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Rebuttal: The Individual or The Firm? Focusing The Threat of Criminal Liability

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I cannot disagree with much of what Mr. Crane has said in his very articulate presentation. One must be careful about trying to prove too much. I have not argued against individual criminal liability, but I do not believe we can rely on it exclusively. Let me therefore confine my reply to this question and to Mr. Crane's criticisms of my equity fine proposal.

Should we focus the threat of the criminal law on the individual or the firm? This key question has two dimensions: fairness and efficiency. Emphasizing the first of these themes, Mr. Crane has suggested that it is unfair to focus the criminal law on the corporation because the costs fall upon the relatively innocent shareholder. I am also concerned about where the costs fall—as I hope my discussion of the "Over-spill" problem has already indicated; I take no pleasure in punishing stockholders (but I see them as a less objectionable cost bearer than workers, customers, or the community surrounding the corporation). However, Mr. Crane suggests that this concern should lead us to focus instead on the manager who is culpable. In many instances, I quite agree and have explained my reasons at some length in a recent symposium on white collar sentencing.[1] I also agree with Mr. Crane that some jail time is necessary, since otherwise financial penalties will be passed back to the firm through covert indemnification. But, I cannot accept the prescription that we focus on the manager as a complete answer and instead believe that we need to punish both the individual and the firm. Let me briefly summarize.

First, Mr. Crane's argument proves too much. If we believe it is unfair to impose the costs of deterrence on stockholders, then we should abolish not only criminal liability for corporations (which has been with us for nearly a century) but also civil treble damages, punitive and exemplary damage awards generally, and perhaps the tort law doctrine of enterprise liability as well. In all these cases, the loss falls on the innocent shareholder. Paradoxically, Mr. Crane seems to approve the treble damages antitrust penalty, but

1. Coffee, *Corporate Crime and Punishment: A Non-Chicago View of the Economics of Criminal Sanctions*, 17 AMER. CRIM. L. REV. 429 (1980).

this cannot be meaningfully distinguished from a criminal penalty imposed on the corporation. My point is that for the corporation there is no significant distinction between civil and criminal sanctions. If considerations of unfairness lead us to believe that the imposition of an indirect financial loss on the stockholders is unacceptable, Mr. Crane must logically follow his argument through to its conclusion and find any form of punitive damages, whether civil or criminal, to be unfair to stockholders as well. What I mean to suggest, of course, is that our society cannot afford so ambitious a fairness principle as this. Its probable result, if adopted, would predictably be to create a strong incentive for the corporation to pressure its employees into criminal behavior because the corporation itself, would be immune from punitive sanctions.

Assuming that we are not prepared to give the corporation immunity from all forms of punitive sanctions—criminal and civil—then the equity fine is not inherently more punitive or drastic than cash fines (as Mr. Crane seems to suggest). The fine can be small or large, as the needs of deterrence require. Its basic difference from cash fines lies in the lesser adverse side effects it produces (or "overspill" in my terminology, or "externalities" in the economist's more formal language). Mr. Crane dissents, arguing that the stockholder is no more privileged or able to bear the loss than the employee (who he suggests can find another job). Sociologically, this analysis is suspect, and I have little doubt that those laid off in the aftermath of a corporate financial crisis are the "last hired, first fired": assembly line workers and office staff, who are at the bottom of the wage scale and who, given a substantial reduction in force by the corporation, wind up competing among themselves for the few available jobs in their community. Could, for example, the assembly line workers of a Ford plant expect to find employment in Detroit today if Ford were penalized by a severe cash fine?

But, even if one declines to accept this socio-economic speculation about the cost bearers of corporate fines, there is a simpler and even more compelling point which distinguishes cash penalties from an equity fine. By definition, any equity fine falls evenly on all stockholders (who typically are numerous) while cash fines fall disproportionately on those empoyees who are laid off. Thus, it is a misleading comparison to analyze workers versus stockholders and say that neither is on *a priori* basis more or less better positioned than the other to bear the cost of penalties. The better comparison is between the spreading of a penalty over an entire class evenly (*i.e.*, the stockholders) versus the imposition of an extreme financial injury on a minority of the empoyees. In short, cost spreading diminishes the intensity of the penalty. Add to this factor the likelihood that most stockholders hold a diversified portfolio, and the penalty visited upon stockholders becomes minute in comparison.[2]

Another objection raised by Mr. Crane is that equity fines will interfere with the process of re-industrialization by denying capital to high risk industries. Analytically, the reverse would appear to be true: cash fines deplete capital while equity fines do not. Although equity fines would have a dilutive effect on the corporation's equity base, thereby forcing the corporation to issue more shares to raise the same amount of money, the simple empirical truth is that for the last decade or more corporations have very rarely used the issuance of equity securities to raise capital.[3] Every indication is that this pattern will persist, and equity issuances will be predominantly confined to two contexts: (1) mergers and (2) stock option or bonus plans for the corporation's managers. Thus, "re-industrialization" is hardly imperilled. To be sure, the abolition of all corporate penalties would certainly facilitate "re-industrialization," but that would be a high price to pay, even if it is the prescription with which Mr. Crane seems to leave us.

A related danger stressed by Mr. Crane is that investors may shy away from high risk industries (*e.g.*, those dealing with toxic chemicals or having chronic environmental problems). Unfortunately, this is to a degree the price of adequate deterrence. Underdeterrence, however, imposes an even higher price on society. More to the point, I think it overstates the case to predict that entire industries will become tainted in the eyes of investors because of the actions of a few delinquent corporations. A whole profession—that of the security analyst—has grown up to assist investors in differentiating among corporations within an industry. Most of us who teach securities law see the security analyst as the real mechanism by which disclosure works and by which the marketplace evaluates competing securities. There is no reason why these

2. Mr. Crane further argues that pension funds are stockholders and thus the penalty falls on employees once again. This ignores both the diversification requirements imposed by ERISA and the Pension Benefit Guaranty Corporation, which ERISA also established to insure such pension funds against the risk of insolvency.

3. For recent statistics showing the insignificant role of equity issuances in the raising of corporate capital, *see Is Desperation the Mother of Invention?*, Forbes, May 12, 1980 at 155.

analysts who can assess complex technologies and the capabilities of management cannot also assess the adequacy of a corporation's monitoring and preventive controls. At present, they have no incentive to do so because the penalties typically imposed are small.[4] But, if such penalties were higher, the analyst's attention would focus on this issue and management would have an incentive to demonstrate to them the relative superiority of their corporation's monitoring skills. In addition, potentially delinquent corporations can be evaluated by their prior record: some companies have been repetitively delinquent within an industry while others have never been delinquent.[5] Finally, the equity fine can itself be geared so that it increases with every conviction for the same offense. This gives investors a degree of warning and focuses the marketplace's disapproval on the recidivist corporation.

Lastly, Mr. Crane argues that there is an inconsistency in arguing that the locus of much corporate crime is at the middle management level and my prescription of the equity fine is likely to threaten higher levels of management. I see no such inconsistency. The middle manager is hardly a born criminal; rather, he is under intense pressure to perform and achieve profit goals at all costs.[6] If we adopt the equity fine approach, we make it in the self-interest of senior management to reduce this pressure. Conversely, if we only prosecute the middle manager as if the only responsibility is his, then we grant great immunity to the corporation (and its senior management) and they will predictably intensify the pressure.

This then leads us to the question of relative efficiency: is it more cost-efficient to punish the individual or the firm? The most significant point to be made here inclines me somewhat towards Mr. Crane's prescription of focusing on the manager: that is, it should be cheaper to punish the individual because only a relatively small portion of the gains from corporate crime acrrue to him; if so, then on a cost-benefit basis, he should be more easily deterred. Also, we can raise the severity of the penalty to a higher

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4. Indeed, Professor Walter Werner has made a persuasive case that the stockmarket may today discount the stock of the overly honest or moral corporation. *See* Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388 (1977).

5. See M. CLINARD *et. al.*, ILLEGAL CORPORATE BEHAVIOR at Chp. VIII 1979; *cf.* Orland, *Reflections on Corporate Crime: Law in Search of Theory and Scholarship*, 17 AM. CRIM. L. REV. 501, at 517-18 (1980).

6. *See* Getschow, *Overdriven Executives: Some Middle Managers Cut Corners to Achieve High Corporate Goals*, Wall St. J., Nov. 8, 1979, at 6, col. 6.

level in the case of the individual, since the injury passed on to stockholders will be a highly diffused one in comparison to even a six month prison term. This is not to say that financial penalties are always less than incarcerative ones, but only that the stockholder has a limited liability (in multiple ways) which reduces his exposure to less than that of the manager.

Important as this point is that it should be cheaper to deter the individual than the firm (both in the sense of lower transaction costs and less "Over-spill"), it is not completely dispositive. There are still important reasons to focus on the firm as well. Before describing them, let me remind you of the obvious point that we need not make an "either/or" choice: both the firm and the individual can be prosecuted, and there are substantial economies of scale in so doing.

First, it is frequently difficult to identify the actual culpable official with the degree of assurance that the criminal law constitutionally requires. Decisions are often made by committees, not individuals; responsibility is diffused and delegated. Who in the Pinto case really decided to use an unsafe gas tank? I doubt that we could say with sufficient certainty. Was it the president or some other senior executive who never read the safety reports, but insisted on a cheap, profitable design? Or the lowly engineer who fashioned a design to the specification of others? Or, was it a middle executive in between who chose the only design, even if its defects were known to him, which complied with cost specifications imposed on him from a higher level? My point here goes to both efficiency and fairness: first, it seems inconsistent to complain about the unfairness of imposing a penalty indirectly on stockholders and then accept vicarious criminal liability for corporate executives; second, to attempt to use a criminal sanction in such a context dominated by shades of gray will predictably cause the nullification problem to re-appear in a more intense form.

Juries are never eager to convict middle class defendants, and will resist particularly when the crime was not wilful, but more a matter of neglience or deliberate inattention. In any event, in these cases where we cannot identify the culpable official we have a choice of focusing on the corporation or no one. So, too, we face the same choice when the responsible official has died or otherwise left the scene. This last variation will be a recurring one given the substantial time lag between the crime and its detection in environmental safety and reckless endangerment crimes. Finally, there is the case where the knowledge which would create guilt existed within the organization but never came to the attention of the decisionmakers. Kenneth Arrow[7] has suggested that this problem will also occur with frequency because the size and complexity of large organizations inhibits efficient information flow. In short, our cast of characters will often lack a true villain.

So far, I have focused solely on the lack of an identifiable culpable official. But there are other reasons for convicting the corporation. First, it is quicker, easier, cheaper, and hence more efficient for the corporation to detect misbehavior within itself than for the state to do so. The costs of detection are lower because the individual manager has no constitutional rights vis-à-vis his corporate employer and can be dismissed or disciplined without trial and in a largely costless manner to the corporation. Moreover, the corporation has a much better idea of where to look for misbehavior and needs only a reasonable suspicion before it acts. Accordingly, if we punish the corporation severely for misbehavior (by either civil or criminal means), we may trigger an internal disciplinary response that is socially desirable. There are problems with this argument: in practice, such an internal disciplinary response has not been empirically observable and it may not work at the upper echelons of corporate management; but these are only reasons for seeking to perfect the internal response, not abandon it.

Still another problem with an exclusive focus on individual criminal sanctions is that the corporate manager—at least at the middle levels—is exposed to countervailing pressures. Society can fine or imprison him for criminal misconduct, but the corporation can dismiss or demote him for unprofitable conduct. If he fails to comply with environmental, toxic, or safety standards, he is subject to society's sanction; if he complies, he may be subject to his employer's sanction. The answer to this dilemma may seem simple: raise society's sanctions to a level the employer cannot match. For example, there may be no financial equivalent (either in terms of positive pay raises or negative sanctions, such as dismissal) to a five year prison sentence. But this answer overlooks the risk of apprehension variable: the likelihood of detection by the corporation for "inefficient" conduct is much higher than that of detection by the state for illegal conduct. If the "deterrence yield" is the product of the risk of apprehension times the severeity of the sanction (as some economists maintain), then it is possible (and I think probable) that the manager will find the pressure from his em-

7. *See*, K. Arrow, Social Choice And Individual Values, (2d ed. 1960).

ployer to be greater than that from the state.

This brings me to a last and maybe most important reason for focusing on the corporation as well as the manager: we need to reduce this countervailing pressure. If there is an incongruence between the motivations of the manager and the corporation, deterrence theory begins to break down: either the manager will take risks which are against the interests of the corporation, or the corporation will pressure the manager to take risks which are against his individual interest. Both must be deterred. But in some cases this is impossible. As I explained in my discussion of the "Doomsday" premise, classical deterrence theory suggests that if the risk of apprehension is sufficiently low (as I think for some organizational crimes it is), there is no financial penalty within the ceiling set by the corporation's bankruptcy theshold which will adequately deter it. The use of the equity fine will raise this ceiling, but still not solve the problem.

Hence, where deterrence fails, we must turn to incapacitation. This can only be done by convicting the corporation and then sentencing it to a term of probation under conditions designed to prevent repetition. Such preventive probation conditions might include auditing and monitoring controls, but also greater judicial oversight to prevent the corporation from increasing the pressure on middle level managers to the point where they find it expedient to take illegal action. In short, there should be two focal points for incapacitative measures: (1) informational controls, which among other things, subject the higher echelon official to criminal prosecution because he now would have the requisite element of knowledge, and (2) motivational controls, which would reduce the incongruence between the interests of the individual and the firm. As an example of the latter, dismissed or demoted middle level officials might be given some avenue of legal appeal (in the case of a corporation on probation) where they allege that such action was the result of "unreasonable" pressure for increased profitability which would require them to use illegal means. Alternatively, a "miniboard" might be established as a buffer for officials within a particular division or subsidiary. Less drastic examples can be drawn from recent SEC enforcement decrees. A noteworthy example is the Toxic Risk Assessment Committee established by Allied Chemical pursuant to an SEC consent decree following its disastrous experience with Kepone. The Committee, which has outside experts serving on it, must review all toxic risks created by the company's activities; it has been hailed as an industry model by the Environmental Protection Agency. Such a sanction seems optimal: there is little overspill and yet society is protected. Yet, the sad irony today is that a civil court can impose such an equitable sanction based only on a preponderance of evidence, but a criminal court may not be able to even after proof beyond a reasonable doubt. I will not take you through the current state of the law on this point, but I will leave you with the thought that the need for incapacitation may be the principal reason for focusing on the firm, rather than only on the manager.