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When Greed Goes Bad
And What America Can Do to Make It Good Again

Chris Brooks*

When [the] ethic of acquisition combines with a strong disposition to regard liberty as the dominant political value... you have created a society in which people believe it is their right to get what they can and to keep what they get.

In the 1980s movie Wall Street, the character Gordon Gecko, corporate raider, made a statement that embodied the prevailing corporate and economic thought of the day. “Ladies and gentlemen,” he stated, “greed, for lack of a better word, is good.” Even up until the corporate scandals of the past few years broke, “greed is good” was still the existing sentiment among economists who espoused Adam Smith’s Invisible Hand as the miracle of the free marketplace. It seemed that greed was indeed good, and people trusted in the Invisible Hand to watch over the markets in combination with existing regulations and laws. However, almost overnight, the glitter of “greed is good” was discovered to be nothing more than fool’s gold, as scandal after scandal rocked corporate America. It was not so much the occurrence of the scandals—corporate crime has been a part of economics throughout history—but their scale that was so shocking.

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1 Lawrence E. Mitchell, Corporate Responsibility (New Haven: Yale University Press, 2001), 36. His argument that today’s market is more concerned about short-term stock price jumps than long-term growth is a pivotal focus point of this article.

Billions of dollars were lost in the Enron, WorldCom, Global Crossing, and other major corporate scandals where it was discovered that senior managers and directors had been fraudulently concealing debts, using “creative accounting” to doctor financial statements and then quietly skimming off what was left for themselves. Greed had become bad. Even as Congress rushed to implement reforms, economists, lawyers, and pundits everywhere were asking how it could be that such a commonly held economic belief could be wrong.

This article seeks to examine that issue as well as some possible solutions to it, exploring twenty years of economic thought, studies, and legal articles. First, I will explore the current economic theory and its weakness. This exploration will begin from the assumptions of rationality that have been made for the accepted economic models of individuals and corporations. I will then show how those assumptions are no longer valid in our current corporate atmosphere. Second, this article will focus on the apparently irrational decisions that lead to corporate scandals. I will show that it is not that the corporations and managers involved made irrational decisions, but rather that the decisions they made were based on a rationality which has more influencing factors than the current theory allowed for. This section will focus especially on the notions of profit maximization and stock price maximization, as well as how stock prices have become such a dominating factor in corporate decision making that they have completely destroyed the model.

A. Why the Current Theory Must Be Revised

Current economic theory (upon which most corporate law is based) relies, among other things, on the premise that most of us act rationally. The assumption is that people are utility-maximizing decision makers. In other words, when faced with decisions, an individual will perform a utility calculation and come up with a plan of action that will maximize his or her expected utility, or happiness. This calculation, according to economists, consists of measuring the costs and benefits of an action. This calculation then leads a rational agent to pursue the best end for himself.

As humans, we have attempted to anthropomorphize the corporation and its decision-making process to fit our rationality model. However, corporations present a certain difficulty for this model. Corporations are large organizations of diverse people with the goal of maximizing profits. In this

1 The analysis that will follow is by no means intended to disparage any economic theories or proposals for corporate reform. My focus and hypothesis is that each of these has merit but must be combined together to achieve any effective and lasting reform.

2 Mark A. Cohen and Sally S. Simpson, “The Origins of Corporate Criminality,” Debating Corporate Crime (Cincinnati: Anderson Publishing Company, 1997). For individuals, this rational calculus is explained best by Cohen and Simpson as a calculation that attempts to maximize an individual's expected utility by taking into account the results of a decision on one's income, quality of life, reputation, and self-respect.

3 If we take the corporation to be a rational entity, Cohen and Simpson provide another calculation for the corporation where the goal is to maximize profit, not utility. The calculus in this case takes into account the results of a decision on the corporation's price of product x total sales, net benefit from illegal activity, cost of production/distribution,
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1720: The first great stock market crash occurred in England when the "South Sea Bubble" in stock of a company monopolizing trade in the South Seas collapsed amid allegations of bribery and stock manipulation.

1920: Charles Ponzi promised investors a 50 percent profit in 45 days for purchasing notes. Early buyers were paid from cash collected from later buyers, but Ponzi took the rest of the proceeds. When late buyers saw through the scheme, it collapsed.

1930: Ivar Krueger, called the "Match King" because he headed companies that made most of the world's matches, used all sorts of shenanigans to deceive shareholders, including secretly borrowing money at high interest rates in order to pay dividends.

1938: Richard Whitney, the ex-president of the New York Stock Exchange, was found to have taken money from a fund for widows and orphans and the New York Yacht Club, among other places, to prop up his own liquor business.

1962: Billie Sol Estes, a Texas wheeler-dealer with high political connections, raised money by mortgaging farm gear that didn't exist.

1986: Wall Street arbitrageur Ivan Boesky was nabbed for insider trading. His testimony led to the conviction of junk bond king Michael Milken for market manipulation.

that most laws and assumptions about corporate behavior are based on. Third, I will examine the issues involved in fixing the current corporate culture and prevention of corporate crimes in the future. This will show that many of the current suggestions and proposals to prevent corporate crime have merit but are too narrow to have any lasting effect by themselves. I will then conclude this area of analysis by presenting a solution combined from the other, narrower proposals. The idea will be to use the strengths of the various strategies while eliminating their weaknesses.

1. NEW WINE IN OLD JARS

A. WHY THE CURRENT THEORY MUST BE REVISED

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context, then, their utility maximization function would attempt to make the greatest amount of profit for the company. This has been the accepted model in the legal world. There is no shortage of court cases in which the corporation has been considered a profit-maximizing rational juris entity, and this idea has been the basis for the decisions in several cases about corporate liability.

Courts generally hold that by the rationality definition, corporations will not commit crimes since the sanctions involved would be so great as to make it irrational to do so. Indeed, this is the basis behind laws and regulations that attempt to make the cost of the crime too high to be rational. Yet even with regulations in place to make corporate crime irrational, it is still committed.

and sanction for illegal activity. However, this creates a problem, as they explain on page 38 of their article: "The model of corporate decision-making we presented is general enough to allow for the case where the firm ignores any social responsibility of business unless the firm finds that its interest (i.e., long run profitability) is best served by being socially responsible, as well as the case where social responsibility is assumed to be one of the constraints on profit maximization itself." In other words, whereas individuals will consider the social and moral ramifications of their actions and factor that into their calculations, corporations only look at social responsibilities in a bottom-line, amoral manner.

Robert A. Prentice, "The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation," Northwestern University Law Review 95, no. 1 (2000): 133. Prentice quotes from several corporate and accounting fraud cases in which it was assumed by the courts (and so reflected in their decisions) that many of the actions the defendants were accused of were irrational, given their situation. The opinion from Melder v. Morris (27 F.3d 1097 5th Cir. 1994) holds that "accounting firms— as with all rational economic actors— seek to maximize their profits. . . . [Therefore], it seems extremely unlikely that [defendant audit firm] was willing to put its professional reputation on the line by conducting fraudulent auditing work for [its client]." Another famous case is quoted on page 136—that of DiLeo v. Ernst & Young (901 F.2d 624 [7th Cir. 1990]), in which the judge wrote, "The complaint does not allege that [the audit firm] had anything to gain from any fraud by [its client]. . . . It would have been irrational for any of them to have joined cause with [the client]." However, as he later notes, auditing companies and other corporations do indeed commit these crimes that would seem to be irrational according to common economic theory.

7 Prentice explains, on page 138 of his article, the consequences of courts looking at rational and irrational behavior when dealing with corporate crime. "DiLeo embodies two of the most significant dangers of law and economics theorizing. First, law and economics analysis is sometimes predicated on flawed core assumptions. In this case, the core assumptions are that (a) auditors are always rational actors, and (b) audit firms are always rational actors. Second, to be operationalized to the real world, the core assumptions of law and economics must typically be supplemented with additional (occasionally unrealistic) assumptions about how the real world works. . . . that (c) it is always irrational for individual auditors to audit fraudulently or recklessly, and (d) it is always irrational for audit firms to audit fraudulently or recklessly."

Donald C. Langevoort, "Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)," University of Pennsylvania Law Review 146 (1997): 106. Langevoort notes that "from a rational standpoint, why would public companies ever deliberately lie to investors when, because they are neither buying nor selling stock in the open market, there is nothing directly to gain. . . . Yet cases of alleged deception seem to persist in large numbers."

8 Some of the limitations on rationality are given by Prentice (133). Those include bounded rationality (an agent can't process information perfectly and does not have perfect information), rational ignorance (the tradeoff between cognitive effort and judgmental accuracy—making merely satisfactory, rather than optimal decisions), perception limitations (agents don't perceive data in a perfect way), memory limitations, undue optimism and overconfidence (which occurs quite frequently in corporate culture), framing (e.g., how a statement is worded—either positively or negatively), the inability to estimate probabilities, behavioral traps (sunk costs, time-delay traps), and bounded willpower.

Aristotle's argument was that a good society needs virtuous (ethical) agents. His solution was that people need laws to bring them up and show them virtue when young so that they will choose virtue as adults. His belief was that virtue is something that we learn, not something that we are necessarily born with. As a result, in order to make correct and virtuous decisions in society, we need to have been trained up in the ways of virtue so that they end up in our calculus for rational action.
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However, the corporation, although it is made up of individuals, has no moral compass nor social responsibilities to factor into its profit-maximizing function. Its only purpose is to make money.10

This is only part of the weakness inherent in the “corporation as a rational entity” model. Another weakness is that it ignores the schizophrenia of the corporation. While it is indeed a profit-maximizing entity, the corporation is made up of people who have different goals. The model begins to break down when we consider all of the different actors involved in the corporation's decisions, as well as the effect that the corporate culture has on them. Clearly, the corporation cannot be considered a decision-making entity in itself, since its board of directors and managers make decisions, not the corporation. On the other hand, the managers and directors have to put aside their own goals to work towards the goals of the firm.11 This creates a schizophrenia that makes our rational model very difficult to use when considering corporate crime.

**B. TOWARDS A MORE WORKABLE MODEL**

A theory as problematic as the rational entity model is not very accurate when we attempt to determine the true nature of why corporate crime occurs and what we can do to prevent it. Legal and economic experts advocate different models to use when examining these issues. We will choose a model that considers the managers and directors to be the decision makers. The two major camps espousing this model are the agency model and the structure model.12 Each of these camps has strengths and weaknesses, based on their specific assumptions and methods.13

For the rest of this article, I propose a model which I call the “expanded agency” model. This is the model hinted at by Mark A. Cohen and Sally S. Simpson. It seems that the best solution lies between the two theories. As

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10 Mitchell (46-47) states that “when we fail we have souls to damn and bodies to kick. We have the capacity and usually the desire to repent for, and sometimes rectify, our mistakes. Corporations have no such mechanism. Quite the opposite . . . the corporation knows one thing and that is profit maximization, regardless of the fact that it requires human beings to help it pursue that goal. The result is that corporations are able to act without morality or accountability for they are formed for a single purpose.”

11 Edward Thurlow, First Baron, is reputed to have said (about 250 years ago), “Did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?” (qtd. in John Coffee, “No Soul to Damn, No Body to Kick,” *Michigan Law Review* 79 [1981]: 386). The corporation’s amoral nature and the manager's moral nature—however weak it may be—clash together when making decisions. Mitchell (72) maintains that “corporate moral development, which means the free moral development of corporate actors as corporate actors, is a precondition to responsible, accountable corporate behavior.” Corporations, by being built on an amoral foundation, often do not allow free moral development and decisions by their agents.

12 Cohen and Simpson (33) explain the agency model’s basic premise “that corporate crime occurs as a result of choices made by managers or other individuals within an organization.” This model looks at the individuals involved in decision making and factors in the corporation’s influence only as a minor factor.

13 Ermann and Rabe, 57. “Motives compete. There are many levels of rationality.” Neither model (agency or structural) is completely correct for this reason, as well as the reasoning given by Cohen and Simpson (Cohen 34). They note that “unlike traditional street crime or white-collar crime, there is often an additional layer of control and decision making that affects the decision to commit [corporate] crime. That layer of control is the corporation itself, which may provide incentives or disincentives to commit [or prevent] criminal activity within the corporation.” Thus we see that the two models are examining different facets of the corporate criminal’s motivation, but neither explores the whole issue. Instead, we must focus our inquiry on a combination of the two theories which will take into account both the individual’s rational calculus as well as the effect that the corporate structure has on the individual's decision. Ermann and Rabe (67) agree with this idea in their statement: "Organizational crime is multicausal. . . . Each decision and non-decision must be understood in light of what has happened up to that point in the company, not in terms of the presumed guiding star of profit maximization."
However, the corporation, although it is made up of individuals, has no moral compass nor social responsibilities to factor into its profit-maximizing function. Its only purpose is to make money.¹⁰

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¹³ David Ermann and Gary A. Rabe, “Organizational Processes (Not Rational Choices) Produce Most Corporate Crimes,” Debating Corporate Crime (Cincinnati: Anderson Publishing Company, 1997), 59. Ermann and Rabe explain the structural model. “Opposing agency models are ‘organizational process’ or structure models which argue that organizational crimes flow from organizational contexts rather than conscious motives. . . . The structural model permits rationality, but it starts from different observations about how corporations cope with the worlds in which they operate. They attempt, sometimes successfully, to balance incompatible goals. . . . Crime may be the product of a set of non-criminal decisions, which ultimately gives later decision-makers the motives and opportunities to commit crimes.” This model looks at the corporate culture as causing the situations that force corporate agents to make certain decisions. In brief, the agency model assumes that the crimes are committed by the individuals working for the organization—the individual acts rationally to pursue the corporation’s goals. The structure model, on the other hand, maintains that the corporate culture itself creates situations in which the outcome of a decision is based solely on that culture—in other words, the philosophy that the devil (the corporation) made me do it.

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Cohen points out, we are obliged to recognize that corporate crime is committed by rationally acting individuals. Even if those individuals are acting on behalf of the corporation, the corporation itself is not the rational actor. As examined by Simpson, we must also note that the environment and culture of corporations is different for each corporation, and thus these factors can and should be accounted for in our determination of the rational calculus of a manager or director of such a corporation.

What this model does for us is to allow us to collapse the apparent schizophrenic decisions of corporations into an understandable process that is built on many years of human philosophical observation. We are no longer limited to looking at a soulless monster (a.k.a. The Corporation), but instead at the parts of the corporation that actually make the daily decisions which are either legal or illegal—decisions based on the individual’s rational calculus which is influenced by the environment in which he is making those decisions. We are also not limited to simply looking at the corporate culture as the sole cause of those decisions. With this model we are prepared to proceed to examine how the current corporate situation causes rational decisions that break the law.

II. GREED GONE VERY BAD

A. THE GOALS OF A CORPORATION

The stated goal of a corporation is to make as much money as possible. In days gone by, businesses would be owned and managed by one person, or a very few people, who would expand the business as much as possible while building a company that had the potential for long-term success. In the event that the company went public with stock, the company’s goal then evolved to maximizing the profit of the new owners—the shareholders—by making the stock worth as much as possible.

Somewhere along the line, though, profit maximization began to mean stock price maximization. This in turn, led managers to focus more on the stock price as the measure of success of the corporation as opposed to other long-term factors which had been the focus in the past. Additionally, whereas stockholders used to invest in the company for the long run, hoping to get a return on their investment as the company grew over time, present-day stockholders wish to make as much money as possible in as short an amount of time as possible. Stockholders no longer care about the future of the company, but rather they care about how much the stock price enriches their portfolio. As this trend has continued, those who invest in stocks have turned from investors to gamblers, buying stocks that they think will rise and then selling them if they fall a little or as soon as the stockholders have made their desired profit.

B. SIDE EFFECTS MAY INCLUDE...

This shift in corporate goals has, in turn, led to an unintended side effect—managers and the board of directors in a corporation have become fixated on the concept of constantly rising stock prices. They have developed this attitude for two reasons. The first is that the profit-maximization function has shifted from worrying about profits to worrying about stock prices. This has led to an increased reliance on a very unreliable value as a metric for the success of the corporation. The second is that annual shareholders’ meetings and elections, an executive’s job is on the line if he does not cause the corporation’s stock to rise consistently. These factors become very strong factors in the corporate manager’s rational decision-making process. The modern corporate manager has to weigh being caught in illegal activity to drive stock prices higher or being fired as a result of planning long term while allowing the company’s stock to depreciate slightly. For many this corporate structure itself: the corporation’s legal structure encourages managers to aim for exactly this short-term result, and it does so by constraining their freedom to act responsibly. . . . The result is immoral behavior.” He further states on page 5: “We no longer invest in corporations, but in analysts’ projections of future stock prices.”

19 Ibid., 144. This is due to the noncommital attitude that shareholders develop towards investing. They think of themselves as gamblers more than they consider themselves owners. Mitchell laments that “this is not an attitude that produces caring stockholders. It is certainly not an attitude that would lead a stockholder to read an annual report or proxy statement, much less to fill out and return a proxy card and vote for directors.”
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Somewhere along the line, though, profit maximization began to mean stock price maximization. This in turn, led managers to focus more on the stock price as the measure of success of the corporation as opposed to other long-term factors which had been the focus in the past. Additionally, whereas stockholders used to invest in the company for the long run, hoping to get a return on their investment as the company grew over time, present-day stockholders wish to make as much money as possible in as short an amount of time as possible. Stockholders no longer care about the future of the company, but rather they care about how much the stock price enriches their portfolio. As this trend has continued, those who invest in stocks have turned from investors to gamblers, buying stocks that they think will rise and then selling them if they fall a little or as soon as the stockholders have made their desired profit.

B. SIDE EFFECTS MAY INCLUDE . . .

This shift in corporate goals has, in turn, led to an unintended side effect—managers and the board of directors in a corporation have become fixated on the concept of constantly rising stock prices. They have developed this attitude for two reasons. The first is that the profit-maximization function has shifted from worrying about profits to worrying about stock prices. This has led to an increased reliance on a very unreliable value as a metric for the success of the corporation. The second is that with annual stockholders’ meetings and elections, an executive’s job is on the line if he does not cause the corporation’s stock to rise consistently. These factors become very strong factors in the corporate manager’s rational decision-making process. The modern corporate manager has to weigh being caught in illegal activity to drive stock prices higher or being fired as a result of planning long-term while allowing the company’s stock to depreciate slightly. For many this corporate structure itself: the corporation’s legal structure encourages managers to aim for exactly this short-term result, and it does so by constraining their freedom to act responsibly. . . . The result is immoral behavior.” He further states on page 5: “We no longer invest in corporations, but in analysts’ projections of future stock prices.”

11 Ibid., 144. This is due to the noncommittal attitude that shareholders develop towards investing. They think of themselves as gamblers more than they consider themselves owners. Mitchell laments that “this is not an attitude that produces caring stockholders. It is certainly not an attitude that would lead a stockholder to read an annual report or proxy statement, much less to fill out and return a proxy card and vote for directors.”
proves to be no contest. This is how scandals such as Enron have come about.

Looking at the situation from more of an ethical standpoint also illuminates another side effect of stock price maximization. Because the fear of being fired for low stock prices is so strong, managers tend to focus on that aspect of management alone. As a result, management becomes numbers-centric. The manager focuses only on the bottom line and becomes more distanced from his employees. To him, all that matters is performance—the means used do not matter, so long as the end result is higher stock prices. What employee is going to give bad news about the quarter’s profits or a project’s schedule to a manager who is likely to fire him as a result? Managers who are more likely to “shoot the messenger” are less likely to be told bad news that should be factored into upper-level decisions in the corporation. This also means that lower-level employees and managers are likely to do whatever it takes—even if it is illegal—to see that their jobs are not threatened or concealed, either to buy time or create the possibility of a settlement.

In order to present a proposal to fix the current problems with greed, we must first examine what has been tried in the past and why it has not worked. Most proposals to prevent corporate crime attempt to influence the rational calculus that is involved in corporate decision making by having the negative impact of the results of corporate crime outweigh the profit gained from it. Generally, society (and legislation) has tried to do this through two different means. The first has been through legal sanctions. The idea behind this is, by imposing penalties if laws are broken, to make it too expensive for the corporation to commit the crime. However, as the recent corporate scandals have demonstrated, these sanctions seem to have been woefully ineffective in preventing major corporate crime. Many believe current legislation to be too soft on corporations. This view is held by many in

C. THE INVISIBLE HAND BOUND

Originally, Adam Smith’s idea of enlightened self-interest—the profit-maximizing rational agent—had greed as an essential part. But while being greedy, that self-interest was supposed to be balanced with a rational calculus that would lead to fair competition. Unfortunately, the factors that entered into the corporation’s decision-making process have skewed self-interest far beyond what Adam Smith envisioned. Greed has now gone bad to such an extent that billions of dollars are lost through the decisions of managers whose hands have been tied by corporate influences. Our goal in the next section will be to see how the Invisible Hand can be unbound and fair competition restored.

III. MAKING GREED GOOD AGAIN

A. LEARNING FROM PAST MISTAKES

"Here Coffee (399) notes in agreement that "for the middle-level official the question is not whether the behavior is too risky to be in the interests of the corporation from a cost/benefit standpoint. Rather, it is which risk is greater—the criminal conviction of the company or his own dismissal for failure to meet targets set by an unsympathetically demanding senior management. Because the conviction of the corporation falls only indirectly on the middle manager, it can seldom exceed the penalty that dismissal or demotion means to him." Here Langevoort (114) agrees. "If the senior management group believes that it faces the threat of company insolvency, with the high probability of group firing, then it will see the tradeoff for not lying as one of the threatened loss of salary, bonuses, and perquisites, plus any personal reputational damage resulting from such a termination. That is a draconian threat indeed, and even a rational actor will be tempted to avoid it through concealment, either to buy time to create the possibility of a turnaround, or simply to milk their positions for as long as possible . . . Legal deterrence is minimal for selfish managers in light of the prevailing doctrinal regime’s strong bias towards vicarious liability, wherein nearly all settlements and judgments are paid either by the company itself or its director and officer liability insurers—not by the managers themselves." Furthermore, Cohen and Simpson (44) indicate that "results show that the greater the importance top management attached to rate of return criteria in evaluations of divisional performance, the greater the incidence of both OSHA and EPA violations." (Not including this may be misleading.)

"This follows from the very simple argument postulated by Langevoort (125). "Positive information will move more quickly to the top, with the primary problem in assessing it being the possibility of overstatement, and excessive and conflicting claims of credit. Negative information will travel more slowly, if at all, and will be more subject to skewing. On average, a natural optimistic bias results."
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Congress. As a result, Congress rushed to pass the Sarbanes-Oxley Act in 2002 to tighten enforcement and increase sanctions as related to the accounting firms and other individuals who manage the books of corporations. Unfortunately, sanctions can go so high that they become ineffective by being too overbearing.

Another technique that has been tried is market sanctions. The theory is that if corporations fear damage to their reputation and loss of market share as a result of crime, then they will not commit those crimes. This policy is similar to what is outlined in Nathaniel Hawthorne’s *The Scarlet Letter*. Unfortunately, most large corporations who commit crime will not suffer enough in market share losses and reputation loss for this to make much of a difference. Market sanctions appear to not have had enough effect in preventing corporate crime.

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20 Ermann and Rabe (66) warn the legal community against being overzealous in imposing sanctions. “Fines are not [generally] paid by the guilty parties. Organizational agents responsible for the criminal behavior are not harmed by an organizational fine... Furthermore, if judges try to order fines in the amounts proposed by economists, they would confront what Coffee calls a ‘deterrence trap.’ Fines would have to be so large that organizations would not have the resources to pay them... Repercussions for the criminal behavior would fall upon guiltless third parties.” Langevoort (114) also cautions about harsh sanctions. “The natural response for the law would be to increase the sanctions, hoping to make the law salient enough to break through the organization’s thick cognitive defenses. As sanctions grow more draconian, however, we encounter the familiar problem of overprecaution... The risks associated with the overlegalized corporation are well noted in the literature... It is hard to predict whether any given high sanction will tend to overdeter rather than strike the right balance” (170–71).

21 David A. Skeel Jr., “Shaming in Corporate Law,” *University of Pennsylvania Law Review* 149, no. 6 (June 2001): 1817–18. Market sanctions work from the theory that a company cannot afford to be “shamed.” As Skeel postulates in this article, “an obvious benefit of shaming sanctions is that they clearly signal a community’s moral disapproval of the offender’s conduct.” However, Skeel continues on to point out the flaw of using shaming as the sole punishment—it is possible that the company (like gang members trying to get a “badge of honor” by being arrested) may defiantly embrace the shame. In such a case, or in cases where the rational calculus determines that the shame does not cost more than is gained from illegal activity, then market sanctions become useless by themselves. Prentice (202) also notes that “there are limits to reputation.”

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B. WHY DID THEY FAIL?

The reason that these two types of sanctions have not had the desired effect on corporate behavior is that they have all operated under an incomplete theory. Those policies have ignored the human factor mixed with the corporate influence that is involved in the decision-making process. Individuals make rational calculations differently than corporations, and within the context of the corporate model they may be influenced to act differently than they would outside of it. Additionally, past models and solutions have focused on the amoral aspects of decision making, assuming that morals have no place in profit maximizing. Past attempts at prevention have not focused on reforming the system by fixing its causes but instead have tried to punish offenders.

One of the issues involved in corporate crime prevention that has been largely overlooked is the issue of trust. The twin concepts of trust—accepting others and relying on them—and trustworthiness—doing what another believes you will do—have been ignored for too long in corporate economic theory and the laws that result from it. Studies of human behavior have shown that trust is an essential factor in an individual’s rational calculus.\(^\text{22}\) Furthermore, studies show that employees who trust their management (and by extension, managers who trust the corporation’s owners, the stockholders) are more trustworthy as well. However, lack of trust fosters an environment in which an individual is less likely to behave in a trustworthy manner and more likely to commit a crime.\(^\text{23}\)

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C. FIRST STEPS TOWARDS A SOLUTION

No proposal focused on just one element of corporate crime can possibly hope to solve the problem completely. There are just too many diverse elements that all combine to cause corporate crime. However, by taking an approach that attacks multiple causes, we can work towards a solution that will be much more effective. In presenting this solution, I propose three tiers that must be focused on in corporate law to prevent corporate crime in the future and make businesses trustworthy again. Those tiers are the shareholders, corporate culture, and employees.

i. Focus on the Source

The first focus should be on the shareholder. Shareholders in today's market are concerned only with how much money the stock makes in as short an amount of time as possible. They generally do not research a corporation thoroughly before investing, nor do they actively participate in its management even though they are technically owners of the firm. There are several possible ways to remedy this.

First, Mitchell presents the idea of tax incentives to encourage investors to stay with one stock for a long period of time.24 The government can tax stock sales when the purchase of the stock took place less than a set time previously, or it can give tax breaks for those who have held a stock for a long time. Giving incentives to stockholders to hold onto stocks longer would prompt them to be more concerned about the future of the company as opposed to its quarterly yield. Additionally, tax incentives may encourage them to consider themselves as part owners of a corporation rather than simply as speculators gambling on how the stock will do over a certain period of time.

correlated with trustworthiness. High trustees not only expect others to cooperate; they are also far more likely to cooperate themselves." Of course, in a corporate environment, the converse also holds true.

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A second solution is proposed by Lipton and Rosenblum. It suggests a way to free management from the shackles that annual stockholders’ elections impose on them by going to a quinquennial election system. Under this system, members of the board of directors would be elected to five-year terms. They would then have the chance to be reelected for another five years based on their record over the past five years and their plans for the next five years. This would have three positive effects. First, it would remove the necessity for managers to perform well constantly in the short-term and allow them to concentrate more on the long-term. Second, it would encourage investors to stay with the stock longer in the hopes that the long-term benefits would be seen. Third, it would also encourage investors and stockholders to educate themselves on the policies and decisions of the corporation.

The idea of stockholder education is also a very important one. Under the current system, managers can have a business plan that is extremely detrimental to the company in the long-run but that produces incredible correlated with trustworthiness. High trustees not only expect others to cooperate; they are also far more likely to cooperate themselves. Of course, in a corporate environment, the converse also holds true.

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profits in the short-run—much like Enron. Investors who have not researched the company will be encouraged to invest in it based solely on the stock price of the corporation and how it has performed in recent months. However, a policy which requires investors to be informed of company decisions, policies, long-term goals, and long-term prospects will have two effects. First, it will result in smarter investors who will be less easily fooled by short-term earnings reports. Second, it will require managers to have good plans and goals in order to attract those educated investors who will also be more likely to invest for the long term.

ii. Change the Culture

Focusing on the investor is only one means of attack on corporate crime. The second means of attack is focusing on corporate culture. Proponents of the structural model of corporate crime are correct in stating that many incidences of corporate crime are related to, and often caused by, a corporation's culture. Changing that culture is as important as informing investors or passing punitive legislation. This culture change has to take place from the top down—starting with the board of directors and managers.

Culture change must start by promoting trust and trustworthiness. There is evidence that the level of trust at a workplace can strongly influence employees' behavior and that an increase of trust and less by-the-numbers management can have a positive effect on the levels of illegal activity occurring in the corporation. However, this cannot be a simple facelift of corporate policies. Having all employees sign a Code of Ethics cannot have any lasting effect in times of crisis unless there is a good faith change on the part of management. But if such a change is made, the effect will be that managers' rational calculations will be able to be made without the negative effects of that lack of trust and adversarial influence that prevails in an environment that is not trust-centric. Information—both good and bad—will flow more smoothly and without distortion. Efficiency will increase. Finally, the culture will transform into a work environment where informed decisions are made and where trust inside the company leads to trustworthy choices.

iii. Facing Reality

Of course, we would be naïve if we were to ignore the fact that no matter how well we educate investors and reform the corporate culture, there will always be bad apples in the corporation. There will be those managers and employees who try to take advantage of the system for personal wealth or other reasons. There must be an additional solution provided for how to deal with these individuals, as sanctions are the only way to prevent them from committing crimes.

Mitchell (155) explains the reasoning behind the need for stockholder education as the company begins to focus on long-term goals. "The results of... good behavior won't be apparent to stockholders in the short-term; in order to make them understand the business benefits, they need to be in it for the long haul. In order for managers to behave... responsibly, they have to educate their stockholders as to the benefits... We have to work toward that goal first by disseminating an understanding of these benefits in business terms." Education is one of the best ways in which investors will invest more wisely and be willing to wait out short-term stock price drops.

Mitchell (227–28) warns that "in order to be genuinely trustworthy you have to internalize the value of trust. The fact that there may be payoff for trustworthy behavior is important, but if that's your only motivation, you will be inclined to break that trust at the margins... [To build trust,]... all you have to do is care—and show it." He notes, in a somewhat optimistic tone on page 51, that "the simple fact is that most corporate managers are good people who very much want to be good... And to look good, they have to be good."
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Mitchell (155) explains the reasoning behind the need for stockholder education as the company begins to focus on long-term goals. "The results of...good behavior won't be apparent to stockholders in the short-term; in order to make them understand the business benefits, they need to be in it for the long haul. In order for managers to behave... responsibly, they have to educate their stockholders as to the benefits... We have to work toward that goal first by disseminating an understanding of these benefits in business terms." Education is one of the best ways in which investors will invest more wisely and be willing to wait out short-term stock price drops.

Mitchell (226, 228, 230, 231) states that when managers conveyed a sense of trust by the way in which they treated their employees, "employees were almost five times more likely to behave in a trustworthy manner." Some suggestions to create that environment of trust include involving workers at higher levels of decision making, assuring workers that they are sharing in productivity gains, reducing pay differential between managers and workers, and letting workers know that criticism of current practices won't lose them their jobs. Mitchell says that the two most important aspects of trust necessary in the corporate culture are "trust that you are doing your job, and trust that your boss is treating you fairly." As Blair and Stout (1738) insist, "The time has come to incorporate the reality of trust behavior into the analysis of corporations and corporate law." Langevoort (108) concludes also that "corporate cultural biases, particularly optimistic ones, can be adaptive mechanisms for encouraging trust and cooperation, and for deflecting the selfishness-inducing last-period problem that arises in times of stress and threat."

Mitchell (227-28) warns that "in order to be genuinely trustworthy you have to internalize the value of trust. The fact that there may be payoff for trustworthy behavior is important, but if that's your only motivation, you will be inclined to break that trust at the margins... [To build trust,...] all you have to do is care—and show it." He notes, in a somewhat optimistic tone on page 51, that "the simple fact is that most corporate managers are good people who very much want to be good. And to look good, they have to be good."
Most legal sanctions are either too soft or else run the risk of being too overbearing. The reason that legal sanctions so often fail to work in preventing corporate crime is that they are undertaken as the only step of prevention. However, when used with attempts to reform the corporate and market culture, they can have a positive effect on corporate decisions. The deciding factor is whether such sanctions affect the rational corporation’s goal—profit maximization—as well as at the rational individual’s goal—utility maximization—in a meaningful way.

If sanctions are put in place only against the corporation itself, the effects are rarely passed on to the management that is most likely the cause of the criminal acts. In fact, the cost may be borne by the workers and investors who have had no hand in the corporation’s crimes.19 This is due to the limited liability of corporations, which, while it has many benefits, also presents some problems because it does not affect the rational individual’s decision calculus. Thus, we must punish the individuals who are responsible for the crimes. We must also go after the corporations involved in the crimes.20 By doing so, we can affect the individual’s choices and the corporation’s choices by making the cost higher than the benefits of illegal activity.

19 Ermann and Rabe, 66.

20 Philip L. Blumberg, “Accountability of Multinational Corporations: The Barriers Presented by Concepts of the Corporate Judicial Entity,” Hastings International and Comparative Law Review 24, no. 1 (Fall 2000): 297. By “responsible,” we mean those cases with an individual’s real intent. Punishments need to target those responsible for the decisions. Blumberg alludes to this with the statement “there nevertheless remains another promising, substantially unexplored, legal route to achieve increased accountability...through use of the judicial process. This is increased reliance on direct actions against the senior American corporate personnel responsible for the corporate activities in question. Such litigation can rest on the established principles of basic tort law. It would present none of the difficulties presented by entity concepts to the imposition of vicarious liability or to the problems presented by the attempted assertion of derivative jurisdiction over foreign affiliates by reason of the activities of a local affiliate. In brief, where an individual commits a tort, he or she is personally liable.”

21 Coffee (387) states that “law enforcement officials cannot afford to ignore either the individual or the firm in choosing their targets, but can realize important economies of scale by simultaneously pursuing both.” Deborah Lohse, “Executives No Longer Getting Off the Hook,” San Jose Mercury News (accessed 14 September 2002): available from http://www.bayarea.com/mld/mercurynews/4076791.htm. This is happening in some courts in California, as the San Jose Mercury News reports. It is an interesting fact to note that such action does not need to be taken by the legislature—the framework to prosecute individuals as well as corporations is already in place. Later Coffee (458) states, “Perhaps surprisingly, courts may be able to achieve [corporate reforms] in substantial measure without legislative action.” This approach shows much promise for future law enforcement.

22 Ermann and Rabe, 66.

Corporate crime is a major problem in America today. Yet it is not something that has appeared overnight. Today’s corporate crime is a result of years of poor economic assumptions, lack of concern for the changing market strategies, and impractical laws and regulations. If American businesses are to be trusted again, it is time for a change.

This change cannot come on the basis of past economic theory. Our incomplete assumptions about rational economic behavior must be cast away, and more complete models must take their place. Foremost among the changes that need to be made is the concept of trust and corporate culture as they affect agents in the corporation. Additionally, the stock market and shareholders’ expectations must be taken into account.

Once we have looked at an economic rational actor model that closely approaches reality, we must implement changes based on this new model. Past preventative approaches to corporate crime have focused on one or two aspects of the corporate decision-making process—such as sanctions—without looking at the more fundamental changes that have to be made to have a lasting effect. Such a narrow focus has proven unable to effectively prevent corporate crime.

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Additionally, legislating punishments on corporations must be more than simply levying fines. Punishments for corporate crime should include alternative sanctions that would affect a corporation more and obtain actual recompense for the victims without making the corporation's innocent employees and investors suffer. There are a myriad of different ways in which this can happen, such as equity fines, probation, publicity, community service, corrective advertising, civil suits, and criminal actions. By going after both the corporation and the individual, we can place pressure on all aspects of the decision-making process and not focus on just one part of it.

IV. CONCLUSION

Corporate crime is a major problem in America today. Yet it is not something that has appeared overnight. Today's corporate crime is a result of years of poor economic assumptions, lack of concern for the changing market strategies, and impractical laws and regulations. If American businesses are to be trusted again, it is time for a change.

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If we focus on different tiers of prevention, we will be able to create a much more effective prevention strategy that will have a chance to prevent prosecute individuals as well as corporations is already in place. Later Coffee (458) states, "Perhaps surprisingly, courts may be able to achieve [corporate reforms] in substantial measure without legislative action." This approach shows much promise for future law enforcement.

\[31\] Ermann and Rabe, 66.
future corporate crime. We first need to focus on those who own stock. By educating and encouraging stockholders to own stocks for longer periods of time, we shift the prevailing attitude to where stocks represent investment, not gambling. By focusing attention on changing corporate cultures that seem to encourage crime, we can make it less likely that an individual will feel the pressure to commit a crime in such an environment. Further, by introducing the idea of trust back into corporate culture, we can stop corporate crime before it occurs. Finally, by prosecuting corporations and individuals with sanctions that will actually have an effect, we can make the cost of crime too high for those that would commit it in the face of stockholders' desires and a trust-centric corporate culture. Through this multi-tiered approach we can work towards a more effective means of preventing corporate crime and make it possible for American businesses to regain the confidence of the investing public.

The possibilities of fraud occur at the moment when an attorney needs to work out the details of an agreement while under tremendous pressure from his or her client... [to] work around laws to reach company goals.

The year is 2001 and Americans feel betrayed. Major corporations have swindled them out of their money. Investors watch in horror as these public companies file for bankruptcy. The shareholders know the chances of their money being returned are slim. Many of the stockholders have put their life savings into corporations such as Enron and WorldCom that are now paying major settlements for fraud. Not only are these corporations leaving the American people's portfolios empty, but they are also robbing them of their trust. As a result, investments in the market plummet. The economy is in a state of turmoil. Everyone wants to know what caused the corporate chaos. The finger naturally points to those occupations within the fraudulent companies that have been exposed.

Responsibility for Fraud

Former Securities and Exchange Commission (SEC) chairman Harvey Pitt points the finger at attorneys. He says, "One of the biggest disappointments for me since I came to the SEC has been observing the way lawyers are often involved in violations of securities laws." Pitt's statement appears to have weight,

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