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CORPORATE CRIMINAL LIABILITY

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Abstract

This chapter reviews the economic literature on corporate crime. Economists have discussed and answered a number of questions about corporate crime in only few years time span. Perhaps this unusual success is due to the questions involving corporations being so similar to other crime issues, previously analysed. However, a number of questions remain largely unexplored. Why do certain firms commit crimes while others do not? What are the social costs imposed by the very high corporate criminal penalties? How does the criminal justice process shape the organisation of firms?

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1. Introduction

The economic analysis of corporate crime only started gaining momentum during the last half dozen years. Of course, one notable exception to this rule is Posner's textbook on the *Economic Analysis of Law* (1992), though the discussion of corporate criminality is relegated to issues such as whether firms should obey the law or maximise profits. (It is also puzzling to report how economists still fail in providing a conclusive definition of a firm. For example, while I am sure that it is not done intentionally, definitions of organised crime appear to be interchangeable with definition of firms (see, for example, Dick, 1995)).

The catalyst for this was the debate over and the subsequent adoption in 1991 of the US government's corporate sentencing guidelines. The research itself has largely focused on theoretical questions raised by the guidelines (for example, what should be included in calculating the social cost of crimes committed by corporations or whether it should be the firm and/or its managers who are penalised), descriptive empirical evidence on how corporate penalties have changed over time, and some evidence indicating what factors predispose firms to violate the law.

2. The Theory

The basic principle behind the economics view of legally imposed sanctions is to ensure that those who break the law internalise the externalities that they impose upon others. Several questions arise in this context: (1) how large is the externality, (2) upon whom should the penalty be imposed, and (3) should the penalty take the form of criminal or civil sanctions or possibly just through the loss of reputation.

While the issue of criminal harm is the same for crimes by firms and individuals (see for example Becker, 1968 or Friedman, 1981), the debate among economists over what should be included in corporate penalties largely arises from the sentencing commission's guidelines, which explicitly include some notion of the third-party spillover effects from crimes like financial or consumer fraud (United States Sentencing Commission, Chapter Eight - Sentencing of Organisations, U.S.S.C. § 8 C5.5, November 1, 1991). In part this interest arises because fraud cases involve almost half of all corporate crimes (Alexander and Cohen, 1996a, p. 427). Upward departures from the guidelines are also required when any corporate crime involves a 'substantial risk to the integrity or continued existence of a market' (United States Sentencing Commission, Chapter Eight - Sentencing of Organisations, U.S.S.C. Proposed Addition to the Sentencing Guidelines, § 8.12, July, 1988).

Some economists, such as Tom Ulen (1996), defend the theory behind the guidelines by arguing that criminal penalties are required to ensure that offending firms internalize the losses imposed on buyers because frauds cause both consumers and firms to take costly defensive actions. In this discussion, fraud affects third parties like a tax, raising both the costs of production by firms and lowering the price that consumers are willing to pay. While Ulen accepts that there is an optimal amount of fraud, criminal penalties should account for these third party losses whenever there is more than the 'socially optimal amount of fraud taking place' (p. 358). How one knows when these frauds are greater than the optimal number is not clear, though most of this discussion identifies dead-weight losses whenever frauds effect third-party behaviour. The question of how large the criminal penalties should be are then a function of those parameters that determine the dead-weight loss from taxes (for example, the elasticity of demand).

An alternative position argues that third parties should normally be seen as benefiting from the frauds committed against others (Daniel and Lott, 1995; Lott, 1996). For example, if after a fraud other firms' customers desire that they acquire more reputation because the customers learn that the existing level of reputation produced less quality assurance than they had previously believed, the revelation of the fraud allows them to better equate the marginal benefits and costs from buying quality assurance. The

distinction drawn here is whether the fraud changes the underlying probability with which other frauds will occur or whether it merely provides other firms' customers with better information to evaluate their own situation. Given that few frauds are likely to innovate new methods of perpetrating the deception that will then be copied by imitators, few frauds will alter the underlying probability of other frauds occurring.

An interesting debate concerns whether it might be more efficient to impose penalties on the principals instead of simply holding agents directly liable for their actions.

Kraakman (1984b) suggests that part of the reason may have to do with monitoring costs. For example, corporate liability may be efficient if the government is better at monitoring corporations and these corporations are good at monitoring agents. Salzborg (1991) and Polinsky and Shavell (1993) point out that the penalties imposed upon the firm may not always be large enough to produce the efficient level of deterrence, thus justifying an additional penalty being imposed upon the agents (while Salzborg merely provides a verbal argument on this issue, Polinsky and Shavell provide the formal model behind this reasoning). Salzborg (1991) also advocates prosecuting corporations because it reduces the prosecutor's burden of investigation and conviction and avoids various perceived procedural problems, though in the end this argument amounts to little more than a claim that both firms and individuals should be prosecuted because it is possible to do so.

Arlen (1994) suggests that penalties on principles may have the unintended effect of inducing principals to expend less effort monitoring, since their own monitoring of principals may increase the likelihood of detection. Unless corporations are compensated for its monitoring efforts through penalty reductions that offset the higher probability of prosecutions that result from the internal monitoring, the private return to monitoring will fall below the social return. Davis (1996) raises the issue of how the possibility that agents' actions can create liability for a firm's principals thus alter agents' compensation. He asks whether agents actually prefer government rules that increase their liability. His conclusion is that there are reasonable assumptions about the agent's risk neutrality and how the earning depend on legal and illegal profits, where agents will prefer legal liability.

However, whatever the answer to these questions, the central question still remains: should corporate criminality even exist. While there are philosophical arguments over whether a corporation as compared to individuals can have intent (Parker, 1996), economists have largely debated whether criminal sanctions are necessary to ensure that corporations internalize the externalities that their illegal behaviour creates. Block (1991), Karpoff and Lott (1993), Fischel and Sykes (1996) and Parker

(1996), ask whether civil penalties might be preferred. Not only do criminal proceedings require higher levels of proof than civil proceedings but, for firms, the ultimate penalty is the same in either case: fines. Civil prosecution provides other benefits ranging from compensation of victims, law enforcement efficiencies, and the ability of apparently obtaining the same stigma produced by criminal prosecution though at a lower cost (Parker, 1996, pp. 387-389).

One question still persists: might the government be better suited to imposing particularly large penalties on individuals because the government can use imprisonment while private firms are limited to monetary damages? While this is true, it misses the central point. Criminal charges can still be pursued against individual agents even if the case against the firm is handled civilly (Fischel and Sykes, 1996).

3. Empirical Evidence

Empirical corporate crime studies take several forms. Either they measure the size of the criminal penalties and how the US Sentencing Guidelines have altered these penalties, test which characteristics are exhibited by firms engaging in crime, measure firm profitability from crime, or examine whether the US Sentencing Guidelines have moved penalties closer towards efficiency.

Penalties prior to the guidelines appear to have exhibited many patterns consistent with optimal penalty theory (Cohen, 1996). Not only did firms creating greater harm face greater sanctions, but individual liability was also greater when the organisation was unable to compensate for the harm done. Interestingly, for the crimes with the largest losses, the penalty that the courts imposed suggested a belief that the probability of detection was higher for those crimes (Cohen, 1991 and Lott, 1991, p. 440). An easy optimal penalty explanation appears to exist for this. For example, large oil spills are virtually certain to be detected, but tiny ones (for example, the discharging of ballast) are most likely to be unnoticed.

The sentencing guidelines turned much of this pre-existing structure on its head, with the multiple now instead increasing with the size of the harm. The guidelines also have dramatically increased criminal penalties. Early estimates indicated increases of 20, 30 or 40 times over previous penalties, and changes as high as 50 to 100 fold for a few select crimes (Cohen, 1991). Others produced estimates of at least twenty-fold (Block, 1991 and Lott, 1991).

With fraud being the largest category of corporate crime and one of the areas with the biggest increases in penalties under the guidelines, much of the recent empirical evidence has focused on it. Analysing the Sentencing

Commission's concerns that the penalties for fraud have been too low, economists sought to investigate whether traditional emphasis on legally imposed penalties underestimated the true penalty. To evaluate this, Karpoff and Lott (1993) measured the extent of reputational penalties for fraudulent firms prior to the 1991 corporate guidelines. An allegation that a corporation had defrauded stakeholders or the government corresponds to an economically and statistically significant loss in the market value of the common stock. On average, very little of this loss, in the order of 6.5 percent, can be attributed to the accused firm's expected legal fees and penalties. It is possible to compute larger portions of the loss that could reflect higher expected penalties for future frauds and the lost value of the cheating firm's profits from committing fraud. But even under extremely unrealistic assumptions, one third of the loss remains. (Yet, firms are not the only entities to suffer from reduced earnings when they commit fraud. White collar criminals face large reductions in legitimate earnings when they are convicted of fraud (Lott, 1992). The average criminal convicted of fraud faces almost a 40 percent drop in legitimate earnings when he returns to the workforce. Similar drops are also observed for embezzlement, larceny and theft.)

Large reputational penalties are associated with frauds committed against stakeholders, government agencies, and investors. In contrast, the reputational loss for frauds involving regulatory violations, in which firms have not violated an implicit or explicit contract with a stakeholder or investor, is negligible (see also Block, 1991). The evidence is consistent with the market penalty for fraud being systematically related to the cost imposed on parties with whom the firm does business. Because of their large size, reputational effects play an important role in disciplining firms that commit fraud. There appear to be very similar reputational penalties when either criminal or civil cases are filed (Block, 1991).

For fraud, the average decrease in common stock value exceeds the US Sentencing Commission's estimates of victim losses by more than 100 times. The Sentencing Commission reports that Department of Justice prosecutors believe the probability of convicting a corporate fraud is between 20 and 57 percent, implying an optimal ratio of actual penalty to social costs of between 1.75 and 5 (Lott, 1996, pp. 374-375). Yet, as mentioned above, the expected *total* penalty far exceeds the Commission's estimated loss borne by the victims, and this holds even at 1980's levels of criminal fines. Thus, unless these numbers are off by a very large magnitude, the past efforts to substantially increase criminal penalties for corporate fraud were completely misguided.

Some evidence indicates that managers conceal bad news from the market (Arlen and Carney, 1992), indirectly supporting a 'last period hypothesis', in which misconduct results from poor performance on the part

of the firm. Yet, other findings suggest no actual or expected deterioration in firm profitability prior to a fraud (Karpoff and Lott, 1993). A study by Alexander and Cohen (1996a) examines other aspects of firms' performance prior to a fraud, as measured by the firm's assets, employment and sales. With the exception of environmental crimes, they find no relationship between these measures and whether a fraud is going to occur.

Antitrust penalties have been studied extensively by economists, and up until recently, when it was displaced by environmental crimes, it involved the second largest number of cases. Asch and Seneca (1975, 1976) provided the earliest evidence in this area by investigating whether the prior performance of firms charged with antitrust violations differed relative to their Fortune 500 counterparts. Surprisingly, Asch and Seneca found a significant negative relationship between collusion and several alternative measures of performance such as growth in sales and return on assets over the five years before the date of the relevant plea or court finding. Staw and Szajkowski (1975) attempt to explain this result as lower profitability leading to collusion. (However, since these studies rely on actual government suits, there is always the nagging question of whether the government can accurately tell which firms if any are engaging in antitrust violations.)

Game theory has also suggested essentially limitless explanations for firm behavior. A number of recent game-theoretic models suggest that with asymmetric information it can be profitable for some firms to acquire a reputation for toughness in order to discourage later entry. One may view these models as providing a method of understanding what factors increase the likelihood that firms commit crimes, though initial empirical evidence provides little support that these models will be particularly useful. Lott and Opler (1996) identify institutional arrangements that firms must undertake to ensure the credibility of any predatory commitments. Simply hiring managers who value market share or output maximisation is not sufficient if the manager can be removed whenever it actually becomes necessary to engage in predation. It is also required that the firms make removing the manager difficult. In addition, the incumbent manager should be rewarded for increasing output as opposed to increasing short-term profits. A study of firms charged with predation failed to yield any support that allegedly predatory firms are organised as these game-theoretic models imply. If anything, the reverse seems to be frequently true.

Alleged predators more often are large firms with managerial compensation schemes relying heavily on short-term profits (Lott and Opler, 1996, pp. 362-363), with this last fact hardly seeming consistent with any known notion of predation. Just as Bork (1978, pp. 347-364) argues, the general picture is consistent with the laws being used to harass large profitable firms.

4. Conclusion

Economists have discussed and answered a number of questions about corporate crime in only few years time span. Perhaps this unusual success is due to the questions involving corporations being so similar to other crime issues, previously analysed. However, a number of questions remain largely unexplored. Why do certain firms commit crimes while others do not? What are the social costs imposed by the very high corporate criminal penalties? How does the criminal justice process shape the organisation of firms? These are areas that should lend themselves to very interesting future research.

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