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Confronting the Two Faces of Corporate Fraud

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CONFRONTING THE TWO FACES OF CORPORATE FRAUD

Miriam H. Baer*

Abstract

Some criminals engage in meticulous planning. Others commit crimes in the heat of the moment. Corporate fraud incorporates both planned and spur-of-the-moment misconduct. Although law and economics scholars have traditionally viewed corporate fraud as a manifestation of opportunism among the corporation's agents, a new generation of scholars, influenced by findings in behavioral psychology, has focused on the temporal aspects of corporate misconduct. Wrongdoing comes about, not simply because an agent opportunistically takes advantage of her principal, but also because her short-term self falls prey to temptations and cognitive biases that effectively disable her law-abiding long-term self.

Although the law and economics and behavioral psychology accounts separately offer important lessons for observers of corporate fraud, neither theory addresses the regulatory implications confronting opportunistic behavior and temporal inconsistency at the same time. How can an internal corporate enforcer best respond to the "two faces" of corporate fraud? This Article explores this question, first by analyzing the interaction between the two dispositions, and then by considering the relative merits of various enforcement approaches.

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INTRODUCTION

Some people hurt others by failing to follow through on their best-laid plans. A corporate manager advises in good faith that he will commence the long-term project that will enhance his unit's earnings and make it more competitive over time. Nevertheless, at the end of the month, he finds that he is no closer to implementing the new project than he was when he first pitched it to his supervisor. To make things worse, when the manager is asked to report his unit's monthly progress, he falsely asserts that he has worked steadily on the project, going so far as to submit fraudulent expense reports to demonstrate significant efforts towards achieving his goal.

Other individuals impose harm by meticulously following through on their malicious intentions. A murderer who plots an assassination

and patiently awaits his prey is an extreme example. Bernard Madoff's Ponzi scheme, in which he persuaded thousands of unwitting victims to invest their money in nonexistent funds, is the less violent version. The problem in both cases is not that an individual changes his mind, but rather, that the individual adheres to and carries out his maleficent plans. This is the very type of consistency that Bernard Madoff's sentencing court found so chilling.¹

The dichotomy between people who fail to adhere to their positive plans and those who steadfastly carry out their evil intentions poses a significant challenge for law enforcers. If individuals engage in varying degrees of opportunistic behavior *and* simultaneously enjoy different degrees of self-control, how can we effectively deter wrongdoing?

This Article explores this question with regard to the pervasive and recurring problem of corporate fraud, in which corporate managers defraud the corporate entity and its shareholders through some combination of deliberate misrepresentations and false statements.² Although this Article focuses on what is commonly classified as "securities" or "accounting fraud," much of the analysis is generalizable to other forms of wrongdoing, such as bribery and embezzlement.³

The law and economics literature views corporate fraud as an extreme example of the agency-cost problem.⁴ Corporate agents abuse their discretion and authority to take advantage of their principals.⁵ At

1. See Benjamin Weiser, *Judge Explains 150-Year Sentence for Madoff*, N.Y. TIMES (June 28, 2011), <http://www.nytimes.com/2011/06/29/nyregion/judge-denny-chin-recounts-his-thoughts-in-bernard-madoff-sentencing.html> (recounting Judge Denny Chin's views of Madoff's crime); see also Transcript of Proceedings as to Bernard L. Madoff Held on June 29, 2009 at 10:00 AM Before Judge Denny Chin at 42-49, *United States v. Bernard L. Madoff*, No. 09-CR-00213 (S.D.N.Y. July 20, 2009), available at <http://www.justice.gov/usao/nys/madoff/20090629sentencingtranscriptcorrected.pdf> ("The breach of trust was massive. Investors—individuals, charities, pension funds, institutional clients—were repeatedly lied to . . .").

2. See, e.g., Daniel T. Ostras, *When Fraud Pays: Executive Self-Dealing and the Failure of Self-Restraint*, 44 AM. BUS. L.J. 571, 571 (2007) (defining fraud broadly as the type of conduct "by which one individual can gain an advantage over another through deliberate false suggestion, concealment, or misrepresentation of the truth").

3. For an exhaustive look at the different types of fraud that arise within the corporation, see generally JOSEPH T. WELLS, *CORPORATE FRAUD HANDBOOK: PREVENTION AND DETECTION* 2-4 (3d ed. 2011).

4. "Securities fraud may best be understood as a species of agency costs." Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2182 (2010).

5. See, e.g., Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1, 3 & n.1 (2009) (ascribing corporate wrongdoing to conflicts of interest and managerial agency costs). The seminal account on agency costs is set

numerous junctures, the agent favors himself over the larger populace in whose favor the agent is supposed to act.⁶ In response, the law offers a combination of sticks and carrots to better bind the agent to his principal and deter the agent's self-serving and opportunistic behavior.⁷

Meanwhile, an alternative view explains wrongdoing as the result of a momentary lapse of judgment. According to this narrative, individuals engage in misconduct when they fall prey to their short-term desires, despite their more socially desirable long-term plans.⁸ The short-term self acts in ways that the long-term self explicitly abhors, up to and including perpetrating violations of law.⁹ The short-term self can impose costs either by repeatedly failing to commence activities that carry large up-front costs, but are ultimately beneficial, (e.g., *procrastination*), or by engaging too easily (or too often) in activities that are initially pleasant, but ultimately harmful (e.g., *overconsumption*).¹⁰

Behavioral researchers explain these lapses as the result of a phenomenon known as "hyperbolic discounting." Whereas rational individuals simply value the present over the future, hyperbolic discounters impose an excessively large discount on changes in utility that occur closest to the present, leading some to call the preference an "immediacy" or "present bias."¹¹ The bias persists because the *discount* the individual assigns a given interval is very high for near term periods, but much smaller for periods that occur at some later

forth in Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308–12 (1976).

6. "Agency costs exist whenever a principal entrusts power to an agent to act on her behalf. The agent may rent-seek, . . . shirk her duty[,], or slack off. Or she may seek to fulfill her job in good faith, but make choices that her principal would not want her to make." Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1267 (2011). For a discussion of agency costs generally and their relationship to corporate crime, see Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 834–35 (1994).

7. See, e.g., Nicola Faith Sharpe, *Process Over Structure: An Organizational Behavior Approach to Improving Corporate Boards*, 85 S. CAL. L. REV. 261, 264–65 (2012) (observing that "[m]ost current regulation and regulatory reform proposals attempt to reduce corporate failure by reducing agency costs").

8. E.g., Manuel A. Utset, *Time-Inconsistent Management and the Sarbanes-Oxley Act*, 31 OHIO N.U. L. REV. 417, 418 (2005).

9. Drew Fudenberg & David K. Levine, *A Dual-Self Model of Impulse Control*, 96 AM. ECON. REV. 1449, 1449–51 (2006).

10. See, e.g., Brian Galle & Manuel Utset, *Is Cap-and-Trade Fair to the Poor? Shortsighted Households and the Timing of Consumption Taxes*, 79 GEO. WASH. L. REV. 33, 65–68 (2010) (setting forth a mathematical model for overconsumption and procrastination).

11. "Stable, time-consistent preferences require a constant exponential discount factor; hyperbolic discounting generates time-inconsistent preferences, sometimes described as present bias." Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1043 (2012).

date.¹² Waiting an hour from “now” for a piece of chocolate cake feels much worse than waiting the same hour if that wait is slated to occur in some future period.¹³ By the same token, commencing a difficult project—such as a long paper—feels inordinately more difficult the day the writer sits down at his computer than one week from today, when the same writer *plans* to commence the very same project. Because of these differences, hyperbolic individuals have a tendency to switch course in often unexpected and self-destructive ways.¹⁴

The temporal inconsistency literature prescribes a significantly different role for legal actors from the standard law and economics canon. Instead of manipulating incentives for good behavior, legal actors should help individuals find ways to control their short-term selves.¹⁵ The mechanism that sophisticated individuals adopt in order to restrain their temporal inconsistency is often referred to as a “precommitment device.”¹⁶ The device “precommits” the individual to his long-term plans by eliminating, or making more difficult, certain options in advance of some foreseen event.¹⁷ Through legal rules and institutions, legal actors can either mandate or encourage the

12. “Hyperbolic discounting involves very steep discounting in the immediate short run and much shallower discounting further out.” Lee Anne Fennell, *Unbundling Risk*, 60 DUKE L.J. 1285, 1348 n.256, 1349 n.259 (2011) (citing GEORGE AINSLIE, *BREAKDOWN OF WILL* 32 & fig.2B (2001)); see also Lee Anne Fennell, *Willpower Taxes*, 99 GEO. L.J. 1371, 1378 n.35 (2011) [hereinafter Fennell, *Willpower Taxes*].

13. “[F]or many people, preferences between logically identical sets of choices may reverse in a predictable direction as the temporal context of the choice changes.” Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051, 1120 (2000) (explaining preference switching).

14. *Cf., e.g., id.* (“An individual might plan to save X percent of her salary next year but then decide when she receives it that she prefers to spend it rather than save (thus making appropriate the cliché that money can ‘burn a hole’ in one’s pocket).”).

15. See, e.g., Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1159, 1162 (2003) (arguing that government can and should “steer people’s choices in welfare-promoting directions” by framing choices in particular ways). For an extended account of how government can do this in various consumer-oriented contexts, see generally RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008).

16. Ulysses’ decision to tie himself to the mast of his ship and plug his sailors’ ears with wax in advance of sailing near the Sirens is the classic example. 1 HOMER, *THE ODYSSEY* 445, 447 (A.T. Murray trans., Harvard Univ. Press 1919); see also John A. Robertson, “*Paying the Alligator*”: *Precommitment in Law, Bioethics, and Constitutions*, 81 TEX. L. REV. 1729, 1731 (2003). See generally JON ELSTER, *ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS* (2000) (examining the benefits of, and philosophical justifications for, precommitment devices). For additional discussion, see *infra* Section I.D.

17. See Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 4–5 (2003) (describing and explaining precommitment strategies in corporate governance).

adoption of precommitment devices.

Numerous scholars have written separately on temporal inconsistency and corporate opportunism, and several scholars, most notably Professor Manuel Utset, have explored the connection between temporal inconsistency and corporate crime and governance.¹⁸ This Article expands on this scholarship, first by considering how *both* opportunism and temporal inconsistency interact within the corporate firm, and then by considering how this interaction challenges the corporation's internal compliance department.¹⁹ The compliance department is the internal unit tasked with preventing and reducing serious wrongdoing within the organization.²⁰ If fraud arises out of both opportunistic and temporally inconsistent behavior, the corporation's compliance personnel bear the burden of comprehending and responding effectively to these

18. Professor Utset has written extensively on this topic and was one of the first legal scholars to demonstrate temporal inconsistency's relationship to corporate crime. *See, e.g.*, Manuel A. Utset, *Corporate Actors, Corporate Crimes and Time-Inconsistent Preferences*, 1 VA. J. CRIM. L. 265, 320–24 (2013) (praising portions of the Sarbanes-Oxley and Dodd-Frank Acts as counterweights to temporal inconsistency in corporations); Manuel A. Utset, *Hyperbolic Criminals and Repeated Time-Inconsistent Misconduct*, 44 HOUS. L. REV. 609, 623–25, 659 (2007) [hereinafter Utset, *Hyperbolic Criminals*] (applying temporal inconsistency theory to explain white-collar criminal conduct); Utset, *supra* note 8, at 418, 428–29 (arguing that “adherence to the time-consistency assumption can lead to mistaken policy decisions” regarding corporate managers). For more general analyses of temporal inconsistency theory to criminal law and procedure, see Richard H. McAdams, *Present Bias and Criminal Law*, 2011 U. ILL. L. REV. 1607, 1614–28, and Rebecca Hollander-Blumoff, *Crime, Punishment, and the Psychology of Self-Control*, 61 EMORY L.J. 501, 545–52 (2012). McAdams also briefly touched upon the subject in a discussion of the signaling value of social norms. *See* Richard H. McAdams, *Signaling Discount Rates: Law, Norms, and Economic Methodology*, 110 YALE L.J. 625, 657–61 (2001) [hereinafter McAdams, *Signaling*] (reviewing ERIC A. POSNER, LAW AND SOCIAL NORMS (2000)) (explaining how inconsistent discount rates complicate Posner's contention that so-called social norms reflect low discount rates that individuals signal to each other).

19. Whether this department is a stand-alone function or should be housed within the corporation's legal department is a source of substantial debate. *See, e.g.*, Michele DeStefano, *Beyond Benchmarking: How Should Law and Corporate Compliance Intersect?*, SLIDESHARE (Nov. 14, 2012), <http://www.slideshare.net/micheledestefano/beyond-benchmarking-how-should-law-and-corporate-compliance-intersect> (presentation at Harvard Law School Program on the Legal Profession); Michele DeStefano, *Creating A Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71, 82–86 (2014).

20. “‘Compliance’ is a system of policies and controls that organizations adopt to deter violations of law and to assure external authorities that they are taking steps to deter violations of law.” Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 958 (2009). Professor Paul McGreal has conducted surveys on corporate compliance and compliance law and regulation for at least the last eight years. *See* Paul E. McGreal, *Corporate Compliance Survey*, 68 BUS. LAW. 163, 163 & n.1 (2012). For earlier analyses of compliance programs adopted in response to specific settlement agreements with federal agencies, see generally F. Joseph Warin & Jason C. Schwartz, *Corporate Compliance Programs as a Component of Plea Agreements and Civil and Administrative Settlements*, 24 J. CORP. L. 71 (1998).

overlapping causes.²¹

This Article adopts the premise that individuals are, by varying degrees, opportunistic and temporally inconsistent. To better understand how these two dispositions interact, the Article hypothesizes a simplified world in which individuals simultaneously occupy positions on two different spectra at any given time. The first spectrum refers to the individual's motivation towards others, and the second indicates the individual's ability to act consistently over successive periods of time. The interaction between these two dispositions generates a typology of employees who are:

- (a) well-motivated, and temporally consistent;
- (b) well-motivated, and temporally inconsistent;
- (c) opportunistic, and temporally inconsistent; and
- (d) opportunistic and temporally consistent.

From this typology, one can see why corporate fraud so often mixes planned and impulsive conduct. With the exception of the employees in category (a), everyone within the corporation has the potential to contribute to or perpetrate a fraud.

Having identified this typology, this Article introduces a number of strategies an internal corporate enforcer might employ in response to these various prototypes. Although compliance personnel have developed a plethora of programs in response to potential wrongdoing, much of their work falls within two categories: the corporate policing approach that is familiar to many, and a structural approach one might call "corporate architecture."²² The policing approach reduces corporate crime by empowering internal policemen to identify, punish, and deter actual and would-be transgressors. The

21. The Article thus takes up the task suggested by Professor Daniel Medwed's comment on Professor Utset's work. See Daniel S. Medwed, Comment, *Deterrence Theory and the Corporate Criminal Actor: Professor Utset's Fresh Take on an Old Problem*, 1 VA. J. CRIM. L. 65, 66 (2013) (querying whether "internal regulation can also be used to protect against the potential overconsumption of criminal activity that derives from time-inconsistent preferences" (emphasis omitted)). It also builds on the distinction I first raised elsewhere regarding the difference between "sanction-based enforcement" and "structural regulation." Miriam H. Baer, *Temporal Inconsistency and the Regulation of Corporate Misconduct*, 1 VA. J. CRIM. L. 350, 360–69 (2013).

22. The structural approach is similar to situational crime prevention, which has been defined as "the conscious design or manipulation of immediate environments . . . to make crime more difficult, more risky, and/or less rewarding . . . to potential offenders." Danny Rosenthal, *Assessing Digital Preemption (and the Future of Law Enforcement?)*, 14 NEW CRIM. L. REV. 576, 580 (2011) (alterations in original) (quoting Tim Hope & Richard Sparks, *For a Sociological Theory of Situations (or How Useful Is Pragmatic Criminology?)*, in ETHICAL AND SOCIAL PERSPECTIVES ON SITUATIONAL CRIME PREVENTION 175, 175 n.2 (Andrew von Hirsch et al. eds., 2000)). Both approaches are discussed more extensively *infra* Part III.

architectural approach encourages corporate personnel to seek out and mitigate problematic *situations* as opposed to problematic people. It seeks proactively to improve decision-making systems, thereby reducing the opportunity and temptation for fraud. It is at once less judgmental and yet potentially more intrusive.

The optimal mix of policing and architecture should vary for different corporations. A number of characteristics in today's enforcement environment, however, favor policing over architecture, which in turn may harm shareholders and the general public.

This Article unfolds in four parts. Part I briefly reviews the opportunism and temporal inconsistency literatures and analyzes their contribution to our understanding of fraud and optimal enforcement strategies. Drawing upon these two theories, Part II constructs a typology of wrongdoers (and do-gooders) within the corporation. This typology, in turn, should guide the corporations's internal compliance efforts.

Part III discusses the contrasts between two internal enforcement approaches: policing and architecture. The two approaches can serve either as substitutes or complements. Policing offers strong protections against consistent, opportunistic wrongdoers; architecture provides more value to populations that are generally well-motivated but prone to hyperbolic behavior. Both approaches are essential components of an effective corporate compliance program.

Finally, Part IV examines and critiques the current state of affairs in corporate compliance. If corporate fraud truly has "two faces," then corporate compliance departments need to focus on generating as many good architects as policemen. For a number of reasons, however, it is doubtful that compliance departments are striking the right balance. This Article therefore ends with a call for a more sustained analysis of the interaction between temporal inconsistency and opportunistic behavior.

I. OPPORTUNISTIC AGENTS AND TEMPORALLY INCONSISTENT DECISION MAKERS

Despite their obvious differences, Fortune 500 corporations, privately owned businesses, nonprofits, and public agencies all share in common key organizational characteristics. As soon as they reach a certain size, most if not all include bureaucratic centers and supervisory relationships between employees and managers.²³ When

23. See Oliver E. Williamson, *The Organization of Work*, 1 J. ECON. BEHAV. & ORG. 5, 35 (1980) (predicting the emergence of hierarchy in "organizations of any size," including private businesses, nonprofits, and government agencies). For an argument that corporate law itself, by vesting authority in a board of directors, fuels hierarchy, see Stephen M. Bainbridge, *Director Primacy*, in RESEARCH HANDBOOK OF THE ECONOMICS OF CORPORATE LAW 17, 23

they behave well, these organizations provide great benefits to society, as they efficiently allocate resources, achieve agreed-upon redistributive goals, and provide tangible and intangible improvements in public welfare.²⁴

Sometimes, however, organizations do not behave well. Or, since organizations lack a mind or soul, the more accurate claim is that some or all of their *members* do not behave well.²⁵ Those who occupy the highest ranks of authority within their organizations abuse their discretion, slack off when no one is noticing, ignore internal rules, engage in self-dealing, violate external laws, and cause all sorts of harm to both outsiders and other members of the organization. Taken as a whole, these harms comprise the agency costs that have long been the focus of scholars who write about private and public organizations.²⁶

In recent decades, the specter of fraud has emerged as a significant threat to corporations and capital markets. Fraud triggers enforcement actions based in federal criminal and civil statutes, such as the mail, wire, and securities fraud statutes.²⁷ Criminal and civil enforcement actions deter harmful conduct by increasing the “price” of wrongdoing,²⁸ and communicate society’s moral condemnation of the deceptive behavior that causes investors economic harm.

What the antifraud statutes do not do, however, is parse

(Claire A. Hill & Brett H. McDonnell eds., 2012).

24. “[C]orporations . . . are encouraged, and granted rights because they serve the goal of promoting overall societal wealth.” Steven M.H. Wallman, *Understanding the Purpose of a Corporation: An Introduction*, 24 J.CORP. L. 807, 810 (1999) (arguing that corporations exist to benefit society as a whole).

25. Economists view corporate crime through the eyes of the individual: “Corporate crimes are not committed by corporations; they are committed by agents of the corporation.” Arlen, *supra* note 6, at 834; see also Sharon Oded, *Inducing Corporate Compliance: A Compound Corporate Liability Regime*, 31 INT’L REV. L. & ECON. 272, 274 (2011) (agreeing that individual agents commit corporate crimes, but arguing that corporations must be held responsible in part to ensure adequate deterrence). By contrast, sociologists and organizational theorists perceive corporate crime as the product of organizational and cultural factors. See, e.g., James A. Fanto, *Recognizing the “Bad Barrel” in Public Business Firms: Social and Organizational Factors in Misconduct by Senior Decision-Makers*, 57 BUFF. L. REV. 1, 1 (2009) (examining the “importance of group and organizational factors in senior-level misconduct within the firm”); Edward L. Rubin, *Images of Organizations and Consequences of Regulation*, 6 THEORETICAL INQUIRIES L. 347, 348 (2005) (comparing and explaining different models).

26. See generally Jensen & Meckling, *supra* note 5, at 308–10 (discussing agency costs).

27. See 18 U.S.C. §§ 1341, 1343, 1348 (2006); 15 U.S.C. §§ 78j(b), 78ff(a) (2006).

28. “[T]he economists’ response to how to deter misconduct is to price any misbehavior. Assuming the entity and its agents are rational economic actors, misbehavior will occur only when its expected utility exceeds the disutility of its accompanying punishment.” James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, LAW & CONTEMP. PROBS., Autumn 1997, at 1, 2.

opportunism and temporal inconsistency. Instead, they more or less presume some basic level of planning by which defendants take advantage of others. For example, the mail, wire, and securities fraud statutes²⁹ all punish an individual's participation in a "scheme to defraud,"³⁰ and yet make no distinction between meticulously planned and executed schemes and hastily-slapped-together schemes.³¹ Indeed, even the word "scheme" is misleading, as a spur-of-the-moment misrepresentation of material fact satisfies the securities fraud statute, and also arguably meets the definition of the term "scheme" for both mail and wire fraud prosecutions.³²

Modern-day jurists and scholars have focused almost exclusively on the intended meaning of the *mens rea* component of the fraud statutes, such as whether fraud requires intentional or merely reckless behavior,³³ and whether the harm caused must be economic, or should

29. The federal mail and wire fraud statutes criminalize an individual's intentional participation in a "scheme or artifice to defraud" another of his property, 18 U.S.C. §§ 1341, 1343, 1348(1), or "intangible right to honest services." *Id.* § 1346. The mail and wire fraud statutes further criminalize a scheme that has the purpose of "obtaining money or property by means of false or fraudulent pretenses, representations, or promises." *Id.* §§ 1341, 1343, 1348(2).

30. Section 10 of the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881, 891 (codified at 15 U.S.C. § 78j), outlaws any "manipulative [or] deceptive device" and authorizes the SEC's Rule 10b-5, which makes it illegal for any person to "employ any device, scheme, or artifice to defraud" or "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading" or "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2013). Federal prosecutors may charge violations of Rule 10b-5 criminally when the prohibited conduct is "willful." 15 U.S.C. § 78ff(a).

31. The U.S. Sentencing Guidelines previously provided a "more than minimal planning" sentence enhancement for crimes that involved either "repeated acts" or attempts at concealment, thus suggesting that statutory fraud could arise from "minimal" planning. See Frank O. Bowman, III, *Pour encourager les autres? The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Guidelines Amendments that Followed*, 1 OHIO ST. J. CRIM. L. 373, 386 n.79 (2004). After the enhancement became so commonplace that it was meaningless, the Sentencing Commission eliminated it in 2001. See *id.* at 407.

32. See *supra* note 29; see also, e.g., *United States v. Trapilo*, 130 F.3d 547, 550 n.3 (2d Cir. 1997) (rejecting defendant's claim that a "simple . . . smuggling" scheme "without an allegation of misrepresentation or deceit" did not meet the definition of wire fraud statute); *United States v. Herzig*, 26 F.2d 487, 489 (S.D.N.Y. 1928) ("A scheme to defraud may be simple in its plan and execution, or it may be elaborate and may require a wide-spread campaign involving many victims.").

33. The federal criminal mail and wire fraud statutes require that the government prove that the defendant "knowingly and willfully participated in the scheme or artifice to defraud . . . with specific intent to defraud." 2 LEONARD B. SAND ET AL., *MODERN FEDERAL JURY INSTRUCTIONS—CRIMINAL* ¶ 44.01, at 444 (2002) (Instruction 44-3).

include intangible harms such as harm to one's right to "honest services."³⁴ One rarely sees, however, an extended discussion of the differences between well-planned deception and spur-of-the-moment fraud.³⁵ By contrast, courts and legislatures have long recognized and debated the "heat of passion" doctrine for homicide, as well as the relevance of premeditation for grading homicide offenses.³⁶ For fraud, however, none of these gradations have made their way into federal criminal statutes. A scheme to defraud is all that is needed.

Admittedly, pragmatists have good reason to reject statutory distinctions. A two-tiered approach that imposed stronger sanctions on "premeditated fraud" could potentially trigger a series of false positives and negatives, as well as increased litigation and associated administrative costs. Defendants might (falsely) claim that their frauds were the result of momentary willpower lapses, whereas prosecutors would be tempted to see all frauds as well planned. More importantly, jurists might encounter difficulty defining the term "premeditation," particularly for frauds in which a defendant initially engaged in wrongdoing due to a willpower lapse, but then continued the fraud for some period of time, either to cover up his original lapse, or to take further advantage of others.³⁷

Accordingly, by accident or design, we have a general law of fraud that requires participation in a scheme, or, in the securities context, either an "untrue statement of . . . material fact" or conduct that "would operate as a fraud or deceit on any person" in connection with the purchase or sale of a security.³⁸ In addition, participation in the proscribed conduct must be "willful" for criminal liability or at least "reckless" for civil liability.³⁹ The underlying temporal context in

34. See, e.g., *Skilling v. United States*, 130 S. Ct. 2896, 2931 (2010) (describing schemes that fit into the "honest services" doctrine). For a critique of the opinion's treatment of "honest services," see generally Samuel W. Buell, *The Court's Fraud Dud*, 6 DUKE J. CONST. L. & PUB. POL'Y (SPECIAL ISSUE) 31 (2010).

35. Presumably, even a spur-of-the-moment deception would fall within that category of wrongs that Professor Samuel Buell labels "core" fraud, which comprises an offender's intentional deception of another person in order to cause that victim "to do or to relinquish something voluntarily that the victim otherwise would not do." Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 526 (2011).

36. See SANFORD H. KADISH ET AL., CRIMINAL LAW AND ITS PROCESSES 436–37 (9th ed. 2012) (discussing the relevance of premeditation). For a discussion on provocation and its role in the "legislative grading" of intentional homicide offenses, see *id.* at 427–63.

37. Some of these problems have caused observers to question the imposition of harsher punishment for "premeditated" murders. See Kimberly Kessler Ferzan, *Plotting Premeditation's Demise*, 75 LAW & CONTEMP. PROBS. 83, 86 (2012) (arguing that premeditation "is woefully under- and overinclusive").

38. 17 C.F.R. § 240.10b-5 (2013).

39. The Supreme Court has never fully explained the scienter requirement for Rule 10b-5 securities fraud claims, and lower courts have failed to define with any consistency the term

which the fraud arose is only of interest, if at all, to the court exercising discretion at sentencing.⁴⁰

Even if criminal fraud statutes fail to parse timing and motivation, there is no reason that internal corporate law enforcers should also fail to do so. Punishment and prevention, after all, are very different concepts; the tools we find most effective for one may not be the ones we find most effective for the other. Accordingly, this Part attempts to unpack these two dispositions.

A. *Opportunistic Agents*

Economists define an agent as any person who has been delegated authority by a principal to act on the principal's behalf.⁴¹ Although agency-cost theory has long been a focus of those who study corporations, the concept has been used to analyze other relationships, such as between public decision makers and the general public.⁴² Although the foundational conflict between corporate managers and shareholders is often described as an agency-cost problem, the label refers primarily to agency *theory* as opposed to the common law of

"willfulness" as it is used in the criminal securities fraud context. Buell, *supra* note 35, at 555–60 (examining numerous attempts by lower courts to define the term). Thus, the difference between "reckless" and "willful" misconduct varies depending on the court. Compare *United States v. Gansman*, 657 F.3d 85, 91 n.7 (2d Cir. 2011) (opining in dicta that, unlike criminal liability, civil liability can attach "if the government proves . . . that the defendant's conduct was merely reckless, rather than willful"), with *United States v. Tarallo*, 380 F.3d 1174, 1188–89 (9th Cir. 2004) (upholding jury instruction that permitted conviction of defendant if he made a representation "with reckless indifference to its truth or falsity").

40. In *United States v. Adelson*, 441 F. Supp. 2d 506, 513 (S.D.N.Y. 2006), the district court justified its decision to impose a sentence well below the range recommended by the U.S. Sentencing Guidelines in part because "Adelson . . . feared the effects of exposing what he had belatedly learned." For a recent analysis of how courts approach white-collar sentencing, see generally Todd Haugh, *Sentencing the Why of White Collar Crime*, 82 FORDHAM L. REV. (forthcoming 2014), available at <http://ssrn.com/abstract=2244569>.

41. "[A]n 'agency problem'—in the most general sense of the term—arises whenever the welfare of one party, termed the 'principal,' depends upon actions taken by another party, termed the 'agent.'" Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE & FUNCTIONAL APPROACH* 21, 21 (Reinier Kraakman et al. eds., 2004). For the differences between economic and legal agents, see Claire A. Hill & Brett H. McDonnell, *Fiduciary Duties: The Emerging Jurisprudence*, in *RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW* 133, 135 (Claire A. Hill & Brett H. McDonnell eds., 2012) ("Under the economics definition directors are agents of shareholders, while under the legal definition they are not because shareholders lack the requisite control.").

42. "[The agency cost problem] exists in all organizations and in all cooperative efforts—at every level of management in firms, in universities, in mutual companies, in cooperatives, in governmental authorities and bureaus, in unions, and in . . . agency relationships . . ." Jensen & Meckling, *supra* note 5, at 309 (citation omitted).

agency.⁴³

Throughout the agency-cost literature, the narrative is roughly the same: those with decision-making authority (i.e., agents) employ their authority and discretion in a manner that benefits themselves at the expense of the people who employ them (i.e., principals).⁴⁴ Within the publicly held corporation, the separation of ownership and control enables managers to take advantage of uninformed and disorganized shareholders.⁴⁵ Agents harm their principals by being opportunistic and by “shirking.”⁴⁶ Shirking encompasses instances in which an agent fails to “devote significant effort” to the tasks delegated by his principal.⁴⁷

Opportunism is more difficult to define.⁴⁸ It is a pejorative term that suggests a type of behavior that combines self-interest, deception, and a willingness to exploit some set of rules. It is, according to Oliver Williamson’s famous definition, a form of self-interest seeking with guile.⁴⁹ Guile, in turn, implies an intention to disguise the nature

43. Fiduciaries, directors, and officers are not the corporate shareholders’ common law agents. *See, e.g.*, D. Theodore Rave, *Politicians as Fiduciaries*, 126 HARV. L. REV. 671, 699–700 (2013) (distinguishing corporate fiduciary relationships from common law agency relationships).

44. “The heart of the dilemma comes from a simple truth: it is expensive (and ultimately impossible) to prevent parties from taking self-interested actions when they are given control over other people’s money.” George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 110 (2009).

45. “Much of the corporate governance in the United States focuses on . . . utilizing different monitoring devices available to protect shareholders from losses resulting from the separation of ownership from control.” Arthur R. Pinto, *An Overview of United States Corporate Governance in Publicly Traded Corporations*, 58 AM. J. COMP. L. 257, 260 (2010).

46. “[T]he agent has an incentive to act opportunistically, skimping on the quality of his performance, or even diverting to himself some of what was promised to the principal.” Hansman & Kraakman, *supra* note 41, at 21 (citation omitted).

47. *See* Jensen & Meckling, *supra* note 5, at 313. “[S]hirking is defined to include any action by a member of a production team that diverges from the interests of the team as a whole. . . . [It] includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.” STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 73 n.94 (2008). Extreme shirking is addressed by the fiduciary duty of care. Ordinary mismanagement is taken up, if at all, through markets and private contract. *See, e.g.*, Mark J. Roe, Abstract, *Corporate Law’s Limits*, 31 J. LEGAL STUD. 233, 233 (2002) (observing that “the business judgment rule puts beyond direct legal inquiry most key agency costs—such as overexpansion, overinvestment, and reluctance to take on profitable but uncomfortable risks”).

48. For more on the difficulties of defining opportunism, *see* Daniel B. Kelly, *Strategic Spillovers*, 111 COLUM. L. REV. 1641, 1653–54 (2011).

49. Oliver E. Williamson, *The Logic of Economic Organization*, 4 J.L. ECON. & ORG. 65, 68 (1988); *see also* Hansmann & Kraakman, *supra* note 41, at 21 n.2 (defining opportunism as “self-interested behavior that involves some element of deception, misrepresentation, or bad faith”). Despite Professor Williamson’s widely accepted definition, not all opportunistic behavior is in fact guileful or deceptive. For example, Williamson’s famous “hold-up”

of one's conduct or to deceive. It is this notion of guile or deception that implies a level of self-awareness that is itself dangerous—the individual *knows* she is doing something the other person might not like and she therefore has the incentive and ability to cover her tracks.

Williamson's guile-based definition of opportunism coincides nicely with popular definitions of white-collar crime. The FBI, for example, has defined white-collar crime as acts that "are characterized by deceit, concealment, or violation of trust."⁵⁰ The guileful, deceptive behavior that underlies so-called schemes to defraud also defeats markets and undermines the public's trust.⁵¹ It is both so morally blameworthy and so economically harmful as to justify the government's intrusion in otherwise private affairs and to trigger promises from public officials to publicly condemn and strip officers of their worldly possessions.⁵² Accordingly, even though agency costs have long been the "domain of state corporate law,"⁵³ managerial opportunism has increasingly become the preoccupation of federal and state prosecutors and regulators.⁵⁴ Although state courts may have initially crafted doctrines such as the duty of loyalty with antifraud norms in mind,⁵⁵ corporate law has ceded much of antifraud enforcement to federal and state enforcement actors.⁵⁶

example—whereby an owner of relation-specific assets takes advantage of a contracting party who has no other options—is not necessarily guileful or underhanded. *See, e.g.,* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1762–63 (1989) (explaining Williamson's hold-up theory).

50. FED. BUREAU OF INVESTIGATION, U.S. DEP'T OF JUSTICE, WHITE COLLAR CRIME: A REPORT TO THE PUBLIC 3 (1989).

51. For a discussion of the economic justification for criminalizing fraud, see Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1195–96 (1985) (offering "market bypass" justifications for crimes such as fraud and theft).

52. *See, e.g.,* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 627 (2007). Langevoort was quoting former SEC Chairman Richard Breiden. *See id.*

53. Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems,"* 31 J. CORP. L. 949, 964 (2006). Langevoort observes that statutes such as the 2002 Sarbanes-Oxley Act "creat[e] a much harsher criminal and civil liability threat if [managerial] noncompliance is detected by the SEC or federal prosecutors." *Id.* at 966.

54. *See, e.g.,* Kulbir Walha & Edward E. Filusch, *Eliot Spitzer: A Crusader Against Corporate Malfeasance or a Politically Ambitious Spotlight Hound? A Case Study of Eliot Spitzer and Marsh & McLennan*, 18 GEO. J. LEGAL ETHICS 1111, 1112 (2005) (discussing Spitzer's use of New York's Martin Act to threaten criminal cases against corporations and their employees).

55. *See, e.g.,* *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (N.Y. Sup. Ct. 1944) (explaining that the duty of loyalty's purpose is "to avoid the possibility of fraud and to avoid the temptation of self-interest" (quoting *In re Ryan's Will*, 52 N.E.2d 909, 923 (N.Y. 1943))).

56. For more on the "federalization" of corporate law and corporate governance in

Corporate criminal behavior—particularly securities fraud—is an agency cost, albeit one that makes some shareholders better off.⁵⁷ All things being equal, shareholders prefer not to be defrauded in their investments. True, some shareholders may benefit temporarily from the corporate officer's decision to fraudulently inflate profits.⁵⁸ But over time, fraud reduces confidence in public markets, decreases allocative efficiency, and increases the corporation's cost of securing needed capital.⁵⁹ Accordingly, officers who commit fraud impose long-term costs on themselves, their employees, and the many shareholders who are likely to get caught paying the bill when various violations of law finally come to light.⁶⁰

Admittedly, not all opportunistic behavior is covered by federal criminal or securities laws. The Supreme Court's narrowing of "honest services" fraud in *Skilling v. United States* now leaves

particular, see generally Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 872–86 (2003) and Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

57. See, e.g., Arlen, *supra* note 6, at 834. For an early argument that corporate fraud is a type of agency cost, see Jennifer H. Arlen and William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 701–03 (theorizing that officers and directors defraud markets to save their jobs, at the expense of corporate shareholders). For later analyses, see Geoffrey Christopher Rapp, *Mutiny by the Bounties? The Attempt to Reform Wall Street by the New Whistleblower Provisions of the Dodd-Frank Act*, 2012 BYU L. REV. 73, 106 (quoting Rose, *supra* note 4, at 2182) (ascribing securities fraud to "opportunities" and "pressures" that are exacerbated by corporate agency costs).

58. Day traders, for example, may benefit from fraud insofar as they sell stock while it is inflated. See John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1559–60 (2006) (discussing incipient conflict between professional traders and undiversified, "buy and hold" investors, who "are more likely to have purchased their stock before the class period commenced"). Buy and hold investors, however, are likely to suffer. *Id.* at 1560. Moreover, as Professor Alicia Davis Evans explains, the average investor loses more money on disclosed frauds than he gains from undisclosed frauds. Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 229 (2007).

59. Rose, *supra* note 4, at 2179–80 (explaining securities fraud's effects on the stock market's ability to reflect accurate prices and thus steer capital away from its most efficient use); see also James J. Park, *Rule 10B-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 355–56 (2010) (citing literature discussing securities fraud's allocative and informational effects).

60. For example, Professor Usha Rodrigues portrays corporate fraud as a conflict of interest problem: "Even as the Enron and Worldcom frauds gave way to fresher tales of options backdating, corporate looting, insider trading, and more recently out-sized golden parachutes, the common denominator remained the fact that corporate agents put their own interests above those of the corporation." Rodrigues, *supra* note 5, at 3 (emphasis added). Others observe that corporate fraud victimizes stakeholders beyond those who meet the narrow legal definition of "principal." See Urska Velikonja, *The Cost of Securities Fraud*, 54 WM. & MARY L. REV. 1887, 1945 (2013) (arguing that fraud affects economic decision-making among firms more broadly, not just shareholders in a specific corporation whose officers misstated earnings).

nondisclosures of conflicts of interests outside the boundaries of federal criminal law.⁶¹ Other conflicts of interest—such as those that arise in the merger context, where managers attempt to fend off takeovers partially to preserve their own positions—are the subject of state corporate law.⁶² Nevertheless, much of what we think of as opportunistic behavior within a firm (e.g., deceitful behavior that causes victims to lose tangible interests such as money) still rests comfortably within the criminal law paradigm.⁶³

B. *Detering Opportunistic Behavior*

Since opportunistic agents are presumptively rational, their misconduct can be deterred.⁶⁴ Deterrence, in turn, depends on the putative wrongdoer's cost-benefit analysis.⁶⁵ When the expected sanction for misconduct, multiplied by the probability of punishment, outweighs its net expected benefits, the would-be wrongdoer desists.⁶⁶ A separate strand of this literature recognizes that legal institutions can reduce wrongdoing by altering the wrongdoer's preferences or tastes for engaging in wrongdoing.⁶⁷ In either case, the law enforcement institution reduces fraud by adding to the would-be wrongdoer's costs or by reducing his expected benefits.

61. See *Skilling v. United States*, 130 S. Ct. 2896, 2931–32 (2010) (limiting definition of “honest services fraud” statute to include only bribery and kickbacks, and not nondisclosure of conflicts of interests).

62. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (discussing the “enhanced duty” that results because of the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders”).

63. “A century ago, lying raised moral and reputational questions but only rarely legal ones. Today, lying by any government official or lying in the course of any business transaction is usually a felony.” William J. Stuntz, *Self-Defeating Crimes*, 86 VA. L. REV. 1871, 1881–82 (2000).

64. See, e.g., Arlen & Carney, *supra* note 57, at 701–03. For more recent accounts of how fraud reflects as agency costs, see for example Harry First, *Branch Office of the Prosecutor: The New Role of the Corporation in Business Crime Prosecutions*, 89 N.C. L. REV. 23 (2010) and Urska Velikonja, *Leverage, Sanctions, and Deterrence of Accounting Fraud*, 44 U.C. DAVIS L. REV. 1281 (2011).

65. For the seminal discussion of this point, see Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 176–79 (1968) (explaining the “supply” of offenses) and Oded, *supra* note 25, at 273 (citing authorities).

66. See, e.g., Posner, *supra* note 51, 1205–14 (discussing the optimal criminal penalties to deter crime); Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1241–46 (1985) (noting that a party would not be “deterred from committing an act if his expected private benefits exceed the disutility of the highest conceivable expected sanction”). See generally Becker, *supra* note 65.

67. See Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 2 (setting forth “an economic analysis of criminal law as a preference-shaping policy”).

Although Professor Gary Becker's seminal account of crime treats sanctions and enforcement probability as substitutes, subsequent deterrence theory scholarship has demonstrated that criminals pay greater attention to increases in probability of punishment than increases in sanctions.⁶⁸ Moreover, punishment's timing plays a big role in its overall effectiveness. Disutility that occurs in later periods is felt less keenly than disutility experienced immediately. Accordingly, the more remote a sanction is in terms of time, the more weakly it deters.⁶⁹

A different strand of deterrence theory recognizes the importance of the corporate firm. The firm functions as a mediating entity: it can either diffuse responsibility for wrongdoing, or it can aid external authorities through self-monitoring and reporting.⁷⁰ Accordingly, as Professors Jennifer Arlen and Reinier Kraakman argue, the best way to reduce organizational wrongdoing is to create a two-tiered scheme of liability for organizations, whereby the organizations can earn reduced sanctions for their employees' wrongdoing by monitoring and self-reporting misconduct to external authorities.⁷¹ Corporations that maintain robust compliance programs thus experience reduced penalties, whereas corporations that forego aggressive monitoring suffer more severe sanctions if they are caught.⁷²

As those familiar with the agency-cost literature well know, lawmakers and private individuals have devised numerous ways to reduce corporate agency costs.⁷³ Nevertheless, the tools most associated with the reduction of corporate fraud are criminal and civil liability, with criminal liability increasingly seen as the more robust mechanism for addressing fraud and similar types of wrongdoing.⁷⁴

68. See Becker, *supra* note 65; see also Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. 1295, 1303–06 & n.38 (offering reasons why increasing the probability of punishment may be more effective than increasing sanctions).

69. See generally Yair Listokin, *Crime and (with a Lag) Punishment: The Implications of Discounting for Equitable Sentencing*, 44 AM. CRIM. L. REV. 115, 116 (2007).

70. See Samuel W. Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1625–27 (2007).

71. See generally Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997); Arlen, *supra* note 6.

72. For an argument that the federal government has failed to effectively implement this two-tiered scheme, see generally Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines*, 66 U. MIAMI L. REV. 321 (2012).

73. Hansmann & Kraakman, *supra* note 41, at 23–28 (dividing various approaches into *ex ante* and *ex post* “regulatory” and “governance” strategies).

74. For a comprehensive argument that civil liability fails to deter corporate fraud due to the shielding effects of director and officer liability insurance, see generally TOM BAKER & SEAN J. GRIFFITH, *ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION* (2010). For other critiques of civil liability, see

C. Temporally Inconsistent Decision Makers

Many, if not all of us, have experienced the phenomenon whereby at T_0 , we promise to take one course of action in the future, only to later reverse that course of action at T_1 , and then express regret at T_2 for not having adhered to our original plans. The decisions we claim that we will make later are not the actual choices we make when “later” arrives, and in many cases, we regret our failure to adhere to our original plans. Psychologists and behavioral economists have devised several explanations for this phenomenon, which are discussed below.

1. Hyperbolic Discounting

The hyperbolic discounting literature theorizes that individuals change their minds suddenly because they discount costs and benefits differently depending on how close a given time interval is to the present.⁷⁵ If asked to choose between a slice of pizza at an earlier point in time and two slices just one hour later, a person feels differently about the hour-long waiting period (and the extra slice) if that period commences now or is slated to commence one week from now.⁷⁶ Far-off tradeoffs are perceived differently from imminent ones.⁷⁷ As a result, given the choice between a single slice of pizza at 5:00 PM next Thursday or two slices at 6:00 PM, a student may very happily agree today to wait just one additional hour for an extra slice of pizza. When “next Thursday” becomes *today*, however, and a single slice is a mere five minutes away, she is apt to change her mind.

generally John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534 (2006); Renee M. Jones, *Law, Norms, and the Breakdown of the Board: Promoting Accountability in Corporate Governance*, 92 IOWA L. REV. 105 (2006).

75. See, e.g., *Preface to CHOICE OVER TIME* (George Loewenstein & Jon Elster eds., 1992) (collecting papers on intertemporal choice); see also George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, J. ECON. PERSP., Fall 1989, at 181, 182–83 (offering common examples of hyperbolic discounting). For more technical treatments, see generally David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443 (1997) and R.H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization*, 23 REV. ECON. STUD. 165 (1956).

76. “When faced with a choice between an inferior early option and a superior later option, hyperbolic discounters will tend to prefer the later, superior option, when both are remote, but switch to a preference for the earlier, inferior option as both approach in time.” CHOICE OVER TIME, *supra* note 75, at xiii; see also Loewenstein & Thaler, *supra* note 75, at 181–83 (explaining mathematical principles behind time inconsistency).

77. Scholars sometimes refer to this as “declining impatience” since impatience declines for more remote time periods. See Yusuke Kinari, Fumio Ohtake & Yoshiro Tsutsui, *Time Discounting: Declining Impatience and Interval Effect*, 39 J. RISK & UNCERTAINTY 87, 88 (2009) (explaining usage of the term).

Psychologists and behavioral economists have labeled this phenomenon “hyperbolic discounting.”⁷⁸ Conventional rational-actor models assume that individuals discount time exponentially, according to a stable “discount.”⁷⁹ Thus, for the rational actor, it does not matter when the wait for two slices of pizza begins. Although she would prefer pizza now to pizza later (as any rational person would), she nevertheless assigns the same value to the one-hour wait (and to the extra slice of pizza), regardless of when that wait commences.

Hyperbolic discounters, by contrast, impose a steeper discount on intervals that occur closest to the present than to intervals slated to occur in the future.⁸⁰ As Professor Oren Bar-Gill explains, “[A]t a given point in time, t , a hyperbolic discounter heavily discounts costs and benefits that will materialize in the near future, at $t+1$, but assigns only a smaller *additional* discount for costs (and benefits) that will materialize in the more distant future, at $t+2$.”⁸¹

Individuals who are unaware of this tendency incorrectly predict their future behavior.⁸² We *think* that we can wait an additional hour for a much-anticipated televised sporting event to begin, but when the additional hour arrives, the wait *feels* more costly, and as a result, we change our plans.⁸³

Hyperbolic discounting is particularly problematic for conduct that generates positive and negative consequences in different periods. True, even rational individuals judge immediate costs or benefits more strongly than equivalent costs or benefits that arise in later periods. But hyperbolic discounters place a much greater premium on near-term costs and benefits, which makes them more likely to put off (and ultimately abandon) activities that feature upfront costs, and to excessively and prematurely consume activities that feature upfront

78. See Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law & Economics*, 50 STAN. L. REV. 1471, 1539–40 (1998) (contrasting hyperbolic discounting with exponential discounting); Ted O’Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103, 106 n.7 (1999).

79. Wright & Ginsburg, *supra* note 11, at 1043.

80. “When considering trade-offs between two future moments, present-biased preferences give stronger relative weight to the earlier moment as it gets closer.” O’Donoghue & Rabin, *supra* note 78, at 103; *see also* Utset, *Hyperbolic Criminals*, *supra* note 18, at 641.

81. Oren Bar-Gill, *Seduction By Plastic*, 98 NW. U. L. REV. 1373, 1396 (2004).

82. “When a hyperbolic discounter is naïve about the nature of her time preferences, she will overestimate her will-power” *Id.* at 81, at 1396 (explaining why consumers excessively borrow money); *see also* Utset, *Hyperbolic Criminals*, *supra* note 18, at 612.

83. Conduct changes when preferences change. Plotted on a graph, this is the moment that the individual’s future and present preference curves “cross.” “[D]iscount curves that cross as a function of time alone do not arise from the conventional, exponential form of discounting.” George Ainslie & Nick Haslam, *Hyperbolic Discounting*, in CHOICE OVER TIME, *supra* note 75, at 57, 63. For more on preference switches generally, *see* Korobkin & Ulen, *supra* note 13, at 1127–43.

benefits.⁸⁴

The hyperbolic discounting literature is concededly messy. Some disagree on when it occurs and others on how to model it.⁸⁵ Researchers have identified a stronger effect on discounts when the interval is framed as a delay of gains as opposed to a delay of losses, and the magnitude of the effect increases for smaller amounts.⁸⁶ Finally, some researchers argue that hyperbolic discounting does not accurately predict behavior beyond an initial interval, and therefore reflects little more than a visceral reaction.⁸⁷

One need not definitely resolve these debates, as most researchers agree that individuals harbor some type of immediacy bias, and that they alter their conduct in ways that conflict with their previously stated intentions.⁸⁸ Regardless of whether we attribute this switch to hyperbolic discounting or other phenomena, the switch presents a problem for policymakers and law enforcers.⁸⁹

2. Willpower and Self-Control Problems

Many individuals discount hyperbolically, but not everyone *acts* in accordance with his or her altered preferences.⁹⁰ Some people stick to their T_0 plans, even at T_1 . We often say (quite approvingly) that these

84. Utset, *supra* note 8, at 419 n.6, 420.

85. See, e.g., Shane Frederick & George Loewenstein, *Conflicting Motives in Evaluations of Sequences*, 37 J. RISK & UNCERTAINTY 221, 221–22 (2008) (acknowledging a lack of consensus among researchers). Professor Daniel Read argues that individuals are “subadditive” in that they impose smaller discounts on longer delays than they do on a sum of shorter delays. See Daniel Read, *Is Time-Discounting Hyperbolic or Subadditive?*, 23 J. RISK & UNCERTAINTY 5 (2001) (demonstrating through experiments that declining discounts are due solely to subadditivity and not hyperbolic discounting). In response, researchers contend that Read failed to test for hyperbolic discounting over shorter delays. See Kinari et al., *supra* note 77 (isolating “interval” and “delay” effects and demonstrating “hyperbolic discounting” for shorter delays while also establishing subadditivity for longer delays).

86. Loewenstein & Thaler, *supra* note 75, at 184.

87. Read, *supra* note 85, at 28 (arguing that “[a]n immediacy effect is *not* declining impatience, but rather a one-time-only charge for delaying consumption”). Read further argues that hyperbolic preferences respond mostly to “visceral” emotions, such as hunger, and that the use of money in his experiments was proper because money “may have some visceral properties, [but] this is not its primary characteristic.” *Id.* at 27.

88. As Professors Fennell and Stark argue, “While there may be questions about how well the hyperbolic discount function tracks the dynamics of preference reversals, it usefully captures the idea that lack of self-control can undo previously preferred plans” Lee Anne Fennell & Kirk J. Stark, *Taxation over Time*, 59 TAX L. REV. 1, 14–15 (2005) (footnote omitted).

89. Jolls et al., *supra* note 78, at 1539–40 (discussing the implication of hyperbolic discounting for “effective deterrence of criminal behavior”).

90. Fennell, *Willpower Taxes*, *supra* note 12, at 1378 (observing that although hyperbolic discounting is often “symptomatic” of willpower lapses, the phenomenon does not “inevitably signify” such lapses).

individuals possess substantial willpower.⁹¹ Professor Lee Anne Fennell defines this elusive ability as “one’s personal efficacy in carrying out the consumption path that one (from a cool, reflective, composite, or long-run perspective) deems to be the best of those that lie open.”⁹²

People who are unable to adhere to their long-term plans are often said to lack self-control.⁹³ As Professor Richard McAdams and Professor Fennell have (separately) pointed out, the naïve person who lacks self-control in a particular moment differs significantly from the myopic individual who maintains a uniformly high discount rate.⁹⁴ The myopic person does not burden herself with long-term plans and therefore experiences no regret when she changes her mind.⁹⁵ The hyperbolic person, by contrast, sincerely embarks upon beneficial, long-term projects, but later abandons them when temptations overwhelm her.⁹⁶ Unlike her impulsive friend, the hyperbolic individual desires and assumes she will behave like the dependable person with the relatively low discount rate, but for some reason, she loses the ability to do so when changes in utility become imminent.⁹⁷

Aside from hyperbolic discounting and willpower lapses, researchers have posed additional explanations for preference switching. The study of emotions has led some to adopt a “hot and cold” explanation of behavior. The “cold state” can dispassionately calculate and net out long-term costs and benefits, whereas the “hot state” abandons this rational framework.⁹⁸ As a result, the cold, rational self chooses a long-term option that yields long-term benefits. The hot, emotional self undoes the cold self’s plans, causing regret (and often serious costs) later on.⁹⁹ And, as is the case with hyperbolic discounting, the cold self underestimates the likelihood and effect that his emotions will cause him to make poor decisions at some later

91. For an extended treatment of the subject and summary of Roy Baumeister’s and other psychologists’ studies on willpower, see generally ROY F. BAUMEISTER & JOHN TIERNEY, *WILLPOWER* (2011).

92. Fennell, *Willpower Taxes*, *supra* note 12, at 1376–77 (footnote omitted).

93. *Id.* at 1377 (observing that “willpower relates to individuals’ subjective optimization efforts”).

94. *Id.* at 1378–79; McAdams, *Signaling*, *supra* note 18, at 657.

95. See McAdams, *Signaling*, *supra* note 18, at 656 (observing that feelings of regret will be felt solely by the persons with inconsistent discount rates and not those with uniformly high discount rates).

96. See Fennell, *Willpower Taxes*, *supra* note 12, at 1378–79.

97. See *id.*

98. George Loewenstein, *Emotions in Economic Theory and Economic Behavior*, 90 AM. ECON. REV. (PAPERS & PROC.) 426, 428 (2000) (“[V]isceral factors often drive people to behave in ways that they view as contrary to their own self-interest.”). For a detailed account of how hot and cold states impact decision-making, see Hollander-Blumoff, *supra* note 18, at 527–29.

99. See Loewenstein, *supra* note 98, at 428.

point in time.¹⁰⁰

Finally, Professor Rebecca Hollander-Blumoff's recent discussion of construal-level theory offers a slightly different explanation for preference switches.¹⁰¹ According to this theory, an individual estimates the costs or benefits of a far-off event differently depending on whether she views the event "abstractly" in the future (high-level construal) or "concretely" in the present (low-level construal).¹⁰² As the event becomes more imminent, costs or benefits of a given activity appear more acute.¹⁰³ As Professor Hollander-Blumoff's account demonstrates, the concrete, near-term calculation is not necessarily more accurate; it is simply felt more strongly.¹⁰⁴ Construal-level theory thus explains why an individual might commit to a goal or obligation, later decide that it is too onerous, and yet feel regret afterward when she fails to follow through on her original plan.¹⁰⁵

Whether the explanation revolves around willpower lapses, hot and cold states, or abstract and concrete reasoning, the outcome is the same: people desire certain long-term commitments, and then view the associated costs and benefits of those commitments differently as decisions move from the future to the present. As a result, they act in ways they would not have predicted in the past, and then experience regret once they change course.

D. Reducing Temporal Inconsistency

The temporal inconsistency literature identifies primarily two types of problems, procrastination and excessive or premature consumption.¹⁰⁶ As Professors Ted O'Donoghue and Matthew Rabin explain: "You *procrastinate*—wait when you should do it—if actions involve immediate costs (writing a paper), and *preoperate*—do it

100. "[P]eople tend to underestimate the impact of visceral factors on their own current and future behavior." *Id.* "When in a 'cold' state . . . , it is difficult to imagine what it would feel like to be in a 'hot' state or to imagine how one might behave in such a state [and vice versa]." *Id.*

101. Hollander-Blumoff, *supra* note 18, at 529–33.

102. *Id.* at 529–30.

103. *Id.* at 530 ("[L]ow-level construals capture the concrete, specific, mundane features of the event." (internal quotation marks omitted)).

104. *See id.* at 530 (noting that high-level, abstract construal "helps individuals exercise self-control").

105. *See id.* at 532 (explaining that "the events are not just weighted [differently], they are also conceptualized differently").

106. *See* Utset, *Hyperbolic Criminals*, *supra* note 18, at 644–45 (discussing how procrastination and overconsumption can generate crime). Some might ask what the difference is between the procrastinator and the person who wholly abandons the project. The procrastinator still thinks she will eventually do the project even though she keeps putting it off.

when you should wait—if actions involve immediate rewards”¹⁰⁷ Both types of conduct impose costs on individuals and third parties.

Professor Manuel Utset applies these concepts to the corporate context and argues that a temporally inconsistent corporate manager may either procrastinate engaging in valuable projects or otherwise “overconsume” misbehavior.¹⁰⁸ The tendency to procrastinate and overconsume, in turn, generates corporate wrongdoing, by serving as either the *cause* of corporate wrongdoing or as the *condition* that precedes such wrongdoing.¹⁰⁹

Consider the evils of procrastination: Kathy, a regional district manager, agrees to meet a sales target set by her supervisor. She must meet that target by next month, and to achieve that target, she agrees that she should reorganize her sales team. But the reorganization, which she previously agreed was necessary and valuable, requires an upfront investment in time and social capital. Accordingly, every day, Kathy puts off her planned reorganization; she plans to do it eventually, but she cannot bring herself to do it “today.” At the end of the month, Kathy has no choice but to lie or accept a negative performance review. If Kathy chooses to lie, we can say that procrastination has played a role in her fraud.

Now consider the evils of overconsumption: Jennifer, a corporate compliance officer, suspects the IT group of filing fraudulent expense reports. When she questions the top Chief Information Officer, he provides her with superficially plausible explanations for his group’s previous reports. Jennifer ought to spend time investigating and questioning the reports, but the immediate benefits of closing out her investigation appear too tempting. As a result she accepts the CIO’s explanation without a follow-up. Jennifer has effectively “overconsumed” an immediate benefit.

The temporal inconsistency literature contends that we can solve the foregoing problems by enacting so-called precommitment devices, which have been defined as “any action by which the present self constrains the choices of the future self.”¹¹⁰ One can do this either by

107. O’Donoghue & Rabin, *supra* note 78, at 104.

108. Presumably, a hyperbolic person could harm his longer-term self by *either* premature consumption or excessive consumption. Compare *id.*, with Utset, *Hyperbolic Criminals*, *supra* note 18. Utset refers to the latter as a form of “nibbling opportunism,” but for reasons set out later, this Article prefers to treat the term “opportunistic” as referring to one’s *motivation*, which is separate from one’s tendency to be consistent or inconsistent. Compare Utset, *Hyperbolic Criminals*, *supra* note 18, at 644, with *infra* Part II.

109. Utset, *supra* note 8, at 432–36 (explaining how temporal inconsistency affects both corporate managers and those “gatekeepers” tasked with monitoring said managers).

110. McAdams, *Signaling*, *supra* note 18, at 657. Professor Stephen Bainbridge sets forth four “precommitment” strategies, which include the deletion of options, increasing the costs of choosing certain options, delays or cooling-off periods, and insulation from knowledge of

creating mechanisms that accelerate costs and benefits the very moment the decision maker is apt to yield to her short-term temptations, or by implementing devices that explicitly reduce options in advance of a foreseen event.¹¹¹ A tool that falls within the former category is a “targeted enforcement device,” and a tool that falls within the latter category is an “option-reducing device.”

Targeted enforcement devices increase the costs of undesirable behavior either by accelerating sanctions or delaying gratification.¹¹² Unlike ordinary deterrence devices, they impose an external cost or benefit at exactly the moment an individual is likely to fall prey to short-term temptations. A nice example is the speed bump; the reason it stops a driver from speeding is that it forces him to experience the “costs” of speeding at the very moment he is tempted to place his foot on the accelerator.¹¹³ By the same token, if every time a company executive wants to take a government client out to dinner, the executive has to describe the existence and purpose of the dinner in a memo and demonstrate why it does not violate state or local procurement laws; the mere fact of having to write the memo imposes an immediate “cost” on the executive’s behavior. In the moment, she may not care about being fired or placed in jail months down the road, but she may so dislike filling out paperwork (or worse, conferring with her supervisor) that she is deflected from engaging in violations of bribery and gratuity laws. The accelerated cost (writing a memo) is more effective than the longer-term cost (being detected and sent to prison).

The same internal reporting system also makes it easier to track or prove violations *ex post* if the employee lies about the purpose of the dinner, or fails to fill out the memo at all. Thus, a targeted enforcement device fulfills two functions. It triggers an early “nonsanction cost” that may deflect an otherwise waffling employee from falling prey to some short-term desire to bribe a potential

certain options. Bainbridge, *supra* note 17, at 4–5. Professor John Robertson similarly describes precommitment devices that work by “removing certain options from the feasible [decision] set, by making them more costly or available only with a delay, and by insulating themselves from knowledge about their existence.” Robertson, *supra* note 16, at 1730 (quoting JOHN ELSTER, *ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS* 1 (2000)).

111. Professor Utset notes that certain provisions of the Sarbanes-Oxley Act of 2002 were intended to perform these functions. Utset, *supra* note 8, at 439–43.

112. See, e.g., Utset, *Hyperbolic Criminals*, *supra* note 18, at 657–62 (arguing in favor of “well-tailored” deterrence approaches that target first-period costs and benefits).

113. See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 696 (2007) (praising the speed bump’s qualities in constraining speeding).

government client.¹¹⁴ At the same time, it increases the costs of engaging in criminal conduct for *all* employees because it increases the overall likelihood of detection and punishment. The employee who was planning all along to obtain a government contract through bribery now must fill out fraudulent paperwork to mask his behavior.¹¹⁵ Such detection avoidance is costly, even if only marginally so, and may trigger a separate, independent punishment for false disclosure.¹¹⁶

Another source of targeted enforcement is the psychic cost that an individual feels at the moment he is about to falsify records or commit other types of wrongdoing. Criminologists have demonstrated that moral inhibitions play a role in reducing crime, including corporate crime.¹¹⁷ Psychic costs, in turn, arise out of social norms.¹¹⁸

If every time an individual falsifies a document, he feels a sudden wave of unpleasant emotions (e.g., fear or shame), he will more likely avoid such behavior.¹¹⁹ The “self-imposed” sanction works not just because it increases the overall cost of wrongdoing, but also because

114. McAdams, *supra* note 18, at 1613 (using the term “nonsanction cost” to denote costs taken by potential criminals in preparing for crime to “lower the probability of detection”).

115. *Cf. id.* at 1616 (noting that when a “criminal must invest in the crime” before any benefits accrue, “sanctions for criminal preparation will cause criminals to incur extra costs in making their preparation to avoid detection”).

116. *See id.*; Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331, 1378–82 (2006) (discussing “piggyback” sanctions employed to punish detected instances of detection avoidance). Concededly, detection avoidance may be costly to the government enforcer as well as the offender. *Id.* at 1353.

117. *See* Nicole Leeper Piquero, M. Lyn Exum & Sally S. Simpson, *Integrating the Desire-for-Control and Rational Choice in a Corporate Crime Context*, 22 JUST. Q. 252, 254 (2005) (citing studies for the proposition that “moral inhibitions consistently have inhibitory effects on crime”); *see also* Raymond Paternoster & Sally S. Simpson, *Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime*, 30 LAW & SOC’Y REV. 549, 554 (1996).

118. “Social norms are standards of behavior that are based on widely shared beliefs about how individual group members ought to behave in a given situation.” Helen Bernhard et al., *Group Affiliation and Altruistic Norm Enforcement*, 96 AM. ECON. REV. (PAPERS & PROC.) 217, 217 (2006); *see also* J. Mark Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 YALE L.J. 604, 644 (1985) (describing psychic costs incident to behaving contrary to social norms).

119. *See* Dan M. Kahan & Martha C. Nussbaum, *Two Conceptions of Emotion in Criminal Law*, 96 COLUM. L. REV. 269, 355–57 (1996) (noting that individuals internalize social norms expressed in criminal laws to avoid discomfort and dissonance associated with desires to commit violations of such laws). Norms can either be imposed internally (through conscience or guilt) or externally (through reputational or societal sanction). *See* Robert D. Cooter, *Three Effects of Social Norms on Law: Expression, Deterrence, and Internalization*, 79 OR. L. REV. 1, 6–8 (2000) (discussing the relationship between internalized norms and external social sanctions); Kahan & Nussbaum, *supra*, at 356–57. For a study of psychic costs and their relationship with corruption, *see* Philip M. Nichols, *The Psychic Costs of Violating Corruption Laws*, 45 VAND. J. TRANSNAT’L L. 145, 193–95, 198–200 (2012).

it surfaces at exactly the moment the individual considers engaging in wrongdoing, and effectively deflects his short-term temptation.¹²⁰

Temporal inconsistency theory thus provides an additional explanation for how “norms” improve compliance.¹²¹ The regulated person follows the law not just because she agrees with the law’s content and finds the lawmaker’s authority “legitimate,”¹²² but also because the norm triggers a strong psychic cost—guilt or shame—at exactly the right time. Certainly, legitimacy matters, but the reason why it matters is likely bound up with its timing. The psychic cost behaves like an internal speed bump and deflects the individual’s short-term temptation to engage in wrongdoing.¹²³

The second type of precommitment device is one that reduces an individual’s options in advance of a foreseen event. Whereas targeted enforcement technically leaves intact the option of behaving badly, option-reducing devices eliminate such discretion.¹²⁴ They do so either by removing options or by blocking access to the information that would cause a decision maker to choose such options.¹²⁵

The most celebrated example is that of Ulysses, who famously directed his crewmen to tie him to the mast of his ship and plugged their ears with wax so that they would not hear his cries when he heard the Sirens’ song.¹²⁶ As a result, he and his crewmembers were, respectively, unable and unaware of any reason to steer the ship in the

120. See Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1665 (1996) (“[S]omeone who has internalized a norm feels guilt from violating it and pride from obeying it. Consequently, internalization may tip the balance for a decisionmaker in favor of obeying a norm.” (footnote omitted)); Richard H. McAdams, *Group Norms, Gossip, and Blackmail*, 144 U. PA. L. REV. 2237, 2249–50 (1996) (similar). That being said, an individual may convince himself that certain behavior, however illegal, does not violate any social norms. See Rapp, *supra* note 57, at 106; see also Haugh, *supra* note 40 (manuscript at 26–34) (drawing on criminological scholarship regarding “neutralization techniques” that defendants use to assure themselves that they are not violating social norms).

121. “Normative commitment through personal morality means obeying a law because one feels the law is just; normative commitment through legitimacy means obeying a law because one feels that the authority enforcing the law has the right to dictate behavior.” TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 4 (2006).

122. *Id.*

123. Temporal inconsistency thus may offer researchers additional avenues through which to test the relative power of social norms as a deterrent.

124. See Bainbridge, *supra* note 17, at 2 (“[S]elf-disablement is a critical aspect of any precommitment strategy.”).

125. *Id.* at 4 (noting the benefits of self-imposed ignorance).

126. 1 HOMER, *supra* note 16, at 445, 447. The device permitted Ulysses to have his cake and eat it too: “Ulysses clogged the ears of his crew with wax so they would not respond to songs of the deadly Sirens, but ordered himself bound to the mast so he could enjoy them without physical power to stray from his predetermined course.” Adam M. Samaha, *Dead Hand Arguments and Constitutional Interpretation*, 108 COLUM. L. REV. 606, 655–56 (2008).

Sirens' direction.

Option-reducing devices are valuable precisely because a decision maker or some other entity can design them to respond to specific temptations.¹²⁷ Option-reducing devices can exclude numerous options or just a few, and they can exclude options irrevocably or conditionally. They can extinguish options through technology (such as a self-shutting engine) or they can delegate the option to some third party who is less likely to fall prey to temptation (such as having an employer pay a portion of his employee's taxes).¹²⁸

The line between an option-reducing device and a targeted enforcement device is admittedly hazy, particularly since many option-reducing devices do not completely eliminate options, but instead make them extremely costly or difficult to achieve. Still, one can grasp the conceptual difference between a speed bump and the act of tying oneself to a ship's mast. The former makes speeding more uncomfortable; the latter all but eliminates the possibility of steering one's ship in a particular direction.

Both types of precommitment devices appear frequently throughout public and private life.¹²⁹ The U.S. Constitution has been described as a precommitment device, as has the standard corporate charter, the Social Security payroll tax, and the Christmas savings club.¹³⁰ All of these mechanisms reduce or vastly circumscribe certain options in advance of a foreseen event. Some precommitment devices are difficult to undo (such as bariatric surgery)¹³¹ and some are relatively weak (such as annual gym memberships).¹³¹

Although the precommitment device presumes a level of "self" commitment, the concept has been slowly expanded to include devices that entities and government agencies impose on others. The least objectionable device is one that an individual imposes on himself with the stated intention of helping only himself.¹³²

127. Bainbridge, *supra* note 17, at 2 (providing examples).

128. Lederman, *supra* note 113, at 697–98, 723–25 (discussing compliance benefits of tax withholding).

129. For illustrative examples, see Daniel Akst, *Commit Yourself*, REASON.COM (May 2011), <http://reason.com/archives/2011/04/18/commit-yourself>.

130. See Susannah Camic, *Earmarking: The Potential Benefits*, 4 PITTSBURGH TAX REV. 55, 64 (2006) (Social Security and Medicare); Michael C. Dorf, *The Aspirational Constitution*, 77 GEO. WASH. L. REV. 1631, 1637–44 (2009) (the Constitution and Bill of Rights); Samuel Issacharoff & Daniel R. Ortiz, *Governing Through Intermediaries*, 85 VA. L. REV. 1627, 1640 (1999) (corporate charters); Deborah M. Weiss, *Paternalistic Pension Policy: Psychological Evidence and Economic Theory*, 58 U. CHI. L. REV. 1275, 1307–08 (1991) (Christmas clubs).

131. Memberships are a weak device because members can still decide to stay home, despite paying money in advance for gym classes. See Stefano DellaVigna & Ulrike Malmendier, *Paying Not to Go to the Gym*, 96 AM. ECON. REV. 694, 695 (2006) (theorizing that consumers overestimate their future self-control in pursuing costly activities).

132. McAdams explicitly refers to self-commitment devices. McAdams, *Signaling*, *supra*

One can also adopt a precommitment device with the express intention of benefitting others. Professor Bainbridge refers to these as “other-regarding” devices.¹³³ If a housing contractor agrees that he will reduce his overall fee if he completes the job after a certain date, he has effectively committed himself to finishing the job on or before that date.¹³⁴ Precommitments like these are unsurprisingly common throughout contract, commercial, and corporate law.¹³⁵ If a corporate officer binds himself in advance to provide shareholders with quarterly and annual reports about the company’s performance, his commitment intentionally aids others and presumably redounds to his long-term benefit as well.¹³⁶

Many of the legal regulations that scholars praise as “structural” also function in the same way as precommitment devices.¹³⁷ “Structure” eliminates the option to defect or engage in socially costly behavior down the road.¹³⁸ As Professor Edward Cheng explains, structure prevails by “subtly shaping the physical, social, or other arrangements that enable the behavior to occur in the first place.”¹³⁹ The difference between the traditional precommitment device and structural regulation, however, is that in the latter case, a government agency designs and implements the structure (albeit in some instances with the public’s backing).¹⁴⁰ When government agents are the

note 18, at 656–58. Bainbridge refers to them as “self-regarding precommitments.” Bainbridge, *supra* note 17, at 5.

133. Bainbridge, *supra* note 17, at 5–6.

134. The contractor may also place such a term in the contract to signal that he takes deadlines seriously.

135. See, e.g., Bainbridge, *supra* note 17, at 2–3, 22–25 (offering examples in corporate and commercial law).

136. Professor Coffee explains that securities disclosure and the decision to place one’s corporation on a public exchange acts as a “bonding” device. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 285 (2007) (citing John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 691–92 (1999)) (“[M]anagers bond[] themselves not to accumulate excessive private benefits by deliberately subjecting themselves to a stricter regulatory regime . . .” (internal quotation marks omitted)). As this Article’s analysis demonstrates, the temporal inconsistency literature adds an additional gloss: the federal securities laws’ disclosure requirements not only “bond” the agent to his principal, but also precommit the corporate agent to a desirable course of conduct.

137. “Unlike fiat, structure does not regulate undesired behavior directly through ex post penalties. Rather, it regulates indirectly and ex ante by subtly shaping the physical, social, or other arrangements that enable the behavior to occur in the first place. Its philosophy is more preventive than reactive.” Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 662 (2006); see also Lederman, *supra* note 113, at 696.

138. Cheng, *supra* note 137, at 662.

139. *Id.* at 655, 662; see also Lederman, *supra* note 113, at 697.

140. “[A] lawmaker can provide cost-effective deterrence by mimicking the commitment devices that sophisticated offenders would adopt for themselves.” Utset, *Hyperbolic Criminals*,

authors of precommitment devices, new concerns arise.

For libertarians, the difference between the self-imposed or government-imposed device is of tremendous significance, since government incursions on decision-making implicate, as Professor Michael Rich observes, “concerns about autonomy, privacy, and bodily integrity.”¹⁴¹ For technocrats interested in improving social welfare, the device’s success and net cost are of more interest, although it seems likely that precommitment’s success depends in part on its source.¹⁴²

The libertarian critique that government ought not intervene to protect the “long-term” self’s interest weakens considerably when one narrows the focus to corporate fraud. The corporate enforcer’s task is not to reduce *all* temporally inconsistent behavior, but rather that type of behavior that society has already declared undesirable through democratically enacted statutes and regulations.¹⁴³ To the extent that an individual’s short-term self (who prefers to lie and steal) is at war with her long-term self (who prefers to abide by the law), there is no contest. The short-term self is clearly out of order; society has already made that clear.¹⁴⁴ At that point, the state has every reason to get involved.

II. HOW OPPORTUNISM AND TEMPORAL INCONSISTENCY INTERACT

Some people are more inclined to take advantage of others through

supra note 18, at 677. “Although one usually thinks about precommitment from an individualist perspective, the term is also usefully applied to group, societal, or national decisions.” Robertson, *supra* note 16, at 1732.

141. Michael L. Rich, *Should We Make Crime Impossible?*, 36 HARV. J.L. & PUB. POL’Y 795, 802 (2013) (discussing the philosophical importance of government involvement in structural criminal regulation); accord Cheng, *supra* note 137, at 669 (“The involuntary nature of structural regulation raises objections of excessive government control, reduced liberty, and invasions of privacy.”).

142. Compare Michael Abramowicz & Ian Ayres, *Commitment Bonds*, 100 GEO. L.J. 605 (2012) (exploring the economic uses of government and privately issued commitment bonds), with Rich, *supra* note 141, at 800–01 (citing specific concerns with government-imposed structural regulations).

143. Concededly, neither courts nor legislatures have defined terms like “fraud” with adequate precision. See generally Buell, *supra* note 34.

144. However, society may not desire the government to punish all conduct that is described as criminal. See, e.g., Rich, *supra* note 141, at 810 (noting that societal perspectives on crime detection and punishment vary depending on the crime at issue); Josh Bowers, *Legal Guilt, Normative Innocence, and the Equitable Decision Not to Prosecute*, 110 COLUM. L. REV. 1655, 1658–59 (2010) (“Most people anticipate something approximating categorical enforcement of very serious felonies but anticipate nonenforcement of some nontrivial number of petty crime incidents.” (footnote omitted)). Accordingly, the presence of precommitment devices places on the legislature greater pressure to clarify *ex ante* which behavior is legally acceptable.

deceptive and illegal means, and some are more likely to fall prey to their short-term desires. How might the combination of these dispositions within a single person—much less a single organization—affect the likelihood of corporate fraud?

This Part explores the above question by examining the interaction between opportunism and temporal inconsistency. Section A briefly reviews the characteristics that render corporations prone to opportunistic and temporally inconsistent misconduct. Section B then models their interaction, generating a typology of corporate employees who present differing degrees of risk (and value) to the corporation.

A. *The Corporate Firm as a Locus of Misconduct*

Opportunism and temporal inconsistency thrive under similar conditions. They are particularly likely to arise in organizations that: (1) grant officers and employees wide discretion, (2) shield decision makers' processes from external review, and (3) embrace objectives that are complex enough to divide costs and benefits into different time periods. Individually and taken as a whole, these conditions increase the likelihood of both opportunistic and temporally inconsistent behavior. Not surprisingly, these conditions are prevalent within corporations.

Corporate firms vest a number of their employees with increasing levels of discretion. Discretion can be quite valuable to the firm as it enables innovation and quick thinking.¹⁴⁵ It may also attract more intelligent, devoted employees.¹⁴⁶ Nevertheless, discretion has its drawbacks. It enables an agent to ignore her principal's interests and instead serve her own.¹⁴⁷ Moreover, with discretion comes temptation and a surfeit of options, all of which enable the decision maker to eschew her long-term interests for short-term pleasures.¹⁴⁸

By the same token, both sets of problems arise when organizations are opaque.¹⁴⁹ Within large and even mid-size corporations,

145. See Nils Stieglitz & Klaus Heine, *Innovations and the Role of Complementarities in a Strategic Theory of the Firm*, 28 STRATEGIC MGMT. J. 1, 7–8 (2007).

146. Catherine E. Ross & Barbara F. Reskin, *Education, Control at Work, and Job Satisfaction*, 21 SOC. SCI. RES. 134, 139 (1992) (finding that “education is linked to significantly less routine work, [and] significantly more job autonomy”).

147. Thomas L. Carson, *Self-Interest and Business Ethics: Some Lessons of the Recent Corporate Scandals*, 43 J. BUS. ETHICS 389, 391 (2003) (“In the case of high-ranking business executives, discretion to do good is also discretion to do bad.”).

148. *Id.*

149. “Private organizations are relatively opaque, the more so the larger and more sophisticated they are. Layers of hierarchy must be penetrated to reach principal actors. Division of labor makes ascription of responsibility for conduct and results challenging.” Buell, *supra* note 70, at 1625.

responsibility and accountability fragment among and between different groups and hierarchies.¹⁵⁰ Agents can more easily deceive principals, and temporally inconsistent individuals are more likely to yield to temptation. When no one else is looking, one can more easily steal from the petty cash account, cook the books, or eat the cookie on someone else's desk.

Finally, both sets of problems arise when decision makers reside in a world in which benefits and costs emerge over different time periods. The child who refuses to eat his broccoli at supper learns quite quickly that he will suffer immediate costs in the form of foregone dessert and reduced access to television. Organizational decision-making, by contrast, inherently plays out over multiple time periods, thereby weakening the feedback loop the corporate officer experiences in response to his wrongful behavior.¹⁵¹

Within the corporate firm, the decision an employee makes today (good or bad) may not produce consequences for months or even years. Similarly, fraud and corruption rarely trigger immediate sanctions, in part because they occur in the context of projects that unspool over a period of months or years. As Professor Utset himself points out, criminal conduct often involves "a series of intertemporal decisions. An offender must plan and execute the crime, and will have to take steps to avoid detection after the fact."¹⁵² Accordingly, benefits and costs are almost always skewed across different time periods. Successive time periods create problems for the rational and hyperbolic alike: they enable corporate agents the time and opportunity necessary to deceive unknowing principals, and they tempt short-term selves sufficiently to disrupt and disable long-term plans.

B. *Theorizing the Interaction*

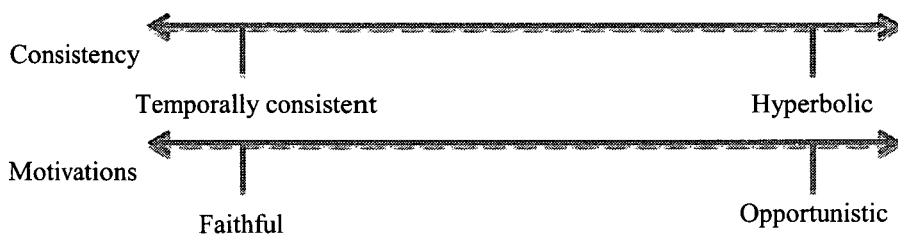
Imagine a world in which individuals occupy different points on two spectra. We might depict these two spectra as follows:

150. See, e.g., ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 17–18 (1988) (describing both the centralization and decentralization of authority and responsibility within corporations); Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 669–71 (1996) (describing "branching hierarchies" within large public organizations that divide, specialize, and delegate authority and responsibility).

151. See Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 176–79 (2000) (discussing intertemporal "time-delay traps" that arise within corporations); cf. Buell, *supra* note 70, at 1627 (referring to the "slow ripening" of criminal liability within corporate firms).

152. Manuel A. Utset, *Inchoate Crimes Revisited: A Behavioral Economic Perspective*, 47 U. RICH. L. REV. 1205, 1206 (2013).

Figure 1: Two Spectra



The bottom line, which we might label the “motivational spectrum,” measures an individual’s intentions. For purposes of simplicity, this Article assumes these intentions are “net” intentions, in light of any applicable rules, social norms, or cognitive biases. When all is said and done, some individuals are more motivated than others to do harm and some are more motivated than others to do good. This indeed remains one of the key challenges for any corporate enforcer: within the corporation, despite efforts designed to assure the contrary, some agents seek to do great deeds, whereas others affirmatively desire harm.

To the extent an agent falls on the faithful, “good” end of the spectrum, her devotion to her principal may arise because she is inherently well-motivated, because she happens to employ a relatively low discount rate, or because her interests are well-aligned by pre-existing legal, economic, and social institutions.¹⁵³ Regardless, our well-motivated agent seeks to achieve the short- and long-term goals that she believes her principal desires. Although she may harm her principal through mistake or accident, the costs of her mistakes are relatively low compared to those costs that arise from intentional misconduct. As a result, society can rely primarily on markets and contractual protections to address these basic competence issues.

At the other end of this motivational spectrum is the pure opportunist. Unlike the well-motivated agent, the opportunist seeks solely to benefit himself, often at the expense of his principal. For purposes of this analysis, it is irrelevant whether the opportunist takes perverse pleasure in denying his principal’s wishes, or simply exploits weaknesses in institutions. Under either scenario, the opportunist knowingly engages in a course of conduct that harms his principal.

153. Accordingly, this Article assumes that an individual’s “net motivation” takes into account various factors such as organization’s culture and its enforcement regime’s perceived legitimacy among its employees. See, e.g., Tom R. Tyler, *Legitimacy and Criminal Justice: The Benefits of Self-Regulation*, 7 OHIO ST. J. CRIM. L. 307, 319–20 (2009) (summarizing the procedural justice model for securing individuals’ voluntary compliance with the law).

More importantly, because our opportunist knows he is acting in contravention of his principal's wishes, he undertakes a number of measures to obscure the nature of his actions. It is this effort to cover one's tracks that evokes Oliver Williamson's famous definition of opportunism: self-interest seeking with guile.¹⁵⁴

Presumably, most individuals fall somewhere on the middle of this motivational spectrum and move around depending on the legal and social institutions involved. Much of the deterrence and agency-cost literature represents an attempt to devise and identify those mechanisms that most effectively move individuals from the "bad" (undesirable) end of the spectrum to good side, and to expel from business organizations (and society itself) those individuals who remain at the opportunistic end, despite all these efforts.

The other spectrum in Figure 1 reflects an individual's temporal consistency. Individuals who harbor different motivations also harbor different perceptions of costs and benefits as time unfolds. At the far end of this spectrum are those who consistently and pathologically favor *long-term* payoffs.¹⁵⁵ These individuals are hyperopic in that they pathologically avoid immediate gratification.¹⁵⁶ Although hyperopia may well impose costs on society, fraud is not likely to be among them. People who pathologically worry about the long-term (which ought to include fines and prison sentences) are not likely to engage in serious illegal conduct.

The more important group, located in the middle of the spectrum, is the one that either "naturally" maintains stable preferences or has external methods to create this type of stability.¹⁵⁷ Even among this group, we may find individuals who maintain consistently high discount rates and therefore seek immediate gratification.¹⁵⁸ In the corporate context, however, this is unlikely, as most corporate employees have attained significant levels of education and employment success. One cannot achieve these mileposts while also

154. See *supra* note 49 and accompanying text. Professor Buell argues that consciousness of wrongdoing—often demonstrated by efforts to cover one's tracks—is often the means by which judges decide whether an instance of misconduct qualifies as criminal "fraud." Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1982–83 (2006).

155. Professor Fennell discusses hyperopia and its tendency to produce people who excessively save. Fennell, *Willpower Taxes*, *supra* note 12, at 1375–76.

156. *Id.*

157. "[I]f there is perfect foresight and perfect means for self-commitment, then a person with a present-bias is just like someone with no bias." McAdams, *Signaling*, *supra* note 18, at 658.

158. As noted earlier, the individual with the consistently high discount rate does not lack willpower so much as she lacks interest in her future. Fennell, *Willpower Taxes*, *supra* note 12, at 1416 (explaining that "the question of willpower . . . assumes knowledge of a better long-term plan than the current self wishes to undertake").

maintaining pathologically high discount rates.¹⁵⁹

Finally, at the inconsistent end of the spectrum are those who lack willpower or who hyperbolically discount time. This is the group that scholars such as Professor Utset have done such a nice job of highlighting.¹⁶⁰ These are the individuals who routinely fall prey to their short-term interests, or react too strongly to their emotions and make “hot” decisions that conflict with longer-term “cold” determinations.¹⁶¹ This, in turn, is the group that is said to “lack willpower.”¹⁶²

At this point, one might wonder if a relationship exists between motivations and temporal consistency. Psychologists have found some correlation between altruism and willpower,¹⁶³ but the finding prompts additional questions: Is there something about being faithful or faithless that *causes* a person to either ignore or swear off his time-inconsistent habits, or is this simply a correlation signifying the importance of some other variable?¹⁶⁴

For now, this Article assumes that the two traits are largely independent of each other. One’s placement on one spectrum should therefore tell us nothing about where one falls on the other spectrum. This leaves us with a basic two-by-two matrix:

159. “Corporations are filled with highly educated individuals who have regularly delayed gratification in some domains in order to achieve longer term gains.” Hollander-Blumoff, *supra* note 18, at 548; see also Sally S. Simpson & Nicole Leeper Piquero, *Low Self-Control, Organizational Theory, and Corporate Crime*, 36 LAW & SOC’Y REV. 509, 533 (2002) (finding that “key tenets of low self-control theory” were unsupported by survey experiment testing attitudes towards corporate crime). Of course, the fact that corporate and white-collar criminals exhibit control in some contexts does not mean that they are able to control themselves in others.

160. E.g., Utset, *Hyperbolic Criminals*, *supra* note 18.

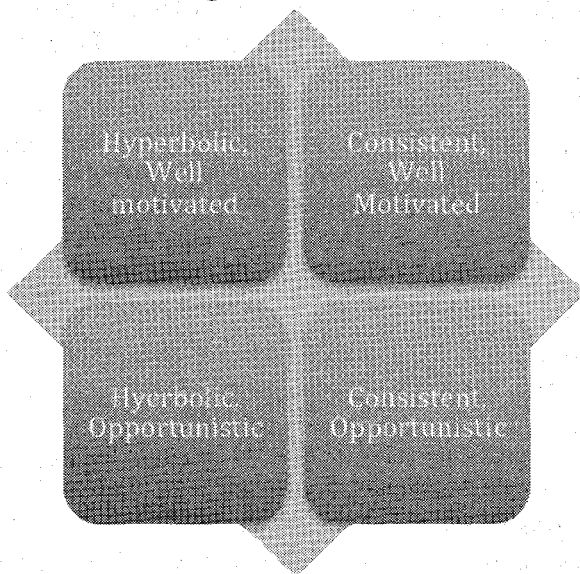
161. E.g., *id.*

162. As Fennell points out, the hyperopic individual also could lack willpower, insofar as she desires—but is otherwise unable—to overcome her tendency to overweigh longer term benefits and costs. Fennell, *Willpower Taxes*, *supra* note 12, at 1375.

163. BAUMEISTER & TIERNEY, *supra* note 91, at 260.

164. See, e.g., Robert H. Frank, *The Role of Moral Sentiments in the Theory of Intertemporal Choice*, in CHOICE OVER TIME, *supra* note 75, at 265, 266 (arguing that “moral sentiments enable people to solve two types of time-inconsistency problems”).

Figure 2: Matrix



Assuming everyone carries equal power and responsibility within the organization, we can generate four categories of individuals. We might array those categories, from “most valuable” to “most harmful,” as follows:

Figure 2a: A Typology of Employees

1. well motivated, consistent
2. well motivated, inconsistent
3. opportunistic, inconsistent
4. opportunistic, consistent

At the top of the heap are those agents who are both well-motivated and able to adhere to their long-term plans. Some individuals come by their self-control naturally. Others may foresee their tendency to switch preferences and therefore bind themselves in advance to their long-term commitments.¹⁶⁵ Whether one’s self-generated consistency is “natural” or “imposed” is irrelevant for now.

Next, we consider the well-motivated but inconsistent person.¹⁶⁶ This individual is the poster child for the unfulfilled promise. She

165. McAdams, *Signaling*, *supra* note 18, at 659.

166. McAdams similarly distinguishes between consistent “good” types and inconsistent “good” types, albeit for different purposes. *Id.* at 658 (discussing ways in which “imperfect self-commitment” increases the difficulty of distinguishing between cooperative and uncooperative partners in prisoner’s dilemma games).

intends (at least initially) to provide value to her principal but she fails to carry out her long-term plans. Instead, she procrastinates and either prematurely or excessively consumes, often to her regret.

All (rational) organizations should prefer category one to category two. This is not to say the inconsistent agent is useless. Some work is cheap and yields quick benefits up front. A well-motivated hyperbolic discounter will experience no problem completing easy projects, some of which may be quite valuable to the firm. Moreover, the inconsistent agent can become more effective if others within the organization devise effective precommitment devices to keep her on track.

On the other side of the ledger are those who harbor harmful intentions toward their principal. These individuals presumably do *some* good work for their organization, if only to escape immediate termination from their jobs. Nevertheless, on net, these are the individuals who either harm or impose a risk of harm on their respective organizations.

Admittedly, motivations are not fixed; they may evolve over time or change in response to new circumstances.¹⁶⁷ An individual's supervisor might threaten to fire an undisclosed number of employees in her group; her company might otherwise treat her in a way she deems unjustified and undeserved. For any number of reasons, the well-motivated employee can become the opportunistic one. Moreover, temporal inconsistency may play a role in how motivations change.

One might conclude from the foregoing analysis that corporations should shy away from anyone who appears to be temporally inconsistent. Unfortunately, that would leave most corporations bereft of many of their employees, and unreasonably so, given the fact that many corporate employees ultimately comply with the law.¹⁶⁸

Finally, one reaches the worst group in the typology, the consistent opportunist. Readers may disagree as to who poses more danger: the consistent or hyperbolic opportunist. The consistent opportunist, who knows that she harbors bad intentions, may ironically plan out a series of "good acts" to cover her fraud. Moreover, she will respond to the threat of sanctions (if they are large and credible enough) because she

167. Indeed, if motivations exist separately from temporal inconsistency, then the consistent, well-motivated person could also morph into a consistent opportunist.

168. "Although newspaper headlines remind us that serious instances of noncompliance constantly recur, it nevertheless appears that (at least in most economically advanced democracies) most business firms, particularly large ones, substantially comply with most kinds of regulations most of the time." Robert A. Kagan et al., *Fear, Duty, and Regulatory Compliance: Lessons from Three Research Projects*, in *EXPLAINING COMPLIANCE* 37, 40 (Christine Parker & Vibeke Lehmann Nielsen eds., 2011).

is rational.¹⁶⁹ Nevertheless, assuming she is undeterred by existing laws, she poses the most danger to her corporation. She has the ability (and inclination) to carry out harmful long-term projects. Indeed, to the extent “harm” combines up-front personal costs with long-term personal benefits, consistent opportunists are dangerous precisely because they possess both the mettle and foresight to bind themselves to their opportunistic plans.

Hyperbolic opportunists, by contrast, pose more of a conundrum. They may harbor desires averse to those of their principal, but they are not likely to engage in the type of harm that requires a substantial amount of up-front work.¹⁷⁰ (Then again, they are not likely to complete any helpful projects that require up-front work either). Accordingly, hyperbolic opportunists are not a threat insofar as harm requires up-front work, but they still can do a fair amount of damage when they can impose harm easily and with little up-front effort.







Given the foregoing, an enforcer who has “maxed out” sanctions and detection efforts ought to prefer the hyperbolic opportunist to the consistent one. Both harbor negative motivations, but only the consistent one will expend the energy to engage in harmful long-term projects. Moreover, hyperbolic opportunists are more easily identified. Consistent opportunists invest more heavily in expensive detection avoidance measures, since avoidance itself requires some degree of up-front planning. Hyperbolic opportunists, because they lack consistency, are less likely to follow through with sophisticated efforts at avoiding detection.

Thus, the analysis of the two dimensions provides a more nuanced portrayal of who is most likely to complete work that is desirable to the principal (“good”), and who is most likely to engage in conduct that is undesirable to the principal (“bad”):

169. Government officials appear to recognize this point: “Someone who violates the law ruthlessly and rationally is more amenable to deterrence than someone who acts impulsively or someone who gives in to enormous pressure.” David M. Becker, *What More Can Be Done to Deter Violations of the Federal Securities Laws?*, 90 TEX. L. REV. 1849, 1851 (2012) (offering observations, as former SEC General Counsel, on how the SEC might improve enforcement).

170. See Utset, *Hyperbolic Criminals*, *supra* note 18, at 665–67 (labeling the phenomenon “time inconsistent obedience”).

Figure 3: Tendencies Towards Good and Bad Acts

	Consistent, Well- Motivated	Inconsistent, Well-Motivated	Inconsistent, Opportunistic	Consistent, Opportunistic
Costly, ¹⁷¹ Good Acts				
Cheap, Good Acts				
Cheap, Bad Acts				
Costly, Bad Acts				

The depiction in Figure 3 is not an exact representation of behavior. Even the consistent, opportunistic employee will perform *some* good activities for his organization. Accordingly, we could easily place an “x” in all of the boxes for “cheap, good acts” and we might also find that even the consistent opportunist engages in some “costly, good acts.”¹⁷² The above table depicts the individual’s tendency to perform such acts, as compared with everyone else. Thus, the individual who is both consistent and opportunistic poses the greatest *threat* of engaging in costly, bad acts. By the same token, the consistent, well-motivated employee is best poised to perform valuable, but initially costly, good acts.

Professor Utset has praised temporal inconsistency as desirable insofar as it reduces an opportunistic agent’s resolve to engage in wrongdoing.¹⁷³ As Figure 3 demonstrates, the story is a bit more nuanced. Opportunistic, temporally inconsistent individuals may be less likely to carry out difficult and long-term negative projects, but they will have no problem engaging in misconduct that requires little effort.

The broader rule of thumb that one can derive from Figure 3 is that temporal inconsistency reduces the variance between faithful and opportunistic employees. Good agents are not as good as they intend to be, and bad agents are not as bad as they desire to be. Accordingly,

171. By “costly,” I mean personally costly to the agent in the first or immediate period, and by “cheap,” I mean personally cheap to the agent in the first or immediate period.

172. Notice, the conduct is not symmetrical. Whereas all employees will perform some “good” acts to keep their jobs, not all employees will perform “bad” acts.

173. Utset, *Hyperbolic Criminals*, *supra* note 18, at 644–45.

when temporal inconsistency is evenly distributed throughout the corporate employee and officer population, it reduces the costs of erroneously identifying a given agent as faithful or opportunistic.

Additional complications ensue when one considers the fluidity of the two dispositions. Motivations change depending on context and personal tastes. The same is true for temporal inconsistency. Some people *always* procrastinate, but others move back and forth along the continuum. Finally, it may be the case that one disposition reduces or exacerbates the other. Perhaps hyperbolic discounting acts as a “gateway” to future opportunistic behavior. (“I already blew the deadline, so maybe I should also lie to my boss.”) Or, perhaps an opportunistic disposition forces a level of discipline on an individual who otherwise would have lacked sufficient willpower. (“Now that I have lied to my shareholders, I better take extra care to check my regional profit reports every day.”).

A final caveat: The above typology assumes that all individuals hold the same position within the firm. In fact, we know that most organizations employ many levels of formal or informal hierarchy.¹⁷⁴ Once we relax the assumption of equal responsibility, the possible combinations of temporal inconsistency and opportunism expand considerably. Even a two-tier hierarchical scheme is more difficult to gauge, as a supervisor may fit any of the four categories, and her employee may also fall within any of those four categories.

III. THE CORPORATE ENFORCER’S TOOLBOX: POLICING AND ARCHITECTURE

Part II’s depiction of the interaction between opportunism and temporal inconsistency provides a useful typology for corporate enforcers. Some individuals are opportunistic and consistent (and presumably very dangerous) whereas others are well-motivated but highly temporally inconsistent, and so on. As one abandons the assumption that all employees hold equal responsibility and power, one recognizes that opportunism and temporal inconsistency play a rich and complex role in generating and masking corporate fraud. With this complexity in mind, Part III identifies three strategies corporate enforcers might employ to reduce fraud. The three strategies, in turn, form the building blocks of two broader enforcement approaches. A *policing* approach attempts to reduce fraud by identifying and sanctioning risky people. An *architectural*

174. Rubin, *supra* note 25, at 352 (observing that “most large firms continue to be organized along hierarchical lines”). *But see* Érica Gorga & Michael Halberstam, *Knowledge Inputs, Legal Institutions and Firm Structure: Towards a Knowledge-Based Theory of the Firm*, 101 NW. U. L. REV. 1123, 1131–32 (2007) (observing that high-tech firms eschew hierarchy).

approach focuses on identifying and changing risky structures, in part through the encouragement and promulgation of precommitment devices.¹⁷⁵

As this Article explains, the two approaches draw upon some of the same tools and can behave as substitutes or complements. There may be times when policing performs better than architecture (or vice versa), but there also may be times when policing benefits from architecture (and vice versa). In a world where corporate employees and officers are, by varying degrees, opportunistic and temporally inconsistent, both approaches are necessary.

A. Three Strategies

Imagine a corporate enforcer who has been tasked with reducing wrongdoing within her organization. She encounters individuals who fall anywhere on both the “consistency” and “motivational” spectra described in Part II. She also confronts a fair amount of wrongdoing that has been caused by varying amounts of opportunism and temporal inconsistency. How should she respond?

Broadly speaking, the hypothetical enforcer¹⁷⁶ can choose among three options. She can *screen out* potential wrongdoers, either by refusing to hire such employees or demanding their termination. She also can *transform* the corporation’s employees, either through some combination of external incentives (sanctions and surveillance) or internal motivations (culture and norms-based education).¹⁷⁷ Finally, she can *restructure* those situations that make opportunism and temporal inconsistency more likely and more dangerous to the

175. To some degree, the two approaches reflect the opposing regulatory styles described by Professor Robert Kagan:

At one pole, aggressive regulatory offices or officials are called “legalistic”, or “sanction”-oriented, devotees of a “deterrence” model or “coercive” style of regulation. Toward the other pole, they are labeled “conciliatory” or “accommodative”, as more interested in “compliance” than in deterrence, as oriented toward seeking results through “cooperation” rather than by coercion, as “consultants” rather than “cops.”

Robert A. Kagan, *Understanding Regulatory Enforcement*, 11 LAW & POL’Y 89, 92 (1989).

176. For the sake of simplicity, this Article imagines a single individual who has the sole responsibility for these functions. In reality, of course, multiple individuals may take on the roles and strategies described within this section.

177. Yuval Feldman describes these two approaches as “extrinsic” and “intrinsic” motivations for compliance. The extrinsic motivation arises from fear of sanctions and detection, whereas intrinsic motivations arise “out of a sense of moral or civic duty.” Yuval Feldman, *The Complexity of Disentangling Intrinsic and Extrinsic Compliance Motivations: Theoretical and Empirical Insights from the Behavioral Analysis of Law*, 35 WASH. U. J.L. & POL’Y 11, 12 (2011).

corporation. Assuming the enforcer is herself well-motivated and consistent (admittedly a large assumption), which strategies should she choose?

1. Screening

A screening strategy requires the enforcer to identify and exclude (or expel, if the employee already works for the corporation) employees who are either consistent or hyperbolic opportunists. She might also wish to screen out well-motivated but temporally inconsistent individuals, since their motivations too may become negative. But at some point, this will leave the corporation with too small an employee pool.¹⁷⁸ Accordingly, we can assume that she will focus primarily on identifying and excluding opportunists.

In theory, screening is a sound strategy. Opportunists favor themselves at everyone else's expense, and temporally inconsistent individuals are either ineffective (since they cannot accomplish desirable goals) or enablers of their more opportunistic colleagues. Accordingly, all things being equal, the enforcer would prefer either to screen out these individuals, or at least fire them before they cause serious problems.

Aside from legal limitations that reduce the corporation's flexibility in hiring or firing, screening's key drawback is that it is prone to error.¹⁷⁹ Opportunists are, by definition, deceptive. As for temporal inconsistency, screeners may encounter difficulty isolating "ordinary" temporal inconsistency from the type of willpower deficiencies most likely to enable or produce wrongdoing.¹⁸⁰ Many people over-eat or fail to complete projects until the last minute, but that does not tell us who will produce fraudulent financial statements or offer illegal bribes to foreign officials.¹⁸¹

Where does this leave our enforcer? Certainly she can perform criminal history and background checks. And she can watch for employees who blatantly transgress rules or repeatedly fail to meet internal deadlines or file necessary reports. But beyond these obvious

178. See *supra* p. 36.

179. Susan J. Stabile, *The Use of Personality Tests as a Hiring Tool: Is the Benefit Worth the Cost?*, 4 U. PA. J. LAB. & EMP. L. 279, 290 (2002).

180. "Firms may try to screen out employees with impulse control problems, but none of the usual methods (psychological tests, interviewing, and checking references) will be completely reliable. Firms will therefore have a proportion of employees who will find the short-term gains from shirking quite irresistible." Daniel S. Nagin et al., *Monitoring, Motivation, and Management: The Determinants of Opportunistic Behavior in a Field Experiment*, 92 AM. ECON. REV. 850, 854 (2002).

181. Researchers have found that individuals can be patient in one context (studying hard for exams) and prone to short-term gratification in others. See *Preface* to CHOICE OVER TIME, *supra* note 75, at xvii–xviii (citing studies showing that discounts can vary for a single person).

red flags, she will have little to guide her. "Screening" might, at its worst, become an excuse for discriminatory employment practices.¹⁸² One can imagine a number of compliance officers either adopting some terrible proxies (assuming that an overweight individual will commit fraud, for example) or administering crude psychology tests.¹⁸³

Apart from error costs, screeners must also contend with unintended consequences. For example, if a corporate department initially employs ten opportunists and the enforcer's efforts reduce that number to two, then the magnitude and frequency of wrongdoing within that department may not in fact decline. For example, if the eight opportunists screened out by the enforcer were low-hanging fruit, she unintentionally does the remaining two opportunists a favor. Freed from competing with eight potential rivals, the remaining two may either fill the vacuum left by the eight, or in fact do *more* harm, now that they no longer have to worry about their rivals.¹⁸⁴

Screening thus suffers the same drawbacks as most preventative strategies. The enforcer who relies on this strategy may exclude (or fire) too many employees or she may exclude (or fire) too few. She may identify the wrong individuals as opportunists or she may find that firing one opportunist perversely increases the effectiveness of the remaining opportunists within the organization. For all these reasons and more, our enforcer will need to rely on additional tools.

2. Transforming

In addition to screening, the enforcer might also attempt to transform the employee population, moving them from one side of either spectra to the other.

With regard to the first disposition, the enforcer can alter a corporate employee's motivation *externally* by imposing sanctions for noncompliance or by informing employees of the sanctions that external enforcers might impose in response to noncompliance.¹⁸⁵ For these sanctions to be credible, however, the enforcer must also engage in some level of monitoring.¹⁸⁶ When the threat of sanctions

182. Stabile, *supra* note 179, at 303–08.

183. For a critique of corporate personality tests, see generally Stabile, *supra* note 179.

184. Cf. Neal Kumar Katyal, *Deterrence's Difficulty*, 95 MICH. L. REV. 2385, 2428 (1997) (presenting a similar situation involving drug rings).

185. See Christine Parker, *The Ethics of Advising on Regulatory Compliance: Autonomy or Independence*, 28 J. BUS. ETHICS 339, 345 (2000) (reporting on conversations with compliance officers who have persuaded employees to change behavior by demonstrating external costs of noncompliance).

186. For a discussion of deterrence theory, see *supra* Section I.B.

increases, the net benefits of opportunistic behavior decreases.¹⁸⁷ This is the common, “deterrence-based” approach to entity-level corporate compliance.¹⁸⁸ Applied too aggressively, the deterrence-oriented compliance program can backfire by causing mid- and lower-level employees to harbor increasing amounts of distrust and resentment within the organization.¹⁸⁹ Applied too weakly, it can devolve into a means for corporations to “purchase” just enough protection from entity-level criminal liability while otherwise ignoring (or subtly encouraging) widespread illegal behavior.¹⁹⁰

Alternately, the corporate enforcer may attempt to alter motivations *internally* through some type of cultural education¹⁹¹ and norms generation.¹⁹² Because internalized norms impose an immediate conscience-created cost at the moment of bad behavior, they may reduce willpower failures. Moreover, they may also increase internal whistle-blowing and the likelihood of detection for pure opportunists.¹⁹³ Corporate cultural efforts thus communicate to employees both the corporation’s background rules and ethical expectations. Cultural compliance efforts tend to remind employees that compliance is “everyone’s concern” and that all employees have

187. As Professor First has noted:

A key insight of economics is that actors, whether individuals or organizations, will respond to incentives. To the extent that there are incentives to cooperate with government investigators in business crime cases, those making decisions for the organization will cooperate, even if it means that some constituents (employees or, perhaps, current shareholders) suffer.

First, *supra* note 64, at 60.

188. An important caveat here is that the corporation must receive leniency for catching and reporting wrongdoing, otherwise it will have no incentive to implement its compliance program. See Arlen & Kraakman, *supra* note 71, at 690–91; Arlen, *supra* note 6, at 837.

189. Cf. Tyler, *supra* note 153, at 310 (criticizing the deterrence approach as fostering an antagonistic relationship between society and the police); see also IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION* 20 (Donald R. Harris et al. eds., 1992) (making a similar argument in the corporate context and observing that “[a] strategy based mostly on punishment fosters an organized business subculture of resistance to regulation”).

190. See William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 52 VAND. L. REV. 1343, 1348 n.15 (1999) (cautioning that corporations may view corporate compliance as a form of “risk management”).

191. See Paternoster & Simpson, *supra* note 117, at 571 (finding that “reported intentions to commit corporate crime were significantly lower for those who thought the act was contrary to their personal moral code”).

192. See Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO. J. LEGAL ETHICS 961, 961 (2012) (describing how communication of norms and values can increase compliance and reporting).

193. For the value of norms in securing compliance, see Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 386 (1997) and Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2030 (1996).

a responsibility to adhere to the law and ensure that others are doing so.¹⁹⁴

Despite their intuitive appeal, strategies that attempt to alter internal motivations have their own drawbacks. Norms are difficult to develop and measure, and opportunists should be best able to fake the presence of good ethics.¹⁹⁵ Scholars have long worried that corporations can enact “cosmetic” compliance measures that insincerely promote ethical behavior while they quietly encourage the opposite.¹⁹⁶

Finally, the external and internal approaches can be self-defeating, working against each other and undermining compliance overall. Strong sanction and monitoring regimes pit the employee in an adversarial relationship with the corporation, thereby undermining the softer, pro-social arguments for helping the company by following the law.¹⁹⁷ If the corporation is not careful, its external efforts (threats of sanctions or monitoring) may crowd out internal motivations, creating a dangerous vacuum in which opportunistic employees who are savvy enough to avoid the corporation’s internal policing apparatus remain unchecked by fellow employees who have become resentful of the organization.¹⁹⁸

3. Structuring

The third strategy relies on a form of structuring and builds on an approach that Professors Cheng and Lederman have separately embraced in other contexts.¹⁹⁹ Under this approach, the Enforcer

194. “[C]ompliance professions continually attempt to ‘cascade’ responsibility for compliance down through line management, so that a culture of compliance commitment permeates the organization” Parker, *supra* note 185, at 346.

195. See Richard A. Posner & Eric B. Rasmusen, *Creating and Enforcing Norms, with Special Reference to Sanctions*, 19 INT’L REV. L. & ECON. 369, 369 (1999) (arguing there is difficulty in government actions designed to “promote desirable norms or repress undesirable ones”); Steven Shavell, *Law Versus Morality as Regulators of Conduct*, 4 AM. L. & ECON. REV. 227, 254 (2002) (explaining the difficulty of inculcating overarching moral principles through the law).

196. See Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 490–91 (2003); Laufer, *supra* note 190, at 1372 (citing surveys indicating that some corporations aim solely for maintaining an appearance of compliance rather than “a meaningful culture of ethical awareness and law abidance”).

197. See Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties, and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1176 (2010) (discussing “crowding out” problems in compliance); see also Milton C. Regan, Jr., *Moral Intuitions and Organizational Culture*, 51 ST. LOUIS U. L.J. 941, 971–73 (2007) (distinguishing deterrence-based compliance programs from “values-based” programs, which focus on internal norms).

198. Feldman & Lobel, *supra* note 197, at 1155.

199. See *supra* Section I.D.

performs a top-down analysis of the company, identifies those situations that appear vulnerable to exploitation, and reduces those vulnerabilities by changing the methods in which decisions are made and implemented.²⁰⁰ Wrongdoing is prevented through institutional design rather than through the threat of sanctions and policing.²⁰¹

The structural approach requires corporate employees to identify operational and compliance risk. At an abstract level, this is not difficult to imagine. A decision-making structure in which one individual enjoys unbridled discretion and oversight over the disposition of large sums of money is one that increases opportunities for embezzlement, fraud, and bribery. By the same token, a structure that shields from internal oversight the collection and external reporting of data increases the probability of financial reporting fraud.²⁰² In both of these situations, compelled and continuous disclosure vastly reduces opportunities for opportunistic and temporally inconsistent behavior.

Some structures may be as simple as multiple signatory requirements (referred to as the “four eyes” principle) or limitations on access to information (“Chinese walls”).²⁰³ Other structures may involve automation or physical limitations that remove individual judgment. A speed bump not only forces the driver to slow down, but it also removes the traffic officer’s discretion to apprehend drivers who exceed certain speeds. The “bump” takes care of the officer’s job. By the same token, automation can also either reduce or replace the manager’s discretion or impose the equivalent of a second set of eyes.

More concretely, Professor David Zaring has reported on new innovations that corporations have devised to reduce foreign bribery, including the use of automation to reduce human interaction between corporate employees and foreign government officials who might

200. See Cheng, *supra* note 137, at 662–66.

201. *Id.* at 662–63.

202. See Lawrence E. Mitchell, *Structural Holes, CEOs, and Informational Monopolies: The Missing Link in Corporate Governance*, 70 BROOK. L. REV. 1313, 1353–54 (2005) (discussing Worldcom). For the role that “informational holes” played in the corporate fraud scandals of early 2000s, and an argument that legal reform should focus on “how the relationship between internal corporate structures and board structures provide opportunities for misconduct,” see *id.* at 1315; see also Nicola Faith Sharpe, *Questioning Authority: The Critical Link Between Board Power and Process*, 38 J. CORP. L. 1, 5–6 (2012), for an argument that board-level information failures promote misconduct.

203. See, e.g., James H. Freis, Jr., *An Outsider’s Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform in Finanzplatz Deutschland*, 19 B.C. INT’L & COMP. L. REV. 1, 98 n.551 (defining the “four eyes” principle); H. Nejat Seyhun, *Insider Trading and the Effectiveness of Chinese Walls in Securities Firms*, 4 J.L. ECON. & POL’Y 369, 369 (2008) (defining Chinese walls).

otherwise demand illegal payments in person.²⁰⁴ By removing human judgment “at the source,” automated technologies eliminate the option of bribing local officials in exchange for better or faster services. In this sense, structure eliminates the possibility of wrongdoing.

Admittedly, not all structures function as precommitment devices, and certainly, not all structures will be viewed as such. A hedge fund that installs a Chinese wall between two operational units to prevent insider trading may be “precommitting” itself by foreclosing communication between those two groups. Indeed, some members of those units may be thankful for the check on strong but passing temptations to break the law. Nevertheless, depending on how the corporation devises its internal rules, other employees may perceive the Chinese wall as yet another level of bureaucratic regulation.

Even when self-imposed, not all structures are valuable devices. Some structures may rely too heavily on automation; others may operate too crudely and foreclose too many options; still others may be merely cosmetic and foreclose too few options. Like screening and transforming, the structural strategy is far from foolproof. Ulysses got it right on the first try, but in the real world, it might take several attempts to figure out how best to tie oneself (and others) to the mast.

B. *Two Approaches*

Section III.A identified three strategies that an enforcer might choose to counteract fraud. The strategies, in turn, build up to two very different enforcement philosophies and modes of behavior. The first is a policing approach that mimics the response we have come to expect from government agencies, whereby enforcers utilize screening and incentive strategies to identify and punish wrongdoers. These are the activities we commonly associate with the term “corporate policing.” Professor Jennifer Arlen nicely describes the approach as including: “(1) monitoring to detect wrongdoing; (2) investigating suspicious activities; (3) reporting violations to federal authorities; and (4) cooperating with [government] authorities to help them identify and sanction the individuals responsible for the violation.”²⁰⁵

Because it is intended to expand the government’s enforcement reach, corporate policing looks and feels very much like its criminal law counterpart, government policing. Internal enforcers are expected to identify and deter potentially bad people through different

204. “Oil service firms and importers have, for example, tried to automate as much of the customs process in Indonesia as possible, limiting the number of personal interactions between firms and officials.” David Zaring, *Private Sector Anti-Bribery Initiatives?*, CONGLOMERATE (Apr. 5, 2013), <http://www.theconglomerate.org/2013/04/private-sector-anti-bribery-initiatives.html>.

205. Arlen, *supra* note 72, at 332.

combinations of surveillance, bounties, threats of sanctions, and increasingly pervasive monitoring.²⁰⁶ Having identified the corporation's offenders, internal enforcers are then expected to punish said employees by terminating their employment and disclosing their names to government authorities.²⁰⁷

The rhetoric of corporate policing is very much suffused with notions of public enforcement and duty. As Professors William Bratton and Michael Wachter observe in their discussion of the federal government's internal control requirements for publicly held companies:

Most people, when they look at compliance systems, see a new layer of mandated costs But something else also is at work here: a corporate compliance officers is a cop, a private sector cop pursuing a public goal.²⁰⁸

Thus, the policing approach reflects not simply the compliance department's discrete tasks, but rather its overall reason for being. It exists to serve the public and it "exercises delegated public authority, harnessing corporate resources toward public ends."²⁰⁹

The second approach is an architectural approach.²¹⁰ It relies primarily on the structural strategy discussed in the preceding Section, although it also draws on norms-based strategies. It seeks not only to educate, but also to strengthen already nascent impulses to resist temptations to violate the law. It finds some of its theoretical grounding in systems theory, which focuses on decision-making processes,²¹¹ and situational crime theory, which explores the ways in

206. Professor Harry First has advocated strongly for this "branch office" role. First, *supra* note 64, at 64. For discussion on some of the drawbacks of corporate policing, see Miriam Hechler Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal?*, 77 U. CIN. L. REV. 523, 550–51 (2008) (citing Larry Cata Backer, *Surveillance and Control: Privatizing and Nationalizing Corporate Monitoring After Sarbanes-Oxley*, 2004 MICH. ST. L. REV. 327, 370–71).

207. It is not a coincidence that a number of recent law review articles have referred to the Dodd-Frank Act's whistleblower provisions as good or bad examples of "bounty-hunting." See, e.g., Justin Blount & Spencer Markel, *The End of the Internal Compliance World as We Know It, or an Enhancement of the Effectiveness of Securities Law Enforcement? Bounty Hunting Under the Dodd-Frank Act's Whistleblower Provisions*, 17 FORDHAM J. CORP. & FIN. L. 1023 (2012).

208. William W. Bratton & Michael L. Wachter, *Tracking Berle's Footsteps: The Trail of The Modern Corporation's Last Chapter*, 33 SEATTLE U. L. REV. 849, 872 (2010).

209. *Id.*

210. Cheng, *supra* note 137, at 662–63.

211. "Systems theory depicts organizations as converting external inputs (e.g., resources, investment new recruits) into outputs (e.g., products and services) via a 'throughput' stage, which comprises the organization's entire operations and activities. See Nicole Gillespie & Graham Dietz, *Trust Repair After an Organization-Level Failure*, 34 ACAD. MGMT. REV. 127,

which geography and other contextual variables affect the incidence of crime.²¹² Under this approach, the corporation's systems are akin to a dark alley or poorly traversed street. The corporate architect identifies the corporation's dark alleys and then attempts either to eliminate or illuminate them.²¹³

Undoubtedly, policing and architecture use some of the same tools. Disclosure and reporting rules, for example, can simultaneously provide a policing regime with necessary proof while also serving as a structural device that deflects temptation at just the right moment. "Monitoring" can serve either as a gentle check on our short-term selves or as a heavy-handed form of oversight designed to deter all but the most hardened opportunists.

Despite this overlap, several characteristics distinguish the two approaches. The policeman's goal (deter and punish) is distinctly different from the architect's (reduce temptation). Policemen and architects communicate with their subjects differently and inspire different reactions in corporate employees. And, as noted earlier, policing serves a quasi-public end, whereas architecture seeks generally to improve the inner workings of the firm.

Not surprisingly, the two approaches also imply different roles for corporate compliance personnel. Since the policing approach places a premium on investigations and sanctions, it favors an "external" compliance department, staffed by lawyers²¹⁴ and situated outside of the corporation's operational units.²¹⁵ By contrast, the architect works

130 (2009).

212. "At the beginning of the twenty-first century, one of the most important and underexplored forms of crime control is architecture." Neal Kumar Katyal, *Architecture as Crime Control*, 111 YALE L.J. 1039, 1041 (2002); see also Darryl K. Brown, *Cost-Benefit Analysis in Criminal Law*, 92 CALIF. L. REV. 323, 349–50 (2004) (explaining the general theory and providing examples); Ronald V. Clarke, *Situational Crime Prevention*, 19 CRIME & JUST. 91, 93 (1995).

213. In a related vein, following the enactment of the Sarbanes-Oxley Act of 2002, Professor Donald Langevoort praised the Act's emphasis on internal controls, in part because internal controls were likely to improve "corporate sightlines" and thereby reduce the opportunity to engage in misconduct. Langevoort, *supra* note 53, at 969.

214. Whether lawyers improve or undermine the corporation's compliance function is a separate debate. Compare DeStefano, *supra* note 19 (arguing in favor of attorney involvement), with Tanina Rostain, *The Emergence of "Law Consultants,"* 75 FORDHAM L. REV. 1397, 1400 (2006) (observing concern that the use of lawyers in nonlegal compliance positions may cause them to become overly technocratic and less wed to "public values").

215. For an argument that corporate compliance has been unnecessarily "decoupled" from the rest of the organization and that integration of the compliance function with the rest of the organization is necessary to improve corporate culture, see Blount & Markel, *supra* note 207, at 1060–61; compare Larry E. Ribstein, *Delawyerizing the Corporation*, 2012 WIS. L. REV. 305, 307 (2012), for an argument that the corporation's in-house legal department may one day dissolve. For an argument that oversight should come from someone who was not a party to an original operational decision, see Medwed, *supra* note 21, at 88.

side by side with the employees and officers who make operational decisions.²¹⁶

The architectural approach incorporates some of the teachings of the corporate values movement that first emerged in the 1990s,²¹⁷ and it bears a strong resemblance to the New Governance regulatory agenda that has become increasingly popular within the past two decades.²¹⁸ The architect may persuade, and indeed at times regulate, but she generally does not punish. The approach additionally reflects more recent arguments regarding the proper direction in which in-house counsel's role ought to evolve. For example, shortly before his death, Professor Larry Ribstein forecasted that the in-house legal function would eventually devolve back into the corporation-at-large;²¹⁹ he referred to this process as "delawyerling."²²⁰ With respect to corporate compliance, Ribstein imagined a world in which "[l]awyers would function . . . as architects and engineers rather than as mechanics applying rules."²²¹

C. Substitutes and Complements

The previous section introduced two enforcement approaches, policing and architecture. The two approaches can function either as substitutes or complements.

Consider, first, the tradeoffs the two approaches pose. The

216. Cf. Ribstein, *supra* note 215, at 315–16 (describing how software can be designed to assist decision makers).

217. See Kathleen M. Boozang & Simone Handler-Hutchinson, "Monitoring" *Corporate Corruption: DOJ's Use of Deferred Prosecution Agreements in Health Care*, 35 AM. J. L. & MED. 89, 105–06 (2009) (distinguishing between discipline and values orientations in compliance programs); David Hess, Robert S. McWhorter & Timothy L. Fort, *The 2004 Amendments to the Federal Sentencing Guidelines and Their Implicit Call for a Symbiotic Integration of Business Ethics*, 11 FORDHAM J. CORP. & FIN. L. 725, 733–34 (2006) (distinguishing a "compliance-based" approach from an "integrity-based" approach); Regan, *supra* note 197, at 970–73 (describing differences between a "values based" and deterrence-based compliance program).

218. Professor Cunningham notes this "philosophical shift away from traditional deterrence-oriented strategies toward more cooperative and rewards-oriented systems to promote compliance." Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 324 (2007). For more on New Governance generally, see Jason M. Solomon, *Law and Governance in the 21st Century Regulatory State*, 86 TEX. L. REV. 819, 821–37 (2008) (book review) (describing New Governance literature and suggesting future directions for New Governance scholarship) and Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004) (discussing the emergence, rationales, and motivations of New Governance theory, the organizing principles of the New Governance model, and its practical application in employment, environmental, and digital technology law).

219. Ribstein, *supra* note 215, at 307.

220. The title of Ribstein's article was *Delawyerling the Corporation*. See *id.* at 305.

221. *Id.* at 316.

policing approach may not be particularly uplifting, but it is an essential component of any compliance program. Temporally consistent, opportunistic individuals pose a constant threat to widely dispersed shareholders within publicly held corporations. Shareholders demand objective and periodic proof of corporate performance, to both eliminate shirking and ensure that they have invested their capital appropriately. Not all employees and officers will meet their performance goals, however, leading some to decide to cheat and commit some variant of fraud.²²² Over the long run, temporally consistent opportunists will perpetrate the worst schemes and the best cover-ups. Since hiring screens inevitably fail, the corporation has no choice but to utilize policing tools to investigate and identify wrongdoers.²²³

Policing, however, imposes a number of costs. First, the corporation's policemen are likely to develop interests in maintaining and increasing their positions of power within the organization, quite apart from actual threats to corporate integrity.²²⁴ Turf-building presents opportunity costs.

Second, policing, as noted earlier, may unintentionally erode compliance norms. For example, heavy-handed methods may trigger feelings of distrust among employees, thereby reducing internal motivations to comply with the law. This is particularly likely if employees believe the corporation has violated their privacy or has imposed an excessive sanction in relation to a given type of misconduct. Finally, policing may create a false sense of security in putative victims, causing them to assume incorrectly that they can relax their vigilance because sanctions and oversight mechanisms have been enacted.²²⁵

Like its counterpart, corporate architecture is also an essential component of an effective compliance program. It is both proactive

222. On the connection between performance failure and fraud, see generally Arlen & Carney, *supra* note 57 (attributing fraud to "final period" problems); Velikonja, *supra* note 60, at 1908–09. *But see* Cindy R. Alexander & Mark A. Cohen, *New Evidence on the Origins of Corporate Crime*, 17 *MANAGERIAL & DECISION ECON.* 421, 432–33 (1996) (finding weaker and not statistically significant correlations between prior performance and corporate fraud in data on public companies from 1975–1989).

223. Nagin et al., *supra* note 180, at 854 (concluding that because screens fail, corporate firms will "therefore have a proportion of employees who will find the short-term gains from shirking quite irresistible" and that responding to such impulses "requires the imposition of costs that are as immediate and near at hand as the gains from shirking").

224. Within larger corporations, budgets for corporate compliance now number in the millions. *See, e.g.*, PRICEWATERHOUSECOOPERS, *BROADER PRESPECTIVES; HIGHER PERFORMANCE: STATE OF COMPLIANCE: 2012 STUDY* 9, 16–17 [hereinafter *PWC STUDY*], http://www.pwc.com/en_US/us/risk-management/assets/2012-compliance-study.pdf.

225. *See generally* Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 24 *YALE J. REG.* 1 (2008).

and potentially innovative. It can reduce both the temptation and opportunity to commit wrongdoing, while also providing adequate space for employees and officers to pursue risky but net positive projects.

To be sure, architecture poses its own set of drawbacks. Oversight, particularly the type of pervasive oversight imagined here, can be time-consuming and expensive. Speed bumps in corporate decision-making can translate into sluggishness in operations.²²⁶ Chinese walls, which reduce wrongdoing by fencing off information, can also cause information holes and inefficiency. At its worst, the architectural approach may fuel a kind of bureaucratic second-guessing that squelches risk-taking and innovation and that inadvertently rewards shirking and risk aversion.

These worries were exactly the types of concerns raised when Congress enacted the Sarbanes-Oxley Act of 2002, which all but demanded additional architecture—and policing—for corporate firms by holding management accountable for inadequate “internal controls.”²²⁷ The Act eliminated plausible deniability for CEO and CFO’s insofar as they were now forced to certify financial statements and attest to the reliability of the firm’s internal financial reporting mechanisms.²²⁸ In addition, the Act required the company’s outside auditor to attest to management’s commitment to maintaining the company’s internal controls.²²⁹ Thus, one could point to the Act’s internal control requirements and conclude that the legislation provided the necessary impetus for improving corporate

226. Chris Durden & Richard Pech, *The Increasing Cost of Corporate Governance: Decision Speed Bumps for Managers*, 6 CORP. GOVERNANCE 84, 92 (2006).

227. Professors Bratton and Wachter perceive the internal controls provisions of the Foreign Corrupt Practices Act and the Sarbanes-Oxley Act as a kind of policing, “forcing corporations to participate directly in the enforcement enterprise.” Bratton & Wachter, *supra* note 208, at 872. By contrast, Professor Utset perceives provisions such as the certification requirement in § 302 as a valuable deflection device that “make[s] more salient—at the point in time when a manager makes a securities filing—the costs she would incur if she were to fail to comply with federal securities laws.” Utset, *Hyperbolic Criminals*, *supra* note 18, at 658.

228. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745, 777–78 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.). On eliminating plausible deniability by forcing certification, see Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1025 (2013).

229. *Id.* § 404. Section 302 requires the CFO and CEO to certify in each quarterly filing that they have reviewed the filing and that it “fairly represents” the company’s financial condition and does not contain, to the best of their knowledge, any misstatement. *Id.* § 302. In addition, § 302 requires the CFO and CEO to attest that they are responsible for ensuring adequate internal controls, that they have evaluated the effectiveness of said controls, and that they have discussed any changes in those controls. *Id.* Section 404 requires management to include in the corporation’s annual report an assessment “of the effectiveness of the internal control structure and procedures of the issuer for financial reporting,” which then must be attested to by the corporation’s outside auditor. *Id.* § 404.

architecture.²³⁰

Critics, however, vehemently disagreed with this happy story. Instead, they claimed the “architecture” that emerged from Sarbanes-Oxley was too costly (at least for smaller firms), overly standardized, and largely politically motivated.²³¹ Moreover, as Professor John Coffee explains, the attestation requirement in § 404 eventually led to the situation whereby auditors conducted a “dual audit” of the corporation: “first, a traditional audit of the issuer’s financial statements and, second, an audit of the issuer’s internal controls.”²³²

In sum, to the extent Sarbanes-Oxley represented a move toward enhanced corporate architecture, it was (to its critics) the worst kind of architecture: expensive, government-mandated, and one that ultimately transferred the shareholders’ wealth to outside auditors.²³³

Responding to the above critiques, Sarbanes-Oxley’s proponents have questioned whether corporations could or would have credibly improved their internal reporting devices on their own.²³⁴ They also contend that the business community exaggerated the Act’s compliance costs and conveniently ignored “its countervailing benefits.”²³⁵

Although largely beyond the scope of this Article, the debate illuminates architecture’s key challenges. Because it is more qualitative than quantitative, it is difficult for outsiders to verify architecture’s existence.²³⁶ For that reason, and particularly in the

230. One might also have concluded, as Professor Cunningham did, that a number of Sarbanes-Oxley’s provisions merely amplified pre-existing requirements. Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915, 918 (2003).

231. The classic critiques include William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of “Going Private,”* 55 EMORY L.J. 141 (2006) (arguing that excessive compliance costs associated with § 404 will cause public firms to go private or delist); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005) (questioning empirical support for several key provisions in Act); and also Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 39 (2002) (similar arguments).

232. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1038 (2012). Coffee observes that the dual audit feature was not mandated by Sarbanes-Oxley itself, but came about because of a ruling by the Public Company Accounting Oversight Board. *Id.*

233. *Id.* (citing argument that dual audits enriched auditing profession).

234. See generally Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843 (2007).

235. Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 703 (2007).

236. Assessing and demonstrating compliance effectiveness has become an important issue for compliance officers. See PWC STUDY, *supra* note 224, at 12–13. For more on the observability of compliance efforts and how it may shape internal compliance decisions, see

wake of public scandals, legislators and regulators are not likely to permit regulated entities to devise their own antifraud architecture. Instead, public actors will be inclined to mandate blunt and politically popular “fixes.”

Although the foregoing discussion has discussed architecture and policing’s relative strengths and weaknesses, the two are not solely substitutes. In numerous instances, they are complements.

For example, structures that stress disclosure or require multiple signatories on filed documents deflect momentary lapses of judgment (architecture), but also make it easier to identify rogues and rank opportunists after the fact (policing). Good processes make policing more effective, which in turn reduces opportunities and incentives to cheat.

At the same time, policing can make architecture more effective. Recall that “structure” can include anything from a narrowly crafted deflection device (a certification requirement or checklist) to a drastic reduction in options (a decision not to do any business in China in order to eliminate the possibility of bribing government officials). The more drastic structures reduce opportunities for innovation and legitimate business activity but otherwise ensure legal compliance. One cannot easily violate the Foreign Corrupt Practices Act if one’s company declines to do work overseas. But that also means foregoing lucrative opportunities across the globe.

Much of the legal scholarship on “structure” has focused on the differences between *ex ante* and *ex post* responses to wrongdoing.²³⁷ A different, yet equally important question is how enforcers structure requirements optimally. If an enforcer chooses a “structural” device, how sharply should that structural device cut? As much as we want Ulysses to foreclose the option of steering the ship in the wrong direction, we still want him to sail home. Which factors enable the corporate architect to fine-tune and customize devices such that they reduce some options, but do not wholly foreclose others?

Here, credible policing may play some salutary role. As Professor Jon Elster observed, a number of precommitment devices depend on third parties in order to function effectively:

Ulysses did not bind himself to the mast; he had himself tied by the rowers and made sure that they could not hear any counterorders he might issue. People who want to force themselves to save can join a Christmas Club,

Alexander S. P. Pfaff & Chris William Sanchirico, *Environmental Self-Auditing: Setting the Proper Incentives for Discovery and Correction of Environmental Harm*, 16 J. L. ECON. & ORG. 189, 198 (2000) (discussing observability problem).

237. See, e.g., Cheng, *supra* note 137, at 657.

which will be deaf to any demands for withdrawal of the funds before December 15. . . . What is common to these and many other cases is that the individual can enlist others in the effort to bind himself.²³⁸

Elster's insight is important: for precommitment devices to function effectively, we need reliable third parties who can help us bind ourselves to our original commitments. If those upon whom we depend are opportunistic and have an interest in seeing us fail, mast-tying and Christmas clubs quickly lose their value. Accordingly, if corporate enforcers can be "bribed" into acquiescence, as critics claim was the case with auditors in the late 1990s and credit rating agencies in the lead-up to the 2008 financial crisis,²³⁹ then some level of policing is necessary to ensure that the enforcers and their overseers maintain a genuine interest in complying with the law.

How do we solve this recursive problem whereby corporate enforcers themselves are so opportunistic or feckless that they fail to implement or maintain existing architectural devices? Here, policing, particularly the type of policing aimed strategically at the worst and most obvious offenders, may assist in the development and refinement of corporate architecture.²⁴⁰ By screening out and deterring the most dangerous and opportunistic wrongdoers, policing can provide the rest of the community the space to devise structures that are permissive and yet disabling in the right proportions.

IV. CORPORATE COMPLIANCE AND THE PREFERENCE FOR POLICING

As the foregoing discussion demonstrates, corporations must confront two dispositions at the same time: the tendency to be temporally inconsistent and the motivation to harm or take advantage of others. Examining the interaction between these dispositions, in turn, reveals a four-part typology that suggests differing levels of danger among corporate employees and officers. Fraud, in turn, arises out of a combination of planned and spur-of-the-moment misconduct. The corporation's internal enforcer therefore must arm himself with

238. Jon Elster, *Don't Burn Your Bridge Before You Come to It: Some Ambiguities and Complexities of Precommitment*, 81 TEX. L. REV. 1751, 1759 (2003).

239. See, e.g., Jodi L. Short, *Competing Normative Frameworks and the Limits of Deterrence Theory: Comments on Baker and Griffith's Ensuring Corporate Misconduct*, 38 LAW & SOC. INQUIRY 493, 497-98 (2013) (comparing auditor failures with credit rating agency failures).

240. For the differences between "randomized," "comprehensive," and "strategic" policing models, along with an endorsement of the benefits of a strategic policing model that targets the worst offenders, see Margaret H. Lemos & Alex Stein, *Strategic Enforcement*, 95 MINN. L. REV. 9, 9-12 (2010).

some combination of policing and architecture.

Ideally, internal corporate enforcers would choose the most cost-effective mix of approaches, depending on the context and attendant risks. In this perfect world, internal enforcers would choose those combinations of screening, transformation, and structural strategies that best reflect their employee population and their company's particular risk profile. Professor Omari Scott Simmons analogizes this contextual, global approach to an immune system that relies on a varied set of adaptive responses in order to minimize external stress and restore "internal equilibrium."²⁴¹ Although broader in scope, Simmons's analogy envelops the pluralistic enforcement approach suggested here.

But what if certain factors skew the internal corporate enforcer's analysis in one direction? Which approach would we expect to dominate, and how would this outcome affect the corporation's internal response to corporate fraud?

This final Part explores these questions, first by discussing the rise of the modern corporate compliance program, and then by constructing a theoretical account of why stakeholders inside and outside the corporation may push its compliance effort excessively towards policing and away from architectural progress.

A. *The Emergence of Corporate Compliance and Risk Management*

Not long after the enactment of the Sarbanes-Oxley Act of 2002,²⁴² Professor Manuel Utset theorized that temporal inconsistency might have played a role in the corporate fraud accounting scandals that had preceded the Act.²⁴³ He theorized that gatekeeping—including the creation of oversight and surveillance systems within the firm—required extensive up-front costs.²⁴⁴ If corporate gatekeepers were temporally inconsistent, Utset reasoned, then they would rationally procrastinate beefing up oversight programs, to the long-term detriment of the company.²⁴⁵ Given this fear, Sarbanes-Oxley's emphasis on internal compliance and enhanced internal corporate controls made sense, as it effectively forced corporate gatekeepers to

241. Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131, 1151–53.

242. Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and 18 U.S.C.).

243. See Utset, *supra* note 8, at 434.

244. See *id.* at 435.

245. *Id.* at 434–35 (casting the problem as arising primarily at the corporate board level). “[G]atekeepers may have had a long-term preference to actively monitor and discipline managers, but they repeatedly procrastinated following through.” *Id.* at 434.

“commit” to corporate compliance.²⁴⁶

Of course, many of the external incentives to develop a corporate compliance program were already in place by the time Sarbanes-Oxley was enacted.²⁴⁷ The compliance profession first emerged in the 1960’s and grew throughout the end of the century.²⁴⁸ Deferred prosecution agreements, the primary settlement tool for criminal prosecutions of corporations, first surfaced in the 1990s.²⁴⁹ The U.S. Sentencing Commission’s Organizational Guidelines were first promulgated in 1991 and then revised in 2004 pursuant to the Sarbanes-Oxley Act in order to further define the meaning of an “effective compliance and ethics program.”²⁵⁰ The Organizational Guidelines significantly reduce criminal sanctions for those organizations that adopt an “effective” internal compliance program.²⁵¹ During the same time period, the SEC implemented its own deferred prosecution regime, memorialized in what is commonly known as the *Seaboard Report*, which offered the promise of leniency for corporations that implemented compliance programs and self-reported evidence of wrongdoing.²⁵²

Meanwhile, the related but distinct “enterprise risk management” (ERM) industry also emerged and expanded during this time period.²⁵³ Enterprise risk management enables firms to identify and

246. *Id.* at 442 (theorizing that Sarbanes-Oxley’s internal controls and certification requirements acted as precommitment devices to counteract gatekeeper tendencies toward procrastination).

247. See Rostain, *supra* note 214, at 1402 (tracing the rise of the “compliance consulting industry” to the enactment of the Federal Organizational Sentencing Guidelines in 1991).

248. “Compliance officers in the U.S. securities industry began to meet as early as the 1960s with their 1996 conference having over 2200 participants.” Parker, *supra* note 185, at 344.

249. John Gibeaut, *A Matter of Opinion: Speakers Debate Whether Deferred Prosecution Agreements Help Corporations*, A.B.A. J., Oct. 2006, at 58, 58.

250. The Guidelines offer the possibility of a reduced sentence for convicted corporations that nevertheless maintained “effective” compliance programs. U.S. SENTENCING COMMISSION GUIDELINES MANUAL § 8B2.1(a) & cmt. background (2012).

251. See Paul Fiorelli & Ann Marie Tracey, *Why Comply? Organizational Guidelines Offer a Safer Harbor in the Storm*, 32 J. CORP. L. 467, 467–68 (2007) (stating there is a potential “80:1 swing in what a company may have to pay in federal fines, depending on whether it had good ethics and compliance programs, or bad ethics and compliance programs”).

252. See U.S. SEC. & EXCH. COMM’N, REPORT OF INVESTIGATION PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION STATEMENT ON THE RELATIONSHIP OF COOPERATION TO AGENCY ENFORCEMENT DECISIONS, Exchange Act Release No. 44,969 (Oct. 23, 2001) [hereinafter SEABOARD REPORT], available at <http://www.sec.gov/litigation/investreport/34-44969.htm>; see also Matt A. Vega, *Beyond Incentives: Making Corporate Whistleblowing Moral in the New Era of Dodd-Frank Act “Bounty-Hunting,”* 45 CONN. L. REV. 483, 517–18 & n.194 (2012) (summarizing and explaining the relevance of the *Seaboard Report* and why it has acquired that name).

253. See Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and*

reduce a variety of enterprise-wide risks, including the risk that employees may break the law.²⁵⁴ The ERM framework, which was developed by the Treadway Commission's Committee of Sponsoring Organizations (COSO),²⁵⁵ was released in 2004,²⁵⁶ two years after Sarbanes-Oxley's enactment. The framework expands upon a number of principles that COSO previously articulated in its "Internal Framework," which would eventually become the Sarbanes-Oxley benchmark for testing internal financial reporting controls within public corporations.²⁵⁷ "Internal controls" in turn, had been a topic of interest to lawmakers and regulators since at least the 1970s.²⁵⁸

In sum, plenty of compliance-related "commitment devices" were in place prior to the enactment of the Sarbanes-Oxley Act, and the emphasis on compliance only expanded in Sarbanes-Oxley's wake. More than a decade following the enactment of Sarbanes-Oxley, both "compliance" and "risk management" have become key functions within public corporations.²⁵⁹ That does not mean, however, that *fraud* is no longer a realistic concern, particularly if compliance programs lack the optimal mix of policing and architecture.

At first glance, compliance and risk management programs are

Corporate Governance, 39 LOY. U. CHI. L.J. 571, 580–81, 583–84 (2008).

254. See Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 969 (2009) ("Enterprise risk management is the process by which a business organization anticipates, prevents, and responds to uncertainties associated with the organization's strategic objectives. . . . [It] is the process by which business organizations proactively determine the types and levels of risk appropriate for achieving the organization's strategic goals." (footnote omitted)); Deborah A. DeMott, *The Stages of Scandal and the Roles of General Counsel*, 2012 WIS. L. REV. 463, 468–69 ("Enterprise risk management incorporates corporate governance as a mechanism of managing behavioral risks with financial and technical risk management"); see also Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. BUS. & TECH. L. 45, 47 (2010) (arguing that financial institutions' inattention to ERM contributed to the financial crisis).

255. COSO comprises the major accounting trade organizations. *About Us*, COMMITTEE SPONSORING ORGS. TREADWAY COMMISSION, <http://www.coso.org/aboutus.htm> (last visited Feb. 10, 2014).

256. *Id.* ("Regarding ERM, in 2004 COSO issued *Enterprise Risk Management – Integrated Framework*.").

257. See Langevoort, *supra* note 53, at 953–55 (describing emergence of COSO's internal controls framework and status as the de facto benchmark for demonstrating adequate internal controls for Sarbanes-Oxley).

258. Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 273 (2004) (tracing the emergence of internal controls regulation back thirty years). For the differences between financial and compliance controls, see *id.* at 277.

259. A 2012 report by PricewaterhouseCoopers and Compliance Week indicated that compliance officers' jurisdiction within their corporations and budgets were increasing. PWC STUDY, *supra* note 224, at 16.

exactly the types of platforms that should accommodate the policing and architectural approaches. One could imagine compliance personnel and risk managers working side by side, the former focusing on policing and the latter implementing and perfecting precommitment devices. Alternately, one could imagine a platform that integrated both goals and approaches at the same time, with compliance and risk managers drawing upon both approaches simultaneously.²⁶⁰ Moreover, legislation such as Sarbanes-Oxley would appear to encourage architecture as much as it encourages corporate policing. It requires firms to strengthen internal monitoring systems, but as Professor Utset has approvingly pointed out, it also demands the implementation of temptation-reducing devices such as prohibitions on loans to officers and requirements that the corporation's CEO and CFO attest to the reliability and health of the company's internal controls.²⁶¹ Ideally, the emergence of these two related and overlapping industries ought to have made corporations—and the economies and industries in which they operate—safer investments and less prone to scandal and misreporting.

So much for the idealized vision. Even with fewer financial reporting scandals, few would argue that the compliance and risk-management industries have lived up to their promise. The 2008 Financial Crisis undercuts any notion of effective risk management, at least with regard to financial firms.²⁶² JPMorgan's recent "London Whale" debacle—in which one of its traders acquired a massive position in risky derivative bets and ultimately caused the bank to lose in excess of six billion dollars—stands as a more recent example of inadequate risk management.²⁶³

In a similar vein, proponents of the Dodd-Frank Act have argued that the directors and managers of financial institutions caused so much harm to the economy precisely because they lacked either the ability or the incentive to properly manage risk.²⁶⁴ At the same time,

260. For the overlapping roles of risk management and compliance assurance for corporate directors and an argument that risk management and compliance are similar "in kind" but differ "in degree," see Bainbridge, *supra* note 254, at 978–84.

261. See discussion *supra* at pp. 50–51.

262. See Harner, *supra* note 254, at 47; Renee M. Jones & Michelle Welsh, *Toward a Public Enforcement Model for Directors' Duty of Oversight*, 45 VAND. J. TRANSNAT'L L. 343, 345–46 (2012).

263. See, e.g., Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262, 1288 (2013) (explaining the scandal and observing that banks "all too often fail to accurately assess their own risk exposures"). For arguments that risk management failures were limited largely to financial institutions, see Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500*, 65 BUS. LAW. 1, 3 (2009).

264. See Jones & Welsh, *supra* note 262, at 346 ("Directors remained blind to significant departures from approved risk management guidelines and failed to detect flaws in financial

corporate compliance officers within those institutions have also come under fire.²⁶⁵ Much hand-wringing occurred, for example, when it became clear that JPMorgan not only allowed excessively risky trading, but also failed to disclose the full size of its losses promptly and transparently. The bank's problems inhered not solely in its management of risk, but also in its reporting of material losses, a core compliance function.²⁶⁶

Even putting aside financial firms, which may be *sui generis*, the evidence is mixed on how well the modern compliance program works.²⁶⁷ Although there now exists a plethora of corporate compliance tools, as well as organizations that provide specialized consulting services to corporations seeking the reduction of wrongdoing,²⁶⁸ fraud and deceptive practices continue to arise, particularly in the wake of market downturns and recessions.²⁶⁹ True, a particular *method* of fraud may decline in the wake of a series of investigations and prosecutions.²⁷⁰ But misrepresentation and similar

reporting practices that led to systematic underreporting of leverage and the concealment of devastating losses.”).

265. This criticism is not new. Lori Richards, then the SEC's Director of the Office of Compliance Inspections and Examinations, addressed a meeting of compliance professionals in 2005, stating in part:

[O]ver the last several years, . . . [t]errible scandals had come to light, with large scale dishonesty, serious breaches of fiduciary duty, violations by well-known leaders of the securities industry, and misconduct of some audacity. I often had the unfortunate duty of asking you - “where was compliance?” Specifically I asked: “Where was compliance when these problems arose, took shape, and became entrenched in the offending firms?”

Lori Richards, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Remarks before the Nat'l Soc'y of Compliance Prof'ls Nat'l Membership Meeting (Oct. 25, 2005) (transcript available at <http://www.sec.gov/news/speech/spch102605lr.htm>).

266. JPMorgan's compliance weaknesses were particularly surprising in light of the fact that the bank's chief compliance officer was Stephen Cutler, a former chief of the SEC's Enforcement Division. See James B. Stewart, *When Trying to Follow Rules Isn't Enough*, N.Y. TIMES (Sept. 20, 2013), available at <http://www.nytimes.com/2013/09/21/business/at-jpmorgan-trying-to-do-the-right-thing-isnt-enough.html> (discussing JPMorgan's compliance failures).

267. For a discussion on the inherent limitations of internal controls, see Cunningham, *supra* note 258. For a more specific argument on how corporate compliance regulation has gone awry, and for a warning that emphasis on “corporate compliance” may ultimately produce “greater individual ‘white collar’ deviance,” see Laufer, *supra* note 190, at 1350.

268. For the growth of the compliance industry, see Baer, *supra* note 20, at 993–99; see also Cunningham, *supra* note 258, at 269 (observing that the emphasis on “internal controls” has helped the auditing and legal professions).

269. Rapp, *supra* note 57, at 104.

270. For example, Kathleen Boozang and Simone Handler-Hutchinson observe with regard to the health care context:

types of wrongdoing appear to be quite sticky.²⁷¹ If financial reporting fraud is not the problem it was in 1999, we still have to worry about international bribery and other alternative types of wrongdoing that have yet to surface. Indeed, this is one of the reasons why the federal criminal fraud statutes are so notoriously open-ended.²⁷²

The evidence on specific corporate settlements between corporations and prosecutors or the SEC is not much better. In separate studies, Professors Jayne Barnard and Brandon Garrett both praise monitors and structural settlements that address the specific situational factors that encourage misconduct.²⁷³ At the same time, both find shortcomings in these programs. Barnard, who interviewed corporate defense attorneys, reports that “everybody hates” the compliance consultants because they are “expensive and disruptive.”²⁷⁴ She further reports that structural terms are idiosyncratic and depend largely on the involvement of particular SEC Enforcement Division personnel.²⁷⁵ She notes further that much of the negotiation tends to boil down to the question of how many executives the company is willing to fire.²⁷⁶ From this perspective, compliance sounds much more like a “check-the-box effort” and hardly like an idealized mix of pluralistic governance approaches.

Garrett, who has studied a number of domestic and foreign corporation settlements with state and federal prosecutors, finds

The two decades of anti-kickback enforcement has been a cat-and-mouse game between enforcers and the health industry. The government promulgates safe harbor regulations, guidelines, fraud alerts, opinion letters, and [corporate integrity agreements] signaling behaviors it deems illegal and the principles underlying its legal interpretations. Industry then eliminates those practices but adopts alternative practices that have not been expressly prohibited.

Boozang & Handler-Hutchinson, *supra* note 217, at 98.

271. See ERNST & YOUNG, GROWING BEYOND: A PLACE FOR INTEGRITY: 12TH GLOBAL FRAUD SURVEY 2, 4 (2012), [http://www.ey.com/Publication/vwLUAssets/Global-Fraud-Survey-a-place-for-integrity-12th-Global-Fraud-Survey/\\$FILE/EY-12th-GLOBAL-FRAUD-SURVEY.pdf](http://www.ey.com/Publication/vwLUAssets/Global-Fraud-Survey-a-place-for-integrity-12th-Global-Fraud-Survey/$FILE/EY-12th-GLOBAL-FRAUD-SURVEY.pdf) (noting that the risk of fraud is increasing); see also Pamela H. Bucy et al., *Why Do They Do It?: The Motives, Mores, and Character of White Collar Criminals*, 82 ST. JOHN'S L. REV. 401, 404–05 (2008) (citing the Association of Certified Fraud Examiner's study regarding prevalence of fraud in corporations and other organizations).

272. Cf. Joseph W. Yockey, *Choosing Governance in the FCPA Reform Debate*, 38 J. CORP. L. 325, 338 (contending that “a certain degree of ambiguity is necessary to fulfill the FCPA's purpose of deterring corruption”).

273. Jayne W. Barnard, *Corporate Therapeutics at the Securities and Exchange Commission*, 2008 COLUM. BUS. L. REV. 793, 794–95; Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 936 (2007).

274. Barnard, *supra* note 273, at 817 (internal quotation marks omitted).

275. *Id.* at 818–19.

276. *Id.* at 828. But see *id.* (“[T]he defenestration of top managers in anticipation of settlement is less common than it was just two years ago.”).

evidence of good-faith attempts to improve internal compliance, along with some alarming examples of prosecutorial rent-seeking.²⁷⁷ Like Barnard, Garrett finds a lack of uniformity in compliance requirements, and little evidence that prosecutors keep track of these reforms after they impose them.²⁷⁸ Some of Garrett's concerns have been echoed by the U.S. Government Accountability Office (GAO), whose December 2009 report to Congress observed that the Department of Justice (DOJ) had just begun to improve its internal tracking of outstanding deferred prosecution (DPA) and nonprosecution (NPA) agreements,²⁷⁹ but that the DOJ had yet to figure out how to measure their individual and overall effectiveness: "DOJ lacks performance measures to assess how DPAs and NPAs contribute to its efforts to combat corporate crime."²⁸⁰ Apparently in response to this problem, the DOJ noted in its 2013 budget proposal that putting in place a tracking system that ensures that corporate offenders are abiding by the terms of their settlement agreements was a "Priority Goal."²⁸¹ Even this additional information—however valuable—fails to tell us how effective compliance is in reducing wrongdoing.

Thus, the compliance industry's ultimate value remains unverified. Why? Some might conclude that the problem is that the government and corporate entities have embraced compliance and risk management in an overly ad hoc matter; others might contend that corporate officers and directors, who have no true interest in reducing the incidence of wrongdoing, simply abuse these platforms for their own purposes.²⁸² Still others might argue that compliance and risk management are relatively young and nascent disciplines and that true

277. Garrett, *supra* note 273, at 857, 860.

278. Brandon L. Garrett, *Globalized Corporate Prosecutions*, 97 VA. L. REV. 1775, 1847 (2011) ("The compliance measures that prosecutors require range widely and it is not clear to what extent prosecutors review or supervise their effectiveness.").

279. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-110, CORPORATE CRIME: DOJ HAS TAKEN STEPS TO BETTER TRACK ITS USE OF DEFERRED AND NON-PROSECUTION AGREEMENTS, BUT SHOULD EVALUATE EFFECTIVENESS 17 (2009), <http://www.gao.gov/assets/300/299781.pdf> (noting that the DOJ had just begun to track deferred prosecution and non-prosecution agreements issued by component departments and United States Attorneys' Offices).

280. *Introduction to id.*; see also *id.* at 21.

281. See U.S. DEP'T OF JUSTICE, SUMMARY OF 2013 BUDGET REQUEST AND PERFORMANCE, 14 (2013), <http://www.justice.gov/jmd/2013summary/pdf/fy13-bud-summary-request-performance.pdf>.

282. See First, *supra* note 64, at 91–92 (worrying that the possibility of deferred prosecution agreement reduces corporations' incentives to self-police). A variant of this argument is that policing imposes a "placebo effect" on potential victims, causing them to become less vigilant because they assume others will detect and punish wrongdoing. See Amitai Aviram, *The Placebo Effect of Law: Law's Role in Manipulating Perceptions*, 75 GEO. WASH. L. REV. 54, 57–61 (2006).

best practices have yet to emerge.²⁸³

All of these arguments are plausible. It may be, however, that our laws encourage a certain mix of compliance strategies that hinders the development of effective responses to corporate misconduct. The next section considers this possibility in greater detail.

B. *Understanding the Preference for Policing*

Assuming some mix of temporal inconsistency and opportunistic motivation, the ideal compliance program would include both architectural and policing approaches to the risk of wrongdoing. It would include strategies designed to confront temporal inconsistency as well as more covert efforts to identify and root out rank opportunism. It would include audits and swift sanctions, but it also would include an array of precommitment devices and structural protections. It would promote overt monitoring and gentle reminders, but it would also countenance covert investigations and periodic punishments of willful misconduct.

As Section IV.A suggested, however, certain groups skew corporate choices in the direction of policing and away from architecture. This Section provides a thumbnail sketch of who those groups are and why they prefer policing.

1. Moral Objectors and Government Enforcers

Those who perceive corporate wrongdoing as a distinctly moral transgression may prefer policing to architecture because policing is intimately related to punishment.²⁸⁴ If corporate wrongdoing is the result of morally objectionable conduct, then wrongdoing merits punishment. Punishment, in turn, entails the singling out of individuals who have harmed others. From this perspective, policing should predominate, since it serves as the precursor to corporate

283. For a discussion of compliance “best practices” and the observation that “best practices” established by so-called compliance experts are being bypassed by Dodd-Frank “bounty-hunting,” see Vega, *supra* note 252, at 519–20. See David Zaring, *Best Practices*, 81 N.Y.U. L. REV. 294, 298 (2006) for an argument that “best practice[]” regimes can devolve into “common practice[]” regimes.

284. Professor Deborah DeMott has criticized ERM’s “neutral” systems-based language for failing to take into account the normative aspects of legal noncompliance:

To the extent the law is treated as simply a source of “risk” that may for this purpose be homogenized with risks stemming from other sources, it is incorporated within a risk-management framework as another constraint on conduct, “not norms that express views of right conduct or desirable states of the world.”

DeMott, *supra* note 254, at 469 (quoting Robert W. Gordon, *A New Role for Lawyers?: The Corporate Counselor After Enron*, 35 CONN. L. REV. 1185, 1192 (2003)).

discipline, which in turn functions as a kind of punishment for individual corporate officers and directors.²⁸⁵

Along the same vein, public enforcers also skew the compliance officer's calculus in favor of policing.²⁸⁶ From the public enforcer's perspective, corporate policing serves two ends. It helps the government prosecute and punish wrongdoers after harm has occurred and it enhances deterrence before harm occurs.²⁸⁷ Because of information asymmetries, the corporation can self-police more easily than external enforcers.²⁸⁸ The government's reliance on corporate compliance, in turn, frees up resources that it can then expend on recidivist and (presumably) more dangerous firms.²⁸⁹

The key method by which prosecutors and regulators demand policing is by defining the term "compliance" to include corporate-wide investigative disciplinary measures. The Principles of Federal Prosecution of Business Organizations, the primary guidance document the DOJ publishes for its U.S. Attorneys' Offices regarding charging decisions for business organizations, explicitly advises prosecutors to assess whether a corporation's compliance program functions effectively.²⁹⁰ The DOJ does not define the term "effective," but instead advises prosecutors to discern the difference between a good-faith effort and a mere "paper program."²⁹¹

285. See Ellen S. Podgor, *Educating Compliance*, 46 AM. CRIM. L. REV. 1523, 1527 (2009) ("A highlight of most deferred prosecution agreements [between prosecutors and corporations] is a requirement that the corporation cooperate with the government by providing evidence of wrongdoing by individuals within the company.").

286. See Buell, *supra* note 70, at 1625–26.

287. See *id.*

288. Professor Arlen has argued that corporations "are uniquely positioned to intervene *ex ante* to deter crime through their ability to structure compensation and promotion policies so as to make crime less profitable." Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW 144, 144 (Alon Harel & Keith N. Hylton eds., 2012).

Professor Buell contends that corporations are better positioned to police their own employees. Buell, *supra* note 70, at 1626 ("The firm is much closer to the action, better educated about the activities under scrutiny, and a more efficient user of enforcement resources.").

289. See AYRES & BRAITHWAITE, *supra* note 189, at 103–06; see also Kagan et al., *supra* note 168, at 39 (observing reliance on internal compliance efforts, in part because "legal coercion is expensive and difficult"). For an empirical analysis of self-policing and an argument that "self-reporting can be a useful tool for reliably identifying and leveraging the voluntary self-policing efforts of regulated companies," see Michael W. Toffel & Jodi L. Short, *Coming Clean and Cleaning Up: Does Voluntary Self-Reporting Indicate Effective Self-Policing?*, 54 J.L. & ECON. 609, 611 (2011).

290. See U.S. DEP'T OF JUSTICE, UNITED STATES ATTORNEYS' MANUAL 9-28.800(B) (2008), available at http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/28mcr.htm.

291. *Id.*

Superficially, the principles are fairly open-ended, permitting the corporate compliance officer to mix structural approaches with standard policing efforts.²⁹² Nevertheless, the DOJ reveals its preference when it advises prosecutors to consider, among other factors, “any remedial actions taken by the corporation, including, for example, disciplinary action against past violators uncovered by the prior compliance program.”²⁹³ As this statement makes clear, the corporation’s safe harbor resides in substantial expenditures for policing, not architecture. A record of aggressive audits followed by swift terminations and corporate-wide shaming demonstrates to public enforcers the corporation’s commitment to nurturing a law-abiding, ethical culture. Experimentation with precommitment devices may be the icing on the cake (particularly when they work well), but it is the record of “remedial actions” and “disciplinary action against past violators” that matters most to prosecutors when they consider a corporate indictment.

Should there be any doubt as to this last point, consider a recent organization-wide indictment, *United States v. S.A.C. Capital Advisors, LP*.²⁹⁴ SAC, the eponymous hedge fund founded by Steven A. Cohen, was indicted on charges that it failed to supervise its employees and effectively permitted and encouraged insider trading.²⁹⁵ The indictment was notable in that it demonstrated the various ways in which SAC’s compliance program was an abject failure—with regard to policing *and* architecture.²⁹⁶ Nevertheless, the most memorable failures related to the department’s policing function: the compliance department failed to screen employees; lacked adequate monitoring systems; conducted few internal investigations; and concluded from these few investigations that no wrongdoing had occurred.²⁹⁷

SAC’s prosecution may well be salutary insofar as it encourages the hedge fund industry to pay greater attention to compliance. Nevertheless, a public indictment that highlights the various ways in which a corporation’s compliance personnel failed to police themselves will inevitably cause compliance officers at other

292. *See id.*

293. *Id.*

294. Sealed Indictment, *United States v. S.A.C. Capital Advisors, L.P.*, No. 13-cr-00541 (S.D.N.Y. July 23, 2013), available at [http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20\(Stamped\).pdf](http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20(Stamped).pdf); see also James O’Toole, *SAC Indictment Depicts Culture of Law-Breaking*, CNNMONEY (July 30, 2013), <http://money.cnn.com/2013/07/26/investing/sac-insider-trading/index.html> (describing the SAC compliance department’s permissiveness).

295. Sealed Indictment, *supra* note 294, ¶ 1.

296. *Id. passim.*

297. *Id.* ¶¶ 24–29.

companies to conclude that the remedy for insufficient compliance is to bulk up one's surveillance and internal punishment apparatus. With the chair of the SEC announcing the Commission's intention to make itself into a "tougher cop," one can hardly fault that choice.²⁹⁸

2. Monitoring Boards

The corporation's board of directors, particularly its composition and its members' preferences, also affect the corporation's choice of policing and architectural approaches. Compliance officers often report to the corporation's board of directors, either indirectly, through the corporation's general counsel, or directly.²⁹⁹ Particularly when corporate fraud is salient, board members care greatly about the shape and content of the corporate compliance program.

Years ago, corporate scholars observed the transformation of the American corporate board from one that provided strategic advice on operations (the "managerial" board) to one that checked corporate management's tendency to shirk and take advantage of ill-informed shareholders (the "monitoring" board).³⁰⁰ One of the hallmarks of the monitoring board was that its members were independent, divorced from the daily operations of the corporation.³⁰¹ Independence, in turn, would reduce conflicts of interest and ensure proper monitoring on behalf of the corporation's shareholders.³⁰² In the wake of the

298. Sue Reisinger, *SEC Chair Wants to Retool Agency as "Tough Cop,"* CORPORATE COUNSEL (Sept. 27, 2013), <http://www.corpcounsel.com/id=1202621030557> (reporting on Commissioner Mary Jo White's "tough cop" speech to the Council of Institutional Investors in Chicago).

299. See U.S. SENTENCING COMMISSION GUIDELINES MANUAL § 8B2.1(b)(2)(C) (2012) (noting that person(s) responsible for daily compliance operations should "report periodically to high-level personnel and, as appropriate, to the governing authority, [i.e., the board] or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program"). As a result of the Guidelines, fewer corporations require its compliance function to report directly to the corporation's general counsel. PWC STUDY, *supra* note 224, at 16. For a discussion of the growing split between those corporations that lodge compliance within the general counsel's office and those that treat it as a separate, free-standing function, see DeStefano, *supra* note 19.

300. See generally Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 268–72 (1997) (describing the rise of the monitoring board).

301. See Ribstein, *supra* note 231, at 11 ("The basic theory is that the corporation's main decision-making body should include a majority of 'independent' directors who do not work full-time for the corporation and therefore theoretically are in a position to watch over the insiders, with wholly independent 'audit' and 'nominating' committees that work with the company's auditing firm and control election of directors.").

302. See Sharpe, *supra* note 202, at 33 ("The contemporary model of corporate governance reform has assumed that if the definition of independence is changed to include more observable traits of independence, firms will perform better."). Sharpe goes on to question this view. See *id.* at 33 & n.192 (citing research indicating that firms with independent directors do not necessarily perform better).

accounting scandals in the late 1990s, the government and the stock exchanges put in place a number of rules that altered the composition and annual responsibility of board members. The stock exchanges' listing requirements and the Sarbanes-Oxley Act require a publicly traded company to maintain a majority of independent directors on its boards, and an all-independent audit committee;³⁰³ the recently enacted Dodd-Frank Act extends the independence obligation to members of the board's compensation committee.³⁰⁴

Putting aside the larger debate as to whether outsiders or insiders are better positioned to monitor the corporation's officers and employees,³⁰⁵ it is not too difficult to see why an independent board might prefer policing to architecture.³⁰⁶

Examining the firm's architecture is a highly contextual and qualitative exercise. It requires an outside director to invest a fair amount of time learning about the corporation and the particular device (or devices) that have been selected within each division. It requires the director to understand the firm, its context, and the particular commitment device. By contrast, policing is more susceptible to quantitative measurement, even if that measurement is itself misleading. A director can rely more easily on reports regarding the number of audits performed, compliance personnel hired, and incidences reported.³⁰⁷ Just as it is easier for a regulator to verify policing, so too is it easier for an independent director to monitor

303. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775-76 (codified at 15 U.S.C. § 78j-1(m)) (requiring an independent audit committee); Eric M. Fogel & Andrew M. Geier, *Strangers in the House: Rethinking Sarbanes-Oxley and the Independent Board of Directors*, 32 DEL. J. CORP. L. 33, 39, 41-42 (2007) (noting that Sarbanes-Oxley did not impose any requirements for independent directors, but that the New York Stock Exchange and NASDAQ Stock Market "submitted to the SEC new listing standards" that required a majority of independent directors).

304. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900-01 (2010).

305. Compare Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) (finding that the belief that firms with more independent boards perform better is unsupported), and Romano, *supra* note 231, at 1530-32 (noting that the literature suggests that "independent boards do not improve performance and that boards with too many outsiders may . . . have a negative impact on performance"), with Prentice & Spence, *supra* note 234, at 1844-45 (disagreeing with Romano).

306. For the inside versus outside director debate, see Simmons, *supra* note 241, at 1155-57; for an analysis of the differences between in-house and external counsel as monitors of corporate misconduct, see Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 413-14 (2008).

307. According to the PricewaterhouseCoopers Compliance Survey conducted in 2012, compliance officers rely on, among other metrics, audits, third party complaints, employee disclosures, hotline reports, and training completion reports to gauge compliance effectiveness. PWC STUDY, *supra* note 224, at 13.

policing, particularly when that director sits on more than one board.

3. Managers

Corporate managers also should prefer policing to architecture. The former may be intrusive, but corporate architecture poses a much greater long-term threat to the corporate officer's operational discretion.³⁰⁸ By definition, precommitment devices narrow the decision maker's options. In contrast, policing leaves corporate officers a "sporting chance" to escape detection and punishment.³⁰⁹ Opportunists optimistic about their abilities to avoid detection will therefore choose policing over architecture.

More importantly, managers may reject corporate architecture for entirely legitimate pro-social reasons. If a manager sincerely believes that corporate compliance personnel are unskilled, risk averse, or otherwise likely to prefer overly restrictive precommitment devices that squelch innovation and competition in an aggressive market, the manager's choice represents nothing more than a rational attempt to preserve the company's operational performance.

4. Compliance Officers

Given the foregoing, compliance officers should also rationally prefer policing to architecture, particularly if they believe they can more easily validate policing in the event of a future compliance failure.³¹⁰ Indeed, should an affirmative "compliance defense" ever materialize in corporate prosecutions, this preference is likely to become even stronger.³¹¹ Quantitative efforts are simply easier to demonstrate and verify than qualitative efforts, and where uncertainty prevails, we should expect risk-averse compliance officers to seek assurance from a bevy of easily proven policing efforts.

Readers should notice the feedback loop this preference creates for the compliance industry itself. Law enforcement agencies prefer policing because it increases their ability to identify and punish wrongdoers. Compliance officers prefer policing because it is easier

308. Cf. Bainbridge, *supra* note 17, at 2–3 (providing examples of precommitment strategies in corporations).

309. Cf. Cheng, *supra* note 137, at 681–83 (discussing speeding and a "sporting chance").

310. See Yockey, *supra* note 272, at 357 ("[O]ne danger posed by the current enforcement climate is that it encourages firms to focus primarily on compliance strategies they can defend later should they happen to come under investigation.").

311. A number of scholars and practitioners have argued for a corporate compliance defense, particularly in regard to prosecutions of violations of the Foreign Corrupt Practices Act. See, e.g., Mike Koehler, *Revisiting a Foreign Corrupt Practices Act Compliance Defense*, 2012 WIS. L. REV. 609. For a particularly thoughtful evaluation of the costs and benefits of such a defense, see generally Peter J. Henning, *Be Careful What You Wish for: Thoughts on a Compliance Defense Under the Foreign Corrupt Practices Act*, 73 OHIO ST. L.J. 883 (2012).

to verify and, in any event, it appears to be the preferred approach among most stakeholders. Those who sell compliance products to corporations have every reason to develop sophisticated policing tools and to develop structural innovations with an eye towards enhanced policing.

CONCLUSION

Corporate fraud is a two-faced problem. People are, by differing degrees, inclined to hurt themselves and others. Corporate firms therefore must address two different and interconnecting dispositions, opportunism and temporal inconsistency. To address both of these problems, a corporation should adopt an integrated response that promotes a combination of policing and structural commitment devices. Do our legal institutions support this pluralistic approach?

Superficially, the answer is "yes": free-standing compliance and risk-management programs offer corporate actors the ability to choose policing and structure as they see fit. Indeed, the government's unwillingness to define "adequate" compliance with specificity may even be a plus.

Nevertheless, a number of factors push the corporation towards policing and away from the architectural approach. An excessive reliance on policing, in turn, may explain compliance's disappointing results in terms of reducing overall fraud. Policing can deter and screen out some of the worst wrongdoers, but it is not likely to cure those violations that arise from temporal inconsistency.

The takeaway here is not a prescription for new regulations or laws, but instead a call for further inquiry and analysis. Experimental researchers can examine the interaction between opportunism and temporal inconsistency. Interpretive scholars can pay closer attention to the two dispositions when they conduct after the fact analyses of corporate scandals. Empirical researchers, who have already studied the effect of "norms" on corporate compliance, should expand their focus to temporal inconsistency and its interaction with opportunism and compliance outcomes.

Meanwhile, corporate enforcers, the general counsels and other personnel who evaluate entity-level compliance, should give more thought to the ways in which they construct their compliance program. Note that this analysis requires more than a simple review of the program's size or budget. For structural approaches to work, corporate enforcers must have requisite freedom to design and test precommitment and targeted-enforcement devices.

The most vexatious quality of our current legal regime is its tendency to frame the corporate compliance platform as a replica of the familiar trial-and-punishment paradigm. This is not the case with

corporate law generally. As corporate scholars have pointed out, corporate law precommits both corporate managers and shareholders in numerous ways.³¹² The state law framework that scholars praise for its enabling character is nevertheless embedded with a number of option-disabling devices. Why has a similar framework not emerged in the corporate compliance context?

Courts have intoned that fraud “is as old as falsehood and as versable as human ingenuity.”³¹³ Although corporate policing may not be as old as fraud, it certainly is as entrenched. In response to a mass of laws and regulations, corporations routinely surround themselves with audits, internal surveillance systems, hotlines, and cultural and educational initiatives. To a large extent, this activity should be lauded, as it plays a strong role in counteracting opportunistic behavior. But policing is ultimately a blunt instrument, whose power is limited. To truly confront corporate fraud’s two faces, the corporate enforcer must utilize a more nuanced strategy, one that addresses our tendency to take advantage not only of others, but also of ourselves.

312. See, e.g., Bainbridge, *supra* note 17, at 7 (“Many provisions of a corporation’s articles of incorporation and bylaws in fact are best understood as other-regarding precommitments”); Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667 (2003) (discussing primarily why shareholders are “bound” to their board).

313. *Weiss v. United States*, 122 F.2d 675, 681 (5th Cir. 1941).

