RUTGERS L. REV. 605, 691 (commenting that a wrongful act of an individual officer or employee may not reflect that of the collective corporate consciousness). For discussion of whether effective compliance programs can aid in civil liability against the corporation see Burlington Industries, Inc. v. Ellerth, 524 U.S. 742 (1998) and Faragher v. Boca Raton, 524 U.S. 775 (1998) which both hold that reasonable compliance systems could earn the corporation a liability reduction in civil suits for sexual harassment.

<sup>120</sup> See ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 13 (1988) (exploring how the law allocates legal rights according to economic rationality); Cynthia A. Williams, *Corporate Compliance With the Law in the Era of Efficiency*, 76 N.C.L. REV. 1265, 1371 (1998) (suggesting that “in giving advice about investing in compliance programs, attorneys are more likely to be concerned with balancing the cost of the program against the probability of violation - a completely different focus, and one that ultimately seeks compliance with the law”); Cynthia E. Carrasco and Michael K. Dupee, *Corporate Criminal Liability*, 36 AM. CRIM. L. REV. 445, 446 (1999) (asserting that “[c]orporations had to evaluate the costs and benefits of implementing compliance programs to discover acts of wrongdoing”). See generally Matthew E. Beck & Matthew E. O’Brien, *Corporate Criminal Liability*, 37 AM. CRIM. L. REV. 261 (discussing the benefits an effective compliance program confers on a corporation).

<sup>121</sup> See Arlen and Kraakman, *supra* note 46, at 716-717 (noting that “courts generally can observe whether a firm investigated or reported wrongdoing. Many compliance programs also can be verified ex

If so, then the involvement of top management may not be needed as a proxy to determine the efficaciousness of internal enforcement measures.

The above arguments suggest that we may not always need to inquire into the involvement of top management to determine the effectiveness of internal enforcement measures. However, one might argue that the involvement of top management goes more to the credibility of corporate threats to self-enforce. If top management is involved in wrongdoing and employees are generally aware of this then top management would have some difficulty credibly conveying that they will report employee misbehavior as that might trigger liability for top management.<sup>122</sup> Thus, one might expect top management's involvement to have some impact on the credibility of self-enforcement measures.

Even this argument, however, is not terribly persuasive. The argument assumes that regular employees are aware of when top management is involved in wrongdoing. One doubts that line employees are generally aware of what top management is up to. For example, Enron seems to provide ample evidence of this as many employees were ignorant of top management's behavior and hence suffered large losses in their pension plans.<sup>123</sup>

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post. For example, courts can review a brokerage firm's library of tape recordings and telephone records to determine whether the firm was taping every call, as threatened, or only some calls. Thus, duty-based rules often can assure the internal credibility of the firm's monitoring, investigating, reporting, and sanctioning measures"); Jennifer F. Reinganum & Louis L. Wilde, *Equilibrium Verification and Reporting Policies in a Model of Tax Compliance*, 27 Int'l Econ. Rev. 739, at 740 (1986). Courts may be able to ascertain these issues if negligence determinations are made as suggested in Mark Grady, *A New Positive Economic Theory of Negligence*, 92 YALE L.J. 799 (1983) (negligence analysis involves a specific analysis of whether there exist any precautions that defendant should have taken but did not, not a global analysis of what is due care).

See William Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability*, 37 AM. CRIM. L. REV. 1285, 1302-1305 (explaining the guidelines and strategies that federal prosecutors developed and use to identify corporate entities that are deserving or undeserving of criminal prosecution). "The existence, adequacy and functionality of a compliance system are important factors in identifying wrongdoing corporations." *Id.*

For some counter-evidence note that courts assess *compliance systems* using the 'good faith' test. Extensive compliance programs have failed to meet the good faith test when supervisors failed to detect flagrant cases of "churning." See Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1615 (1990) (noting also that without reasonable supervision and an extensive program, courts are unlikely to read "good faith" into a compliance program).

<sup>122</sup> If top management could find an easy scapegoat then things would be different. See Celia Wells, *Corporate Manslaughter: A Cultural and Legal Form*, 6 CRIM. L.F. 45, 58 (1995) (discussing the concept of "scapegoating"). I am assuming that finding a scapegoat is not without costs.

<sup>123</sup> See: Wednesday, December 19, 2001, *Enron Workers Face Losses On Pensions, Not Just 401(k)s*, by Ellen E. Schultz. See also: The Wall Street Journal, Monday, January 21, 2002, *Your Money Matters, Enron Isn't the Only Retirement Tale That Leads to Hard Lesson: 'Diversify'*, by Ellen E. Schultz and Theo Francis.

Indeed, even if we look at current rates of employee reporting on alleged top management misbehavior it would appear that employees are only infrequently aware of what top management is doing. See PRICE WATERHOUSE, LLP (1996), SURVEY OF CORPORATE COMPLIANCE PRACTICES: EXECUTIVE SUMMARY.

The arguments might be somewhat different if we are dealing with a small closely held corporation where the employees and managers may know each other quite well and may even be related.

Thus, only in some instances would the presence of top management's involvement in wrongdoing amount to something meriting a sanction increase under a non-strict liability standard. Once again we have occasional reasons to increase corporate sanctions when top management is involved in wrongdoing, but those reasons may not really provide an "across-the-board" reason.<sup>124</sup>

## V. COSTS ASSOCIATED WITH INCREASING CORPORATE SANCTIONS DUE TO TOP MANAGEMENT'S INVOLVEMENT IN WRONGDOING.

The discussion so far has proceeded with little regard to any potential costs associated with imposing greater corporate sanctions because of top management involvement in wrongdoing. In this Part I discuss three potential costs with such a sanctioning system. When we have considered both the costs (Part V) and the benefits (Part IV) then we can provide a more complete picture of when we should rely on top management involvement in wrongdoing to increase corporate sanctions. Once again what we witness is a drive towards more contextualized inquiry rather than the "across-the-board" rule we currently have. Part VI will then inquire into whether there might be other reasons for preferring an across-the-board rule.

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<sup>124</sup> Another potential reason to sanction a corporation more severely when top management is involved in wrongdoing might arise if we thought there was a significant agency cost problem that prevents corporations from sanctioning top management. One common explanation for corporate liability is that it will induce the corporation to monitor agents or punish the wrongdoers. See Kraakman, *supra* note 3; Sykes, *supra* note 3. However, when the relevant agents are top management this might become difficult as we would in effect be asking the board to monitor some of its own members and we may wonder how likely/effective this might be. See Langevoort, *supra* note 21. If we thought monitoring and sanctioning were not likely or would not be very effective then we might consider imposing a greater penalty on the corporation to induce it to overcome this agency concern. The agency cost story seems to ring true for certain corporations, however, it does not necessarily lead one to conclude that top management's involvement in wrongdoing should lead to an increase in corporate sanctions. First, if it costs too much for the board or the shareholders to monitor management (or it is too difficult to monitor or sanction them) then that is *prima facie* evidence that such monitoring may not be cost justified. This is because shareholders bear the costs of the monitoring and receive the benefit (reduced instances of corporate wrongdoing and hence corporate penalties). Second, if the agency costs are inhibiting monitoring of management why would we think imposing more costs on those who, *ex hypothesi*, are not effectively monitoring would improve the situation? This may require making some questionable assumptions (e.g., that the current corporate sanction is somehow understating the true harm, in which case the correct response is to increase the current sanction for harm rather than increase sanctions *only* when top management is involved in wrongdoing). We could also consider increasing sanctions on top management directly rather than indirectly doing it through the corporation when we know it may face some agency concerns.

Perhaps we could also claim that top management involvement in wrongdoing is suggestive that the corporation should screen more effectively its top management (i.e., it negligently screened its managers). This is a difficult argument as it presumes a standard of screening against which to assess the choices for top management. This seems difficult to develop given the heterogeneity of most firms. See Bebchuk, Fried & Walker, *supra* note 20, at 817-818. Further, the simple fact that top management was involved in wrongdoing does not mean the corporation had negligent screening any more than the fact of wrongdoing means the corporation was negligent. We can be non-negligent and still have wrongdoing occur.

### A. Information Gathering

Increasing corporate sanctions when top management is involved in wrongdoing means that we increase corporate sanctions whenever someone in top management has sufficient information to meet the “involved” standard (i.e., knowing or reckless). Whenever we premise sanctions on the knowledge or information that someone possesses we give that person (and those around him) an incentive to become or remain uninformed in order to reduce the probability of having to bear an increased sanction.<sup>125</sup> Thus, top management, the board, employees, and the corporation may have an incentive to keep top management less than optimally informed. This is one potential cost associated with increasing corporate sanctions due to the involvement of top management. Further, there is already anecdotal evidence that “bad” news tends not to travel too quickly up the corporate hierarchy and our current sanctioning strategy will only increase the incentive of lower level employees to keep top management in “the dark”.<sup>126</sup> This is socially undesirable because it may lead to increased wrongdoing as people in the corporation become less aware of the harmful consequences of their and their subordinates’ actions.<sup>127</sup> Also, as top management becomes less informed about the corporation then lower level agents will probably believe they have freer reign over the corporation (even outside of areas of crime and tort) and this should increase the agency costs associated with the corporate form (e.g., more shirking).<sup>128</sup> Thus, increasing corporate sanctions when top management is involved in wrongdoing might decrease the amount of information management has and hence increase wrongdoing and may generally increase agency costs as well.

I hasten to qualify this argument with a few points. First, the incentive to be uninformed is countered to some extent by the general need and desire of management to be informed to perform their tasks – sometimes the added liability exposure will not be enough to deter or prevent management from gathering information.<sup>129</sup> Second, other laws may constrain the incentive to

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<sup>125</sup> See generally Khanna, *supra* note 9, at 378-382 (discussing the disincentive to gather information under a Single Actor Mens Rea Standard). See also Steven Shavell, *Liability and the Incentive to Obtain Information about Risk*, 21 J. LEGAL STUD. 259, at 260, 263 (discussing incentive effects of strict liability and some negligence rules); *Developments*, *supra* note 3, at 1269, 1274.

<sup>126</sup> See Khanna, *supra* note 9, at 379-382.

<sup>127</sup> See Khanna, *supra* note 9, at 378-382 (discussing DES example).

<sup>128</sup> Cf. John C. Coffee, Jr., *American Law Institute’s Corporate Governance Project: Remedies: Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (noting that an increase in risk of liability would drive the agency cost up due to higher risk premium and executive compensations).

<sup>129</sup> See Khanna, *supra* note 9, at 378-380 (noting that “[o]ften the costs of gathering information may exceed the costs of not gathering information for the corporation, and the corporation may not acquire information even when it is socially desirable to do so”). This suggests that sometimes agents will still gather information – just not always.

become uninformed – such as mandatory information gathering duties.<sup>130</sup> Nonetheless, the point I am making is not that managers will *always* be uninformed, but simply that they will tend to be less informed when corporate liability is premised on the level of information they possess. As long as this general point is true then the costs associated with less information gathering by management (e.g., increased agency costs, increasing wrongdoing) are present in some measure and need to be considered.

*B. Increase in Monitoring Costs.*

Another cost associated with increasing corporate sanctions is that corporations are likely to respond by expending greater efforts on monitoring or screening managers. These extra monitoring efforts are an added cost of our current scheme. If corporate sanctions are increased in the contextual manner described in Part IV then these extra monitoring efforts might well be worth the effort (depending on the circumstances), but if we increase corporate sanctions outside of the Part IV schema then these extra monitoring costs are, by definition, a social waste.<sup>131</sup> This waste and the general costs associated with greater monitoring need to be considered as well.

*C. Other Costs.*

Another cost associated with imposing greater corporate sanctions when top management is involved is that this increases the cost of making the product and should increase the price that corporations charge for their products.<sup>132</sup> Even those corporations that are not held liable know they face some risk of a sanction and that this risk is potentially greater when top managers are involved in wrongdoing. The added risk of greater liability should be reflected in product prices.<sup>133</sup> If the added liability reflects the true social costs of the product

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<sup>130</sup> See RICHARD S. GRUNER, *CORPORATE CRIME AND SENTENCING* 585 (1st ed. 1994); James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 *BUFFALO L. REV.* 249, 336-338 (2001) (describing the directors' duty to independently gather information rather than adopting conclusions regarding the synergistic effect of a potential merger); Stephen M. Bainbridge, *Fundamental Themes in Business Law Education: Contractarianism in the Business Associations Classroom: Kovacik v. Reed and the Allocation of Capital Losses in Service Partnerships*, 34 *GA. L. REV.* 631, 660-661 (2000) (implying that a requirement for management to gather information carries with it significant transaction costs).

<sup>131</sup> See generally Richard S. Gruner, *Just Punishment and Adequate Deterrence for Organizational Misconduct: Scaling Economic Penalties Under the New Corporate Sentencing Guidelines*, 66 *S. CAL. L. REV.* 225 (1992). See also Fischel & Sykes, *supra* note 106.

<sup>132</sup> See generally Steven Shavell, *Strict Liability Versus Negligence*, 9 *J. LEGAL STUD.* 1 (1980). See Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 *B.U.L. REV.* 395, 402 (1991) (articulating that “[e]xcessive fines, designed to punish corporations, will more likely than not hurt consumers by requiring an excessive increase in prices as well as an excessive diversion of resources to prevention activities”).

<sup>133</sup> See Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 *CORNELL L. REV.* 129 (commenting in footnote 116 that increases in liability lead to increases in product cost, which drives up the price of products); Polinsky & Shavell, *supra* note 3.

(following Part IV) then this is desirable. However, under our current across-the-board approach we would increase corporate sanctions outside of the schema of Part IV. In such cases, if the added liability risk results in the corporation bearing more than the true social costs of its products then too little of the product will be produced from society's perspective. If the product is a "pet rock" we may not be too concerned, but if the product is a pharmaceutical used in treating certain illnesses or a product designed to improve the ability of factories to reduce harmful emissions then our concern should be greater.<sup>134</sup>

These costs urge for an even more contextual approach to sanction setting than Part IV. For example, sometimes an increase in the corporate sanction might be worthwhile under Part IV, but the increased costs under Part V may make it undesirable. As a general matter the analysis here suggests that once the costs are brought into consideration the optimal scope for increasing corporate sanctions when top management is involved in wrongdoing is smaller than in Part IV alone and again very contextual.

## VI. REASONS FOR OPTING FOR AN ACROSS-THE-BOARD APPROACH

Although my analysis so far has indicated that a contextual approach to setting corporate sanctions might be desirable, the law has eschewed this in favor of an "across the board" approach. In this Part, I address some arguments for why this "across the board" approach might be desirable in spite of the arguments in Parts IV and V.

### A. *Administrative and Error Costs*

Any contextual approach relies a great deal on fact specific inquiry and investigation. We would need courts to ascertain whether pure strict liability or a composite regime was desirable (i.e., a rough measure of the probability of the firm being sanctioned before considering any enforcement measures), whether the kind of wrong at issue is such that the involvement of top management in wrongdoing might be a proxy for a relevant sanctioning consideration, whether reliance on the top management proxy was desirable relative to direct inquiry and a whole host of other matters. Each of these inquiries is likely to be costly and potentially rife with errors. If we did indeed implement such a system one might expect a fairly high cost in setting sanctions and potentially a high number of errors.<sup>135</sup>

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<sup>134</sup> See Khanna, *supra* note 9, at 369-370.

<sup>135</sup> See generally Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994).

In light of these costs we might think it desirable to simplify the process in some way by moving to fewer inquiries or to a more across-the-board approach. The issue is then whether we would prefer to move towards an approach that always increased corporate sanctions when top management was involved or one that rarely did. This depends on how, as a general matter, we might think the answers to the questions in the above paragraph would turn out. If we thought most corporate wrongs involved instances where reliance on top management's involvement as a proxy was desirable then it would make some sense to opt for an across-the-board sanction increase. Alternatively, if we thought that top management's involvement was rarely a desirable proxy then we might wish to opt for a system that did not consider this factor. One might surmise that our current system reflects an inclination that that the former situation is more likely.<sup>136</sup>

Although this might reflect our initial inclinations, there are reasons for thinking that the error and administrative costs are not as large as one might imagine. Consider for the moment our current organizational sentencing guidelines. They take into account many of the same factors in determining corporate sanctions that we would need to ascertain whether the involvement of top management in wrongdoing should be a relevant sanctioning factor.<sup>137</sup> Prosecutors and courts seem to be gaining experience at this task and perhaps reducing both errors and administrative costs.<sup>138</sup> Further, as the system becomes more accurate, deterrence is enhanced and the increased administrative costs would be borne less frequently (as deterrence leads to fewer cases of wrongdoing).<sup>139</sup> Thus, the evidence from our current regime suggests that the administrative and error costs associated with a contextualized inquiry do not seem to provide a persuasive reason to adopt an across-the-board sanction increase.

#### B. *Corporate Norms*

Another reason for increasing corporate sanctions when top management is involved in wrongdoing is that top management's involvement may indicate that the informal sanctions within a corporation against illegal behavior are very weak and hence we need to strengthen the formal sanctions to make up the

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<sup>136</sup> Cf. Anthony J. Daboub et al., *Top Management Team Characteristics and Corporate Illegal Activity*, 20 ACAD. MGMT. REV. 138, 138-39 (1995) (noting the consensus view among legal scholars that corporate crime is most often caused by top management).

<sup>137</sup> See William Laufer & Alan Strudler, *Corporate Intentionality, Desert, and Variants of Vicarious Liability*, 37 AM. CRIM. L. REV. 1285, 1302-1305 (discussing prosecutorial guidelines).

<sup>138</sup> See Khanna, *supra* note 12, at 1271 – 73. See generally PRICE WATERHOUSE, *supra* note 123.

<sup>139</sup> See generally Kaplow, *supra* note 134.

slack.<sup>140</sup> To expand on this argument it is important to note that corporations, like any social organization, are governed by both formal rules and sanctions and informal rules and sanctions.<sup>141</sup> It is both of these operating together that influence corporate agents' behavior.

One could argue that top management's involvement in wrongdoing is an indication that the informal sanctions and rules within a corporation are too weak with regards to the behavior at issue. If so, corporate agents are under-deterred (they face, relative to the social ideal, a *weak* informal sanction) and to achieve optimal deterrence we may need to increase the formal sanction.<sup>142</sup> This argument is premised on a number of claims.

First, top management's behavior is important in setting the informal rules and sanctions within an organization. This claim seems supported by whatever evidence we have on it. Leaders do matter – they set the tone and are influential in setting the formal and informal rules and sanctions within the corporation.<sup>143</sup>

Second, if leaders do matter in setting informal sanctions would the involvement of top management in wrongdoing lead to a reduction in the informal sanction. This presumably requires lower level employees to be aware that even if top management espouses compliant behavior they are behaving otherwise. One might imagine that this is the case in some (perhaps many), but not all instances (e.g., Enron). This is reminiscent of the arguments above when discussing the credibility of self-enforcement measures in Part IV.B.

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<sup>140</sup> See Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133 (1996); Eric A. Posner, *Symbols, Signals, and Social Norms in Politics and the Law*, 37 J. LEGAL STUD. 765 (1998); Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 96 COLUM. L. REV. 903 (1996); Robert C. Ellickson, *Market for Social Norms*, 3 AM. L. & ECON. REV. 1 (2001); Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147, 204-205 (2001) (analyzing 'social norms' generally and in the area of corporate law).

<sup>141</sup> See David M. Kreps, *Corporate Culture & Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 90 (JAMES E. ALT & KENNETH A. SHEPSON, eds) (1990); Darryl K. Brown, *Street Crime, Corporate Crime, and the Contingency of Criminal Liability*, 149 U. PA. L. REV. 1295, 1299-1301 (2001) (discussing 'social norms' as informal rules and sanctions); Richard A. Posner, *Social Norms and the Law: An Economic Approach*, 96 COLUM. L. REV. 903 (1996).

For a definition of informal rules see Jack Knight & Douglass North, *Explaining Economic Change: The Interplay Between Cognition and Institutions*, 3 LEGAL THEORY 211, 214 (1997) (defining generally 'formal rules' as constitutions, statute, common law, and regulations, and 'informal rules' as conventions and social norms).

<sup>142</sup> See Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1270 (1999) (commenting on how formal sanctions established by legal rules may facilitate the effectiveness of informal sanctions by norms).

<sup>143</sup> See Barnard, *supra* note 1, at 976-980 (showing how top management, particularly the CEO, can set the tone and influence the norms of a corporation); Huang & Wu, *supra* note 18; Jean Tirole, *Hierarchies & Bureaucracies: On the Role of Collusion in Organizations*, 2 J.L.ECON. & ORG'N 181 (1986).

Third, even if leaders matter and informal sanctions do drop as a result of top management involvement, is that any reason to increase the corporation's sanction outside of the Part IV schema? Here the answer would appear to be probably not. The reason is that the advantages of having strong informal sanctions are essentially internalized by the corporation under pure strict liability.<sup>144</sup> The costs of setting up informal sanctions are borne by the corporation and the benefits (reduced wrongs and hence fewer corporate sanctions) are also received by the corporation. The corporation should then make socially desirable decisions under a pure strict liability rule as it bears the costs and benefits of informal sanctions.

It is only when pure strict liability is not desirable (e.g., when a composite regime might be desirable) that we might countenance an argument for increasing corporate sanctions when top management is involved in wrongdoing. Here the involvement of top management in wrongdoing may suggest that the corporation's informal sanctions are not effective or are simply "window dressing". This may well be true, but it is in essence the same inquiry we conducted in Part IV. B when considering whether the internal enforcement measures were effective. As such the informal sanctions argument does not provide a reason *independent* of those identified in Part IV for increasing corporate sanctions when top management is involved in wrongdoing.

This analysis suggests that from a deterrence-based perspective it is difficult to justify our current law. Indeed, a deterrence-based approach would commend a much more contextualized inquiry than we currently have. Deterrence, however, may not be the only justification for our current law. In the next Part I discuss other justifications and explanations.

## VII. ALTERNATIVE JUSTIFICATIONS FOR OUR CURRENT LAW

There are potentially other explanations and justifications for our current law that should be examined. In particular, whether an expressive approach might justify our current law and then whether a risk-bearing thesis might explain our current law. This Part examines both of these issues.

### A. *Expressive Concerns*

Let us consider whether increasing corporate sanctions due to top management involvement in wrongdoing is desirable because of its "expressive" effects.<sup>145</sup> Although expressive law may come in many flavors I focus only on

<sup>144</sup> See Shavell, *supra* note 47, at 2 – 4.

<sup>145</sup> See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1225 – 1304 (discussing law enforcement and criminal law under their framework) (2001); Louis Kaplow & Steven

those aspects of expressive law that are likely to be implicated in the context of increasing corporate sanctions when top management is involved in corporate wrongdoing.<sup>146</sup> First, that our current sanctioning regime increases the utility that certain members of society receive. Second, that our current sanctioning regime may help to send beneficial messages to members of society. I consider each argument in turn.

It may be that certain members of society (or many of them) derive some particular utility from expressing increased condemnation for a corporation when top management is involved in wrongdoing.<sup>147</sup> This argument is simply that members of society may (for whatever reason) believe that corporations are more “culpable” if members of top management are involved in wrongdoing.<sup>148</sup> Further, more culpable corporations should be punished more severely than less culpable corporations regardless of whether there are any other advantages to such a system.<sup>149</sup> This argument is an empirical claim that members of society prefer the punishment of the more culpable to the less culpable and that

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Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713, 717-18 (1996); Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 2 – 3 (arguing that there may be some social utility in sending a message to society that a culpable act is socially disfavored).

<sup>146</sup> The “expressive law” literature has experienced tremendous growth in recent years. See, e.g., Richard McAdams, *A Focal Point Theory of Expressive Law*, 86 Va. L. Rev. 1649 (2000) [hereinafter *Focal Point*]; Richard McAdams, *An Attitudinal Theory of Expressive Law*, 79 Or. L. Rev. 339 (2000) [hereinafter *Attitudinal*]; Dhammika Dharmapala & Richard McAdams, *The Condorcet Jury Theorem and the Expressive Function of the Law: A Theory of Informative Law* (2002) (on file with the University of Illinois College of Law); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998).

In this Part I focus largely on the attitudinal theory and the condorcet theory. The focal point theory applies largely in the context of cooperative situations – that is where the parties are attempting to coordinate their behavior. Much corporate criminal wrongdoing does not match that description – it seems closer to competitive or conflict situations. In any case, even if we did discuss the focal point theory we would need to determine if increasing corporate sanctions was the best way to achieve the desired end of a focal point approach – might increasing individual penalties work better?

<sup>147</sup> Cf. Principles Adopted by the U.S. Sentencing Commission to Guide the Drafting of the November 1990 Draft Organizational Guidelines (noting that “[m]itigating factors should be designed to reduce fines for two primary reasons: to recognize an organization’s relative degree of culpability, and to encourage desirable organizational behavior.... For example, the guidelines should permit an organization a reduction if it demonstrates that the offense was caused by a rogue employee rather than at the direction or with the tacit approval of ‘management’”).

**See also** Joseph Sanders, V. Lee Hamilton, Gennedy Denisovsky, Naotaka Kato, Mikio Kawai, Polina Kozyreva, Takashi Kubo, Michael Matskovsky, Haruo Nishimura & Kazuhiko Tokoro, *Distributing Responsibility for Wrongdoing Inside Corporate Hierarchies: Public Judgments in Three Societies*, 21 LAW & SOCIAL INQUIRY 815, 842 – 846 (1996).

<sup>148</sup> See Sanders, et al., *supra* note 147.

<sup>149</sup> See Sanders, et al., *supra* note 147; Jonathan C. Poling & Kimberly Murphy White, *Corporate Criminal Liability*, 38 AM. CRIM. L. REV. 525 (2001) (mentioning in footnote 143 that U.S.S.G. MANUAL § 8C2.5(b) background cmt. (1998) lists “factors for determining extent of involvement of high-ranking corporate officials and corresponding effect on culpability score”). This also seems consistent with the findings in W. Kip Viscusi, *Corporate Risk Analysis: A Reckless Act?*, 52 STAN. L. REV. 547 (2000) (noting that jurors in an experiment tended to hold corporations more liable when they engaged in a cost-benefit analysis before undertaking an activity suggesting that “knowing” or “culpable” corporate actions receive greater penalties and that this may have a negative impact on informed risk decisions by corporations).

corporations are considered by members of society to be more culpable if top management is involved in wrongdoing. Satisfying this preference might be said to increase social welfare.<sup>150</sup>

Although there are not many studies of this empirical claim, the ones that do exist appear to confirm this idea – that greater culpability is attached to corporations when “higher-ups” are involved in wrongdoing.<sup>151</sup> If so then that might provide a reason to increase corporate sanctions – to increase the utility of members of society who view things in this manner. This argument should be more fully investigated empirically, but assuming it is correct that means we would need to balance these added “expressive” gains against the costs of an over-broad liability regime (such as fewer products, excess monitoring costs, greater agency costs, and more dangerous products) and then decide if the trade off is worth it.<sup>152</sup> This suggests a contextual approach as well.

Also, we would want to compare whether the “expressive” gains by increasing corporate sanctions were much greater than simply imposing a greater sanction on the member of top management directly or by using other measures that might not have all the costs of increased corporate sanctions.<sup>153</sup> One suspects that again the desirability of increasing corporate sanctions might turn out to be contextual rather than across-the-board. In other words, sometimes imposing liability on other parties (e.g., top managers directly) may be preferred to imposing greater sanctions on the corporation.

Another expressive claim might be that we are trying to send a message to society that either (a) this wrongdoing is particularly harmful or that (b) there is a social norm that when leaders of an organization are involved in wrongdoing that is somehow worse than when non-leaders are involved. The first argument is premised on the government having greater information about the true risks of the underlying activity and the second on the government having greater information about what are the true social norms.<sup>154</sup> I consider each of these in turn.<sup>155</sup>

<sup>150</sup> See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 Harv. L. Rev. 961 (2001).

<sup>151</sup> See Sanders, et al., *supra* note 147.

<sup>152</sup> See Khanna, *supra* note 39, at 1531 – 32. One concern with the expressive argument is: what if the reason people receive utility is because the law says it is bad and that initially the law had little if any reason to declare it bad (i.e., it was a mistake). What is one to do then? This and related issues are taken up in V.S. Khanna, *Corporate Criminal Liability and Expressive Law* (2002) (on file with author).

<sup>153</sup> See generally Khanna, *supra* note 39 (comparing “the costs and benefits of corporate criminal liability with the costs and benefits of other possible liability strategies, including various forms of corporate civil liability, managers’ personal liability, third-party liability, and administrative sanctions, in an effort to determine the best strategy or mix of strategies for society”). For a cost-benefit analysis comparing enterprise and managerial liability that uses an analogous approach, see Kraakman, *supra* note 3, at 857-58.

<sup>154</sup> These two claims encompass the attitudinal and condorcet theories of expressive law as developed by McAdams and by Dharmapala & McAdams. The attitudinal theory is that the law informs members of society what the prevailing social norms are so that people can adapt their behavior to it. See

If the government has greater information about the true risks of an activity then it might want to convey that by sending a message to society, through increasing sanctions, that this behavior is unacceptable.<sup>156</sup> This may be

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McAdams, *Attitudinal*, *supra* note 146, at 340. This encompasses claim (b). The condorcet theory suggests that the law is informing society about the risk associated with this behavior. See Dharmapala & McAdams, *supra* note 146. Claim (a) covers this approach.

Another expressive theory is the focal point one. See Richard McAdams, *A Focal Point Theory of Expressive Law*, 86 Va. L. Rev. 1649 (2000). This is largely inapplicable in the context of this paper. The reason is that a focal point theory is about when parties are trying to coordinate their behavior around a particular point (e.g., what side of the road to drive on) when it is more important that people coordinate rather than have their particular way. This does not really describe the setting of corporate crime, which only infrequently involves cooperative situations.

Note that frequently, the expressive law literature discusses the possibility of the law changing people's values and preferences. See Cooter, *supra* note 146. I do not discuss that in any depth here. If the reason people's values change is because they are now informed about the greater risk an activity possesses or that it is disapproved by social norms then the argument is essentially piggy-backing off of the attitudinal and condorcet theories. If the reason for changing values is due to something else (a generalized respect for the law independent of perceptions of the attitudinal and condorcet theories) then we would inquire into whether corporate sanctions are better than say individual sanctions for achieving this end.

<sup>155</sup> There are other things we may be trying to convey to society. For example, that top management should take greater measures to reduce wrongdoing or that people (citizens or shareholders) should choose their leaders carefully to avoid greater penalties on the organization. For the former the appropriate response would appear to be to increase penalties on top management rather than on the corporation. After all, it is top management's behavior we are trying to adjust. See generally John C. Coffee, Jr., *Rebuttal: The Individual or the Firm? Focusing the Threat of Criminal Liability*, 1 N. ILL. U.L. REV. 48 (1980) (showing that individual liability has higher deterrence effect); John C. Coffee, Jr., *"No Soul to Damn, No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 397 (1981) (arguing that sanctioning the corporation may not effectively deter lower-level wrongdoing managers) [hereinafter Coffee, *No Soul*]; Kathleen Segerson & Tom Tietenberg, *The Structure of Penalties in Environmental Enforcement: An Economic Analysis*, 23 J. ENV'T ECO. & MGT 179 (1992) (noting that individual liability may sometimes be preferable to corporate liability alone). See e.g., ROBERT MOKHIBER, CORPORATE CRIME AND VIOLENCE 54 (1988) (mentioning a case where barring convicted executives from holding similar office showed both general and specific deterrent effect); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG'N 53, 56-57 (1986) (noting that liability of people besides the wrongdoer is normally premised on a belief that direct liability against the wrongdoer would not achieve the desired results. If liability against the wrongdoer effectively deters wrongful conducts, then it probably is more desirable than imposing liability on third party). See Bebchuk, Fried & Walker, *supra* note 20, at 751 (discussing how optimal contracting does not reflect the reality of executive compensation arrangements).

For the latter the idea is that we want to send a message to those people in society who have an influence on training, screening and selecting leaders that these leaders should generally be law-abiding. This may well be the case, but one wonders whether increasing *corporate* sanctions when top management is involved is needed to send this message. If we increase sanctions on top management presumably a similar message will be sent. Further, board members are probably in a better position to screen corporate managers than corporate shareholders. See MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1975); Mark J. Lowenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 813 (1994). This means that liability, if needed, would be more effectively placed on board members rather than the corporation (i.e., shareholders).

Note one could provide other reasons for expressing something through the law, but to do so when we are not trying to convey greater harm than previously thought or that there is a social norm that people are not very aware of might be difficult to justify.

<sup>156</sup> Cf. Harold G. Graswick & Donald E. Green, *Legal Punishment, Social Disapproval and Internalization as Inhibitors of Illegal Behavior*, 71 J. CRIM L. & CRIMINOLOGY 325 (1990) (finding that internalization, social opprobrium and official penalties all had a significant impact on influencing criminal behavior).

so, but it does not provide any reason to increase *corporate* sanctions *because* of top management involvement. It provides a reason to increase corporate sanctions because of the *wrong or activity* in question – regardless of which agent committed it.

A variant of this might be to argue that the wrongdoing is more harmful when top management is involved rather than when a lower level employee is involved. This argument is essentially analogous to that discussed earlier in Part IV A.1. wherein I noted that sometimes the involvement of top management might be correlated with greater harm. That line of argumentation only led us to conclude that a contextual approach is preferred to an across the board rule. That conclusion still holds.

Argument (b) is based on conveying to society that there is a social norm that wrongdoing is worse when the leaders of an organization are involved in it compared to when other members are involved. Note that this is not a claim that this norm is *desirable*, but simply a claim that this norm *exists*.<sup>157</sup> The primary areas for debate would be (i) is this actually the social norm and (ii) can we convey this through means that are less costly than increasing corporate sanctions? On the first issue we can only reach a resolution by empirically examining what are the social norms in this area. Let us assume that, for the purposes of argument, the norm is that matters are worse when top management is involved in wrongdoing. On the second issue we might consider relying on other liability strategies – such as individual managerial liability – to convey this norm. The issue here would be which liability strategy provided the highest net benefit in conveying this message. Net benefit here refers to the expressive gains from people adjusting their behavior to the social norm and the losses from compromised deterrence because we are imposing sanctions contra the analysis in Parts IV and V.<sup>158</sup> Thus, it might be that individual liability for managers would have a greater expressive force than increased corporate sanctions and may provide a higher net benefit than increased corporate sanctions. At a minimum, one can imagine scenarios in which the analysis might cut in either

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<sup>157</sup> This raises the issue about whether norms are efficient. This is an important topic on its own and something on which this paper says little. For further discussion see ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991); Dan M. Kahan, *Social Meaning and the Economic Analysis of Crime*, 27 J. LEGAL STUD. 609 (1998); Paul G. Mahoney & Chris W. Sanchirico, *Competing Norms and Social Evolution: Is the Fittest Norm Efficient?*, 149 U. PA. L. REV. 2027 (2001); Richard H. McAdams, *The Origins, Development and Regulation of Norms*, 96 MICH. L. REV. 338 (1997); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903 (1996). There is then another question about what the law should do if it thinks the current norms are inefficient. For further discussion of that issue see Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998); Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. CHI. L. REV. 607 (2000); Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697 (1996) .

<sup>158</sup> The expressive gain here is people adjusting to the social norm – this essentially assumes that the social norm is desirable in itself. This is a debatable assumption. See *discussion supra note 157*.

direction which suggests that a contextualized inquiry is probably preferable to an across the board rule.

The analysis here once again suggests that under an expressive approach increasing corporate sanctions when top management is involved in wrongdoing is desirable in only some cases. This urges us towards contextualized inquiry rather than the across the board rule we currently have.

*B. Risk-bearing?*

All of the explanations I have discussed above seem to provide support for our current law in only *some* instances. This suggests that we may still be missing something from the picture. Let us then consider the argument that imposing liability on the corporation is preferable to imposing liability on managers because corporations are better risk-bearers.<sup>159</sup> In other words, perhaps increasing corporate sanctions when top management is involved in wrongdoing substitutes for increasing sanctions on top management. This might be desirable because corporations are better risk-bearers than top management. I examine this argument through the following example.

Let us assume that top management is involved in a corporate wrong that requires, under a deterrence-based approach, an optimal penalty of \$3 Million. If corporations and top managers can bargain cheaply then it does not matter how the law splits liability between managers and the corporation.<sup>160</sup> This is an application of the Coase Theorem – when transactions costs are low the parties will bargain for the optimal outcome.<sup>161</sup> Thus, we could impose the \$3 Million penalty on either party or split it in anyway we like. The net outcome would be the same – the parties will negotiate to share liability in the optimal manner.<sup>162</sup>

Of course, transactions costs are rarely zero and there is reason to believe that the bargaining process between management and the corporation is not exactly “arm’s length”.<sup>163</sup> Consequently, where we impose liability does matter because, given bargaining impediments, that is where it may end up. In light of that we might be inclined to place more liability on the corporation than the manager. The reason is that corporations (i.e., shareholders) are better risk-bearers than managers because shareholders can diversify their stockholdings

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<sup>159</sup> See Kraakman, *supra* note 3, at 864-67.

<sup>160</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1996).

<sup>161</sup> See R.H. Coase, *The Problem of Social Cost*, 3 J.L. ECON. 1 (1960).

<sup>162</sup> See *id.* Many other papers have essentially confirmed this approach.

<sup>163</sup> See, e.g., Bebchuk, Fried & Walker, *supra* note 20, at 764-74.

and reduce risk.<sup>164</sup> Managers, on the other hand, tend to find it more difficult to diversify their investment in human capital in the firm.<sup>165</sup> Consequently, letting liability rest with the corporation seems the desirable outcome and indeed matches current law. Could this provide an explanation for our current law?

The problem is that this story is a little too simple. The corporation is the better risk-bearer for *unintentional* wrongdoing, but the corporation is not the better risk-bearer for the *intentional or knowing* misdeeds of top management, which is the activity we are concerned about.<sup>166</sup> The reason is a standard one in the insurance literature. Insurance companies do not insure against intentional wrongdoing because that might provide the insured with an incentive to engage in the wrongdoing – to obtain the insurance payout.<sup>167</sup> Similar problems would apply if we placed liability on corporations for the knowing wrongdoing of management when bargaining is difficult.<sup>168</sup> If we did this we would force the corporation to bear the losses from a manager’s knowing misbehavior which should lead to sub-optimal results (e.g., greater harm caused as managers are less deterred than when more liability is placed on their shoulders).<sup>169</sup>

If we are substituting corporate sanctions for sanctions on managers when managers knowingly engage in misdeeds and when bargaining is not “arm’s length” then we are hampering deterrence. Why would we do this? One explanation is that it is a simple legislative mistake. Another explanation is that top management might prefer to lobby Congress to shift some liability from themselves to the corporation.<sup>170</sup> I refer to this as the deflection thesis – that is, top management wishes to deflect some liability from themselves on to the

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<sup>164</sup> See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J., 857 (1984).

<sup>165</sup> See *id.*

<sup>166</sup> Where the wrongdoing is unintentional, management will evade liability by means of the business judgment rule. See *Litwin v. Allen*, 25 N.Y.S. 2d 667 (Sup. Ct. 1940) (holding that management will be insulated provided that there is no showing of egregious carelessness). **See also** Joseph Sanders, V. Lee Hamilton, Gennedy Denisovsky, Naotaka Kato, Mikio Kawai, Polina Kozyreva, Takashi Kubo, Michael Matskovsky, Haruo Nishimura & Kazuhiko Tokoro, *Distributing Responsibility for Wrongdoing Inside Corporate Hierarchies: Public Judgments in Three Societies*, 21 LAW & SOC. INQUIRY 815, 838-839 (1996).

<sup>167</sup> See, e.g., KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 14-16 (1986); ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW*, 14-15 (1988). Standard issues that might be implicated here are moral hazard and adverse selection. The moral hazard describes an insured individual’s potentially decreased incentive to avoid covered costs as well as to mitigate those costs, given that the individual knows that the injury will be covered by insurance. This can lead to potentially higher claim activity and under-deterrence of the group. Adverse selection occurs when higher-risk individuals, aware of their situation, purchase insurance, while at the same time, lower-risk people do not opt for coverage. This occurrence throws off the insurance company’s determination of the risk characteristics of a group and leads to more claims than the group, as a whole, would normally produce.

<sup>168</sup> See *id.*

<sup>169</sup> See Coffee, *No Soul*, *supra* note 155, at 408. Note that to the extent that there is ambiguity in when managers “knew” about something we might treat it as analogous to unintentional wrongdoing – where moral hazard and adverse selection concerns are less.

<sup>170</sup> See Khanna, *supra* note 39, at 1495-96.

corporation. If bargaining is difficult then top management may be able to reduce their total penalty by lobbying for increased sanctions on the corporation in lieu of increased sanctions on themselves.<sup>171</sup>

There is some evidence that might be taken to support this thesis. First, there is evidence that when a manager and a corporation are both defendants in a criminal case the likelihood of the manager being acquitted is greater than when the manager is the sole defendant.<sup>172</sup> This suggests that sometimes the corporation may essentially “take the fall” for management. Further, given that management has fairly strong control over the corporations they run one might not expect much resistance from the corporation over such an approach.<sup>173</sup> If this is a relatively accurate description of our current law then we need to re-examine it from the deflection perspective.

In light of the arguments developed in this paper we can come to a few conclusions. If our current law does not reflect the deflection thesis then we should reform the law to make it more contextual in terms of setting corporate sanctions. If our current law reflects the deflection thesis then we also need to reform our law and recognize the costs it is imposing on society.

### **VIII. CONCLUSION.**

It is a very common feature of legal systems throughout the world that sanctions on organizations or groups are increased whenever leaders are involved in wrongdoing relative to non-leaders. The sanction increases when top management is involved in wrongdoing are but an instance of this general feature. In spite of the commonality of this feature there is little deterrence or functionally-based analysis of whether it is desirable to increase corporate (organizational) sanctions when members of top management (leaders) are involved in wrongdoing. This paper remedies this gap.

I begin by setting out how corporations are held liable for the acts of agents and how the fact that a specific level agent – someone in top management – is involved in wrongdoing influences the sanction a corporation faces. As a general matter corporate sanctions rise whenever top management is involved in wrongdoing relative to when some other agent is involved. This is so regardless of whether we are looking at criminal or civil liability and regardless of whether we are looking at US law or the law in foreign jurisdictions.

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<sup>171</sup> See Coffee, *No Soul*, *supra* note 155, at 397-402; Khanna, *supra* note 39, at 1495-96, 1510-11.

<sup>172</sup> See Khanna, *supra* note 39, at 1495-96.

<sup>173</sup> See Bebchuk, Fried & Walker, *supra* note 20, at 784-85.

I then examine how corporate sanctions should be set under a deterrence-based theory – the primary theory discussed in the literature. The analysis suggests that a great deal depends on what kind of liability standard is desirable – strict liability or some other alternative. If strict liability is preferred then the harm caused and the likelihood of the firm being sanctioned are the relevant sanctioning factors. If an alternative liability standard is preferred then the harm caused, the likelihood of the firm being sanctioned and the effectiveness of the firm's internal enforcement measures are the relevant sanctioning factors. Determining which liability standard is preferred depends on how likely it is that the wrongdoing will be detected and sanctioned by the authorities. The more likely this is the more we tend towards strict liability.

Following this, I discuss how the involvement of top management in wrongdoing may be relevant to the sanctioning factors (i.e., the harm caused, the likelihood of the firm being sanctioned and the effectiveness of internal enforcement measures). As a general matter top management's involvement might be useful in setting sanctions when it acts as a proxy for changes in the sanctioning factors and when such a proxy is desirable compared to direct inquiry into these factors. My analysis suggests that in *some* instances top management's involvement may meet both of these requirements. Further, these benefits need to be balanced against the costs associated with increasing corporate sanctions whenever top management is involved in wrongdoing. My analysis suggests that sometimes the benefits may exceed the costs, but that this is not enough to justify an across the board sanction increase when top management is involved in wrongdoing. At best, it can justify relying on top management's involvement as a sanction enhancing factor in some cases. In other words, the analysis calls for a context specific approach not an across the board approach. The current across-the-board approach is probably generating social losses and reconsideration of it is encouraged.

The analysis then proceeds to consider reasons why we might want to continue with an across the board approach even though it may generate social losses in many instances. One reason is that the administrative costs of an across the board approach are lower than those costs associated with a fact specific approach. This is true in the abstract, but in the corporate context it is largely inapplicable because the current method of setting corporate sanctions already engages in a fair amount of fact specific inquiry. Another reason I consider is the impact of top management involvement on corporate norms (i.e., norms within the corporation). Although top management's behavior is relevant to corporate norms that does not provide a reason independent of those already discussed for adjusting corporate sanctions – that is we still are urged to engage in fact specific inquiries.

I then move on to discuss alternative justifications and explanations for our current law. I discuss whether we might increase corporate sanctions when top management is involved in wrongdoing to express condemnation and obtain utility from that or to shape behavior by sending messages to society through corporate liability. My analysis suggests that certain forms of these justifications are quite weak, but that there may still be room for using other versions of them. Even then, however, the analysis tends towards a fact specific use of top management's involvement in setting corporate sanctions.

An alternative justification is that the law may be attempting to place liability on the corporation because it is the better risk bearer than top management. This argument is not very convincing for knowing or reckless wrongdoing by management. In particular, shifting liability from top management to the corporation for the *knowing or reckless* wrongdoing of top management is likely to impede deterrence. Indeed, if current law may be explained by an attempt to shift liability from top management to the corporation then that is a dangerous outcome. This is because if the corporation does not shift this liability back to top management, which it probably will not due to less-than-arm's-length bargaining, then reduced deterrence and increased wrongdoing are likely.

In the final analysis, regardless of which justification one relies upon current law is in need of reform. Primarily, the desire would be to contextualize sanction setting more and to be cognizant of concerns over the deflection thesis if we are serious about reducing the incidence of and harms from corporate wrongdoing.