2013

Temporal Inconsistency and the Regulation of Corporate Misconduct

Miriam H. Baer
miriam.baer@brooklaw.edu

Recommended Citation
1 Va. J. Crim. L. 351 (2012-2013)

TEMPORAL INCONSISTENCY AND THE REGULATION OF CORPORATE MISCONDUCT

Miriam H. Baer[*]

TABLE OF CONTENTS

INTRODUCTION

Manuel Utset does us a great service by applying the theory of time-inconsistent (TI) behavior to the timeworn question of how we can best deal with misconduct within corporate firms.[1] Whereas the time-consistent (TC) actor weighs net benefits and costs according to a single, exponential discount rate, the TI actor places heightened emphasis on

---

[*] Associate Professor of Law, Brooklyn Law School.

[1] Manuel Utset, *Corporate Actors, Corporate Crimes, and Time-Inconsistent Preferences*, 1 VA. J. CRIM. L. 266 (2013).

immediate variations in costs or benefits.[2] Although TI and TC individuals may share the same, welfare-increasing long-term goals at some starting point (T_0), the TI actor inexplicably abandons those goals at some later point, particularly when gaps occur between the delivery of costs and benefits. In lay terms, time inconsistency explains why an individual can pledge, quite sincerely, to eat healthily and exercise on January 1st, but then abandon this goal and instead devour a decadent piece of chocolate cake on January 2nd.[3]

According to Utset, TI corporate actors suffer two opposing but related maladies. They procrastinate investing in long-term valuable projects that present steep up-front costs, and they engage excessively in conduct that pairs immediate benefits with substantial but delayed costs.[4] Moreover, Utset reasons, corporations are quite likely to encounter TI-related problems because corporations are inhabited by decision-makers who repeatedly encounter gaps between the imposition of "costs" (e.g., writing a report, checking a piece of equipment, disposing of toxic waste in a responsible manner), and the delivery of benefits (promotions, increases in salary, respect by one's peers).[5] Thus, Utset concludes, policy makers who wish to deter "corporate misconduct" are best advised to fashion their regulatory responses with TI actors in mind.[6] For Utset, this prescription translates into an embrace of targeted enforcement regimes that reduce the short-term costs of investing in corporate compliance and

---

[2] *Id.* at 22. *See also* Eric Rasmusen, *Some Confusions about Hyperbolic Discounting*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1091392.

[3] For more on the field generally see Manuel Utset, *Hyperbolic Criminals and Repeated Time-Inconsistent Misconduct*, 44 HOUS. L. REV. 609 (2007). ("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, 1349 nn.256 & 259 (2011) (citing GEORGE AINSLIE, BREAKDOWN OF WILL 32 & fig. 2B (2001)); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443, 446–51 (1997).

[4] Utset, *supra* note 1, at 5–6, 13–16.

[5] *Id.*

[6] *Id.* at 7. (concluding that "TI corporate actors—and thus corporations—will be systematically underdeterred by the sanctions that are optimal for TC actors").

simultaneously delay or eliminate the short-term benefits of breaking the law.[7]

Utset's elegantly stated theory of TI misconduct is helpful on a number of fronts. It adds to a growing literature that has strongly challenged the use of crude sanction regimes to deter misconduct. It perceptively demonstrates the ways in which the bias for immediate benefits ironically encourages certain TI actors to forego otherwise harmful misconduct.[8] Finally, it offers a novel argument in favor of this century's two major pieces of corporate and financial governance legislation, the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Act of 2011 (Dodd-Frank).[9]

Although the TI-theory is fairly straightforward, it implies a number of complex decisions for regulators seeking to reduce misconduct within corporate firms.[10] The optimal response to TI-related problems will likely differ depending on context. With this caveat in mind, this Comment explores, in Parts I, II and III, a series of related choices that policy makers are likely to confront as they design legal regimes to deter corporate misconduct. The first choice, discussed at length in Part I, is between sanctions and enforcement. Where corporate misconduct has reached undesirable levels, social planners must choose between an approach that emphasizes increased sanctions and one that allocates additional resources for increased policing and enforcement. Utset

---

[7] "[R]educing the immediate benefits from misconduct or, in the case of compliance procrastination, decreasing the immediate costs of complying with a legal rule, is generally a more effective and economical way of deterring TI misconduct." *Id.* at 7

[8] Utset, *supra* note 1, at 7.

[9] Utset, *supra* note 1, at 8–9. *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010).

[10] Utset couches his discussion as one of corporate criminal liability, *supra* note 1, at 1 & 4, but there is no reason to assume that the underlying conduct—much less the TI behavior that exacerbates such conduct—should be subject to criminal law as opposed to other types of regulation. Accordingly, I speak generically of "regulation" throughout this piece, although such regulation could include a mix of criminal, civil and administrative enforcement responses.

believes that time-inconsistency explains the preference for enforcement over sanctions, but as I show in Part I, a number of factors suggest that we often should choose enforcement over sanctions, regardless of temporal inconsistency.

The second choice, the subject of Part II, is between sanction-based and structural enforcement. Here, social planners must decide between negative laws that tell corporate officers "not" to do something (such as Rule 10-b-5's antifraud provision[11]), and structural regulation that directly intervenes in corporate affairs and directs corporate actors on how to behave. Utset's defense of Sarbanes-Oxley presumes a sanction-based model, whereby corporate actors alter their behavior in response to increased monitoring by gatekeepers and other third parties. As I explain in Part II, this emphasis on corporate policing has its drawbacks, in part because it fails to consider the difference between *intra*personal and *inter*personal conflict. Time inconsistent actors are effectively conflicted with themselves, whereas opportunists consistently favor their own interests over that of others, regardless of legal obligation or contract.[12] As I explain in Part II, the policing strategies best designed to counteract temporal consistency may not be optimal for identifying, deterring and incapacitating this more dangerous group of opportunists. Part II then closes by suggesting a different approach, which is what I refer to as structural enforcement.

The third choice is between public regulation and private ordering. When should public actors attempt to cure or mitigate temporal inconsistency, and when should they step back and allow markets and private ordering to do their magic? Utset backs away slightly from this debate by suggesting that TI actors should be indifferent as to who solves

---

[11] 15 U.S.C. §78j(b); 17 C.F.R. §240.10b-5.

[12] I recognize that an opportunist can also harbor time-inconsistent preferences. As Utset perceptively demonstrates, time inconsistency ironically can improve social welfare by causing the opportunist to delay wrongdoing when the upfront costs of engaging in such wrongdoing seem too high. Utset, *supra* note 1, at 6. For a more in-depth discussion of the interaction between one's motivation to do harm and one's tendency toward temporal inconsistency and the various challenges this interaction poses for an *internal* corporate enforcer, see Miriam H. Baer, *Confronting the Two Faces of Corporate Fraud*, 65 FLA. L. REV. (forthcoming 2014, manuscript on file with author).

the TI problem so long as those solutions are most cost-effective.[13] Public regulation versus markets and private ordering, however, is a central debate in corporate governance scholarship.[14] Moreover, any inquiry premised on the utilitarian aim of reducing misconduct must contend with the comparative benefits and drawbacks of public and private solutions.

Finally, assuming public intervention is necessary, which type of regulation should a public actor impose? Here, I do not focus on specific institutions or familiar debates over rules and standards.[15] Rather, I consider the differences between traditional mandatory regulation and the more experimental, cooperative form of regulation that has been described as "New Governance."

There are, of course, other questions that any regulator would want to answer, which are beyond the scope of this Comment.[16] My purpose here is simply to show how Utset's behavioral analysis deepens our understanding of corporate wrongdoing but does not necessarily offer

---

[13] "All other things being equal, sophisticated actors should be indifferent between their own commitment devices and those imposed by society." Utset, *supra* note 1, at 63.

[14] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (praising "enabling" and non-mandatory aspects of state corporate law); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553 (1989) (pointing out corporate law's mandatory components and praising some as necessary and value-increasing). On the regulatory front, compare John R. Coffee, Jr. & Hillary Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 711 (2011) [hereinafter Coffee & Sale, *Redesigning*] (invoking need for increased regulatory oversight of financial firms) with Roberta Romano, *Regulating in the Dark*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1974148 (criticizing emergency-style regulations adopted in the wake of crises) [hereinafter Romano, *Regulating*].

[15] *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

[16] Like Utset, I do not spend much time here considering whether the regulation of corporate misconduct ought to be based in criminal or civil law, although I agree these are important questions to be considered. Nevertheless, I do assume, as Utset does, that the public's primary goal is cost-effective deterrence.

a clear-cut path for the well-intentioned public actors who desire to avert it.[17]

I. SANCTIONS OR ENFORCEMENT?

Imagine a public actor who confronts a series of wrongdoings within a given context. The public actor could be a prosecutor, legislator, head of a regulatory agency or division, or a judge. For the sake of convenience, however, I will refer to that person generically as a *regulator,* who seeks to deter conduct that reduces social welfare.[18] If our regulator is intent on deterring or mitigating the effects of TI-related misconduct, what types of rules and regulations should she implement?

The first question our regulator might ask herself is how she should choose between "enforcement," which refers broadly to a series of state actions encompassing investigation, prosecution and the setting of penalties that economists frequently refer to as "sanctions." Rational criminals refrain from wrongdoing when their net costs outweigh their net benefits.[19] The criminal's net cost is portrayed as a function of two variables: the sanction that ensues in response to a given act, and the probability that the state will impose it.[20] To deter wrongdoing, the state should set the probability-adjusted sanction to equal the harm caused by

---

[17] On the general limitations of behavioral economics as a prescriptive guide for lawmakers and regulators, see Doron Teichman, *The Optimism Bias of the Behavioral Analysis of Crime Control*, 2011 U. ILL. L. REV. 1697 (2011).

[18] Utset's thesis does not focus on the retributive aspects of TI behavior. Although there may be good reasons to consider whether TI behavior independently triggers a retributive response, I have drafted this Comment with Utset's utilitarian framework in mind.

[19] *See generally* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[20] *Id. See also* A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LITERATURE 45, 49 (1998) ("In general, he will commit the [harmful] act only if his expected utility from doing so, taking into account his gain and the chance of his being caught and sanctioned, exceeds his utility if he does not commit the act.").

such wrongdoing, or p(S) = H.[21] Note that the S in the above equation can be a fine, or a nonmonetary sanction such as prison.[22]

Given that detection and prosecution are costly, social planners might well presume that the most cost-effective way to deter misconduct is to impose monetary sanctions, thereby setting "S" at maximal levels, and "p" at minimal levels in order to conserve enforcement resources.[23] But as economists and criminologists long ago realized, sanction-heavy regimes create a number of unintended problems. If sanctions are fines, and the fines are set too high, then many potential wrongdoers may become judgment proof.[24] In the corporate context, this arguably is one of the reasons we hold corporate entities vicariously liable for their employees' crimes.[25]

To overcome the judgment-proof problem, deterrence theorists support nonmonetary sanctions, such as prison, even though imprisonment imposes separate and quite substantial costs on society. Nonmonetary sanctions create translation and calibration problems for policy makers

---

[21] Where the state has decided that all activity is undesirable and seeks "complete" deterrence, it should set the adjusted sanction equal to the criminal's expected gain. Where the activity includes socially desirable conduct and the state seeks solely "optimal" deterrence, it should set adjusted sanctions to equal the victim's loss. *See generally* Albert Alschuler, *Two Ways to Think About the Punishment of Corporations*, 46 AM. CRIM. L. REV. 1359, 1391 n.173 (2009), citing A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 918 (1998).

[22] Prison is necessary both because individuals may be judgment proof and because they may require incapacitation. *See* Daniel Fischel & Alan Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 322 (1996) (explaining judgment-proof problem). The fact that individuals may be judgment proof is also a justification for corporate liability, although not necessarily corporate *criminal* liability. *Id.* at 322.

[23] Becker, *supra* note 19, at 213.

[24] Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193, 1203–05 (1985) (explaining strategies for overcoming the judgment-proof problem).

[25] *See also* Renier Kraakman & Jennifer Arlen, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 692 (1997) [hereinafter Kraakman & Arlen, *Controlling*] ("[C]orporate liability is generally needed because, for example, individual agents are judgment-proof or government sanctioning of agents is too costly.").

seeking optimal deterrence. It is one thing to say that a fraudster should "internalize" his $100,000 fraud, but it quite another matter to estimate how much prison time corresponds to the harm caused by that fraud.[26]

Aside from the translation problem, sanctions are also burdened by their declining marginal effect on deterrence.[27] Prison sentences are expressed in units of time; fines are expressed in units of money. For each, there is a marginal decline in the disutility posed by each additional unit. Thus, a ten million dollar fine does not cause ten times as much disutility as a one million dollar fine, and a ten-year sentence of imprisonment is not twice as horrible as a five-year sentence of imprisonment. Accordingly, as a state resorts to imposing increasingly heavier and harsher sanctions, the additional deterrent effect decreases.

Sanction-heavy approaches also impair marginal deterrence from more to less serious crimes. If the state spends little on enforcement, then it must impose uniformly high sanctions for both moderate and seriously harmful conduct.[28] Wrongdoers might then decide that it is "cheaper" to engage in more wrongdoing and not less. The corporate officer who perceives a massive fine for spilling even an ounce of waste on the ground

---

[26] "When sanctions and harm are not strictly monetary in nature, there is a translation problem: The sanction that the government sets might not accurately reflect the harm the defendant causes, regardless of the probability of detection and punishment." Miriam Baer, *Evaluating the Consequences of Calibrated Punishment: A Reply to Professor Kolber*, 109 COLUM L. REV. SIDEBAR 11, 13 (2009) [hereinafter Baer, *Evaluating*]; *see also* Cass Sunstein, *On the Psychology of Punishment*, 11 SUP. ECON. REV. 171, 180–81 (2003) (explaining that decision makers render incoherent punishments in part because "those entrusted with the task of 'mapping' lack a modulus with which to discipline their decisions").

[27] A. Mitchell Polinsky & Steven Shavell, *On the Disutility and Discounting of Imprisonment and the Theory of Deterrence*, 28 J. LEGAL STUD. 1 (1999) (exploring implications of declining disutility and criminals' discounting of extended periods of imprisonment). For evidence from social psychology that long prison sentences offer declining social utility, see Jeremy A. Blumenthal, *Law and the Emotions: The Problems of Affective Forecasting*, 80 IND. L.J. 155 (2005) (explaining that criminal defendants' ability to adapt to imprisonment reduces effectiveness of longer prison sentences).

[28] *See* Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions As a Deterrent*, 85 COLUM. L. REV. 1232, 1245–46 & n.52 (1985) [hereinafter Shavell, *Criminal Law*] (explaining how uniformly maximal sanctions eliminate marginal deterrence of less harmful crimes).

might decide that it is prudent to risk spilling much more. Accordingly, a schedule of gradually increasing sanctions (in proportion with the harm and corresponding probability of detection) is preferable to a regime based on several blunt, draconian sanctions. This complicated schedule, however, introduces new costs: administrative costs (since there will be more haggling about the schedule and how to set it), transaction costs (since defense lawyers and prosecutors will strike bargains according to an increasingly complex schedule), and error costs (the costs that accrue when the schedule fails to approximate harm and probability of detection, or when a well-written schedule is applied improperly).[29]

Sanction-heavy regimes are also problematic because they provide the public with less reliable information about emerging problems or evolving forms of wrongdoing. With fewer enforcement agents on the ground, the government necessarily collects less information—including less data about how its own enforcement agencies are performing. Less information, in turn, leads to less effective detection and prosecution techniques. Note that this information vacuum also affects potential offenders. When enforcement levels are low, offenders are likely to make greater mistakes calculating their overall likelihood and costs of punishment.

It is important to note that the foregoing problems exist, *regardless* of whether individuals employ consistent or inconsistent discount rates. The discount rate simply tells us the rate at which future expected utility (or expected *dis*utility) declines. Some individuals employ high rates, and are said to be present-oriented, myopic or to display low self-control. Others employ much lower rates, valuing later benefits (and later disutility) much more than their myopic counterparts.[30]

---

[29] On the costs of adjudicative error, see generally Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994). For a discussion of administrative and error costs that arise within contextual corporate crime regimes, see Vikramaditya Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1244–46 (2003).

[30] "[M]any criminologists have stressed poor self-control or willpower problems as a key individual variable associated with crime. This claim could result either from time inconsistency of the sort explored here or from internally consistent but unusually high discount rates." Richard McAdams, *Present Bias and Criminal Law*, 2011 U. ILL. L.

Putting aside time-inconsistency, it is doubtful that individuals across a large population employ the same discount rates. Some people are patient and wait their turn, whereas others grab what they want and act on impulse. Even without the TI-related complication, this heterogeneity poses tremendous challenges for our regulator. First, the regulator may err and choose a sanction with the wrong discount rate in mind. The implications of such error grow if the regulator resides in a high sanction/low enforcement regime.[31] Accordingly, regulators should choose less than maximal sanctions when they are unsure of the relevant population's discount rate.

By contrast, a regime that focuses more intently on enforcement and keeps sanctions relatively low can gradually identify and calibrate its enforcement efforts towards the group of individuals that are presumed to maintain the highest discount rates.[32] As time passes and enforcers receive additional information, an enforcement-heavy regime may do a better job of identifying and responding to high-discount rate individuals than a regime that stresses sanctions over enforcement.

I could go on, but the foregoing provides a clear enough picture: there exist numerous reasons for regulators to invest resources in those factors that increase the probability of detection and punishment, and not to rely exclusively on high sanctions as a method of deterring misconduct. To this mix, Utset has added the theory that individuals maintain inconsistent discount rates relative to a single point in time. The theory is both plausible and intuitive, and Utset's survey of empirical evidence is quite convincing.[33] But there are numerous other behavioral and economic factors that justify an emphasis on enforcement and not exclusively

---

REV. 1607, 1609 (2011) (distinguishing time-inconsistent individuals from those possessing internally consistent, but abnormally high, discount rates).

[31] *See* Miriam H. Baer, *Linkage and the Deterrence of Corporate Fraud*, 94 VA. L. REV. 1295, 1306-07 & n.39 (2009), *citing* Lucian Arye Bebchuk & Louis Kaplow, *Optimal Sanctions When Individuals Are Imperfectly Informed About the Probability of Apprehension*, 21 J. LEG. STUD. 365, 366-67 (1992).

[32] I have referred to this concept, in previous work, as calibrated policing. *See* Baer, *Evaluating*, *supra* note 26, at 14 (explaining concept of calibrated policing and arguing that it is likely more efficient than calibrated punishment).

[33] Utset, *supra* note 1, at 11-13.

sanctions. TI theory does not explain this emphasis, but it does join the many arguments in favor of it.

II. SANCTION-BASED ENFORCEMENT OR STRUCTURAL INTERVENTION?

Having decided that emphasizing sanctions is insufficient to deter wrongdoing, our regulator now faces a new choice: What type of enforcement mechanisms should she promulgate? Should she allocate increased resources to government enforcers, who can then more ably police corporate firms? Or, should she mandate so-called structural interventions? If so, what might those interventions look like? I explore these issues below.

A. SANCTION-BASED ENFORCEMENT

The standard regime that regulators invoke in response to misconduct is what I refer to as a "sanction-based" enforcement regime. This is the type of regime in which the state enacts a law or regulation forbidding certain conduct, imposes sanctions for transgressing the law or regulation, and backs up the sanctions through public enforcement efforts. From this perspective, a law that tells corporate officers not to engage in fraud is not terribly different from a law that commands motorists not to speed on a highway.[34]

Sanction-based enforcement regimes can deter TI behavior by increasing the up-front costs of undesirable behavior. Substantial investments in enforcement—provided those investments make enforcement more "salient" in earlier periods—can vastly increase the likelihood, severity and swiftness of a sanction, all of which increase deterrence for both TI individuals and other criminals who happen to

---

[34] Professor Edward Cheng summarizes this approach: "The legislature issues a command prohibiting the undesired conduct, and if these commands are violated, the state pursues, prosecutes and punishes the offender. Other citizens are subsequently deterred, and the legislature succeeds in addressing the problem." Edward Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 656 (2006).

harbor high discount rates or are simply opportunistic.[35] Similarly, broad definitions of misconduct, as well as liability for attempts and mere scheming, also increase the up-front costs of misconduct because they increase the putative offender's immediate risks.[36]

Utset's Article discusses at length sanction-based enforcement regimes, which increase the costs of misconduct immediately after the misconduct occurs or which delay immediate benefits to later time periods.[37] We might think of this as "targeted" enforcement. Many of the criminal or quasi-criminal provisions of the Sarbanes-Oxley Act of 2002 that Utset praises appear to fall within the targeted sanctions category. As Utset points out, SOX's various criminal and reporting provisions increase the costs of misconduct by making it more likely that others will object to, or report, a corporate officer's fraud or misrepresentation.[38] Moreover, because the offender is likely to encounter objecting employees far earlier in time than external enforcement agents, SOX succeeds in accelerating the costs of misconduct back in time, to the moment when a corporate officer or employee is particularly likely to fall to temptation.

Although targeted sanctions do, as Utset observes, improve deterrence, they also carry serious drawbacks. Enforcement is itself expensive, and investments in enforcement may be distorted by political factors, such as an enforcement agency's political clout with legislators. Enforcement is also difficult; it is far from obvious that the internal controls envisioned by SOX can counteract much of the rationalization and cognitive dissonance that arises in corporate settings, when officers and employees slide, almost imperceptibly, from aggressive behavior into downright illegal misconduct.[39]

---

[35] Utset, *supra* note 1, at 38-40.

[36] McAdams, *supra* note 30, at 1617–18. McAdams points out that these enforcement-based moves affect present-biased offenders by immediately increasing their risks of arrest. *Id.* at 1618.

[37] Utset, *supra* note 1, at 38-41.

[38] *Id.* at 53-54.

[39] On the limitations of internal controls, see Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism and Other Ills*, 29 J. CORP. L. 267 (2004).

Consider SOX. Portions of the Act adopt a standard enforcement approach; they increase the probability of punishment for corporate officers who mislead the market. The Act creates criminal liability for those who retaliate against corporate whistleblowers, expands the obstruction of justice statute to include interference with audits and investigations, requires CEO's and CFO's to certify the truthfulness of their companies' financial statements, and subjects them to criminal liability for certifying such claims falsely.[40] These are what one might refer to as the "external" enforcement provisions of the Act. Other parts of the Act encourage the growth of "internal" corporate policing, such as Sections 302 and 404, which require the corporation to affirm and establish a system of internal controls for learning and reporting material financial information.[41]

From these multiple provisions, one can divine two legislative goals. The first is to signal to corporate officers the government's willingness to devote substantially greater resources to the apprehension and punishment of those who engaged in false or misleading financial reporting. The second, which is more controversial, is to force corporate firms to internalize the costs of enforcement by improving their own internal monitoring and policing networks.[42] However reasonable the two goals may be in theory, both impose substantial costs.[43]

Policing is not an unconditional good. It can, depending on how it is implemented, create additional unintended problems for the corporation's shareholders and society. It can endow a group of persons within the corporation the power to demand resources that are not

---

[40] *See, e.g.*, Lisa Kern Griffin, *Compelled Cooperation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 331–32 (2007) (summarizing various provisions that expand criminal liability in connection with corporate reporting).

[41] *See generally* Robert Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703, 705–06 (2007) (defending and explaining Act's emphasis on internal controls).

[42] *See* Miriam H. Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949 (2009) [hereinafter Baer, *Governing*].

[43] For an evenhanded discussion of SOX's costs and benefits, as well as the importance of how it is perceived by regulators and regulated entities alike, *see* Donald Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 MICH. L. REV. 1817 (2007).

necessarily justified by rational cost-benefit accounting.[44] It can cause corporate employees to put a "price" on good behavior that previously did not exist, and which may exceed the bounty the government is willing to pay.[45] It can reduce employees' intuitive inclinations to comply by triggering more adversarial relations between the corporation and its employees.[46] And, as recently demonstrated, it can cause corporate directors to focus excess energy on finding so-called "bad actors" or evidence of intentional wrongdoing, and ignore more long-term but equally vexatious problems, such as failing business operations or increased exposure to systemic risks.[47]

Aside from the foregoing problems, corporate policing suffers from a more fundamental problem, which Utset's discussion of temporal inconsistency brings into focus. Policing—at least the overt, "in your face" variety—may cause divergent reactions among individuals who display *intrapersonal* conflict between their long and short term selves, and

---

[44] An entire industry of compliance consultants and attorneys has flourished in the wake of SOX's enactment. *See* Baer, *Governing*, *supra* note 42, at 993–99 (discussing growth of compliance industry); Donald Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 965–68 (2006) (explaining how push for internal controls benefits certain actors, such as attorneys, consultants and accountants).

[45] For example, Yuval Feldman and Orly Lobel found, through experimental testing, that where informants lacked a "moral imperative" to report wrongdoing, the state's offer of a low reward triggered less reporting than alternate approaches. Yuval Feldman & Orly Lobel, *The Incentives Matrix: The Comparative Effectiveness of Rewards, Liabilities, Duties and Protections for Reporting Illegality*, 88 TEX. L. REV. 1151, 1155 (2010).

[46] *See* Baer, *Governing*, *supra* note 42, at 985–90.

[47] *See* Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture and Ethics of Financial Risk-Taking*, 96 CORNELL L. REV. 1209, 1214 (2011) [hereinafter Langevoort, *Chasing*] (arguing that corporate gatekeepers and monitors must watch for more than "visible signs of disloyalty" and that "hard work, intensity, optimism, and enthusiasm can sometimes be the source of the trouble").

individuals who consistently favor themselves over those whose interests they purport to serve.[48]

Much of corporate law focuses on the reduction of interpersonal conflicts, which are generically known as agency costs.[49] Utset's primary contribution to the deterrence literature is to demonstrate that corporate policymakers must also take into account *intra*personal conflicts. As Utset perceptively notes, however, the two dispositions can sometimes combine in ways that benefit society.[50] For example, some opportunists ironically may be deterred by their own need for instant gratification, and therefore forego criminal conduct that requires an upfront investment in time and patience.[51]

Time inconsistency, however, is hardly a solution for opportunism and agency costs. *Some* percentage of opportunists will be cunning, patient, and *rational* enough to choose a long-term plan of misconduct and stick to it. Just as it may be folly to ignore TI-related misconduct, so too is it folly to ignore rank opportunism.

At this moment, a well-intentioned regulator comes to an important fork in the road. Should she worry more about the initially well-meaning, "spur of the moment" fraudster or the rank opportunist? Which group poses a greater danger to corporate firms and their shareholders?

We might consider TI-individuals less dangerous than rank opportunists. One of the most important implications of Utset's distillation of TI theory is that time-inconsistent individuals may initially harbor long-term socially desirable goals. In other words, the TI corporate officer at T_0 may well desire the same long-term outcomes as shareholders and the

---

[48] For the sake of this Comment, I am treating these two populations as if they are completely separate. In a forthcoming article, *Confronting the Two Faces of Corporate Fraud*, I offer an extended account of how opportunism and temporal inconsistency might interact and shape the corporation's employee population. *See* Baer, *supra* note 12.

[49] *See, e.g.*, STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 73 (2008).

[50] Utset, *supra* note 1, at 8.

[51] *Id.*

general public.[52] It is only at some later, unexpected point in time that the TI officer loses his resolve to comply with the law, and succumbs to the temptation to engage in socially undesirable behavior.[53]

By contrast, a time-consistent opportunist simply enjoys his own personal welfare to the exclusion of everyone else's – *and he knows it.* This self-knowledge and self-control, in turn, renders the rank opportunist more dangerous because he can more effectively cover up any evidence that he has done anything wrong.[54]

Notice, then, the problem for our regulator: Requirements that corporate firms create compliance departments, screen and educate their employees, and improve internal auditing of financial statements, primarily improve *overt* enforcement efforts. Such enforcement may deflect the sudden, TI-related temptation to substitute misconduct for law-abiding conduct when performance falls short of previously set metrics.[55] Overt enforcement, however, will be far less effective in eliminating sophisticated, intentional scheming. Instead, overt enforcement may cause opportunists to (a) cast about for equally harmful substitutes,[56] and (b)

---

[52] For the sake of simplicity, I am admittedly assuming that shareholders and the general public harbor the same socially desirable goals.

[53] *See generally* Utset, *supra* note 1. Utset concedes that some TI individuals may harbor socially undesirable goals at T_0. Indeed, he creatively demonstrates that TI increases societal welfare by causing the TI opportunist to abandon her planned wrongdoing because it does not accord her sufficient immediate gratification. For a different, but in many respects similar account of how corporate employees may slide into fraudulent conduct, *see generally*, Sung Hui Kim, *The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983 (2005) (explaining how a person's situational factors may encourage and permit the person to engage in wrongdoing such as fraud).

[54] For a similar type of analysis, see Shavell's explanation for imposing more serious criminal penalties on intentional misconduct. *See* Shavell, *Criminal Law*, supra note 28, at 1248 ("[I]ntent may be linked to the probability that a party will escape a sanction, since a party who intends to commit a harmful act is more likely to choose a particular place and time to avoid identification and arrest, or to take steps thereafter to do so.").

[55] *See* Utset, *supra* note 1, at 26.

[56] On the potential for substitutes, see Neal Kumar Katyal, *Deterrence's Difficulty*, 95 MICH. L. REV. 2385, 2391 (1997) (exploring how enforcement of

take greater care to avoid detection.[57] To use a simpler analogy, when drivers see a police officer's car on a highway, they slow down for a temporary stretch of time, but they do not necessarily abandon all speeding. To the contrary, the worst and most knowledgeable offenders simply find other roads on which to drive (and speed).

To counteract this problem, a regulator might therefore choose *covert* enforcement methods. When covert enforcement (including undercover stings and wiretapping operations) is well known and advertised, it creates a number of problems for offenders, who must screen their compatriots more carefully, look over their shoulder more often, and view potential clients with more suspicion.[58]

Covert enforcement, however, creates *other* costs, such as lost transparency, the potential for government corruption, reduced trust between government actors and private citizens, and worrisome violations of privacy.[59] Moreover, covert enforcement also poses an interesting problem for the group that is the focus of Utset's inquiry. Because it is conducted secretly, covert enforcement may be less effective in steering extremely "naïve" TI individuals away from temptations to commit fraud. And for the naïve TI individual, out of sight is largely out of mind. Accordingly, the regulator who conducts covert enforcement is not likely

---

trafficking in one narcotic may cause criminals to choose to traffic in a different narcotic); Samuel Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. 611, 612–613 (2011) (observing that the enactment of a law intended to forbid conduct "can defeat itself by causing people to develop new behaviors designed to avoid its force").

[57] Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331 (2006).

[58] Indeed, Richard McAdams cites these up-front costs favorably because they impose an immediate cost—the increased threat of detection—on time-inconsistent criminals. McAdams, *supra* note 30, at 1619–20. McAdams does not consider, however, the relative *salience* of threats posed by covert as opposed to overt policing. Although covert policing can become salient (following the announcement of multiple arrests at the conclusion of a complex sting), it may eventually recede into the background and thereby fail to deter those time-inconsistent offenders who possess short memories.

[59] *See* Alexandra Natapoff, *Snitching: The Institutional and Communal Consequences*, 73 U. CIN. L. REV. 645 (2004).

to figure prominently in the TI actor's decision-making process, unless the fact of such covert enforcement is particularly salient and well known.[60]

This leaves our well-intentioned regulator with an ugly choice: Rely primarily on overt enforcement, and leave untouched those intentional opportunists who find ways to cover up their behavior, or rely primarily on covert enforcement efforts, and reduce deterrence among naïve TI individuals. Perhaps in some contexts the choice is straightforward. In others, the regulator may seek other alternatives, one of which I discuss below.

B. STRUCTURAL REGULATION

Apart from sanction-based enforcement, public actors can reduce temporally inconsistent decision-making by mandating changes in how the corporation governs itself. In other words, instead of punishing or threatening to swiftly punish someone for engaging in misconduct, the regulator can design a structure at T_0 that all but removes a corporate manager's freedom to bow to such temptation at T_1. For the purposes of this Comment, I refer to these interventions collectively as "structural regulation."[61]

The preference for structural regulation over sanction-based enforcement has been discussed in a number of fields, ranging from traffic control to taxation.[62] Rather than punish an individual for making the "wrong" choice, such as speeding or failing to pay one's taxes, the regulator creates certain structural rules that limit the individual's range of choices in the first place.[63]

---

[60] By contrast, a more sophisticated TI-actor might respond to the possibility of covert enforcement by avoiding wrongdoing. *See* McAdams, *supra* note 30, at 1620.

[61] *See generally* Cheng, *supra* note 34; Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007) (exploring the value of structural laws in procuring increased tax compliance).

[62] *See, e.g.*, Cheng, *supra* note 34; Lederman, *supra* note 61.

[63] "Structural laws establish mechanisms or procedures that push citizens toward compliance by making the undesirable behavior less profitable or more troublesome." Cheng, *supra* note 34, at 657.

Structural regulation bears much resemblance to the vaunted pre-commitment devices that TI theorists (including Utset) often praise.[64] The key distinction between pre-commitment and structural devices is the creator of the device. Public actors promulgate and design structural regulation, whereas private actors often create and bind themselves through pre-commitment devices. Then again, perhaps the distinction is not so strong. As Utset observes (quite favorably), public regulators can promote and devise "off the rack" commitment devices, which private actors (or firms) then adopt.[65]

The distinction between commitment devices (which private actors often adopt) and structural regulation (which public actors mandate) bears significant importance for political purposes. As a society, we are far more willing to accept our own limitations on decision-making than those limitations that government actors impose on us. Accordingly, it seems unlikely that TI individuals will be "indifferent" as to the source of the limitations on their decision-making abilities. When possible, they will favor their own commitment devices over government-mandated regulation, even when regulation provides better outcomes over the long run.

Structural approaches are far from perfect. Public actors who devise and promulgate structures are human and prone to error. Indeed, they may suffer the same TI-related maladies that the rest of the populace suffers. For example, public actors may choose structures that sound pleasing and gather quick political support, but fail to attack TI-related harms over the long run. Moreover, they may choose structures that eliminate TI in one instance, but create other unintended, long-term and costly problems in others.

---

[64] *See, e.g.*, Steven Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 4-5 (2003) (describing four varieties of pre-commitment strategies); John Robertson, *Paying the Alligator: Precommitment in Law, Bioethics and Constitutions,* 81 TEX. L. REV. 1729 (2002) (identifying pre-commitment devices across various contexts); JON ELSTER, ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS (2000) (analyzing arguments in favor of pre-commitment devices, including those retained across generations).

[65] Utset, *supra* note 1, at 61-63.

As the foregoing discussion demonstrates, "structure" in theory is more easily embraced than "structure" on the ground. Thus, the regulator who prefers structural strategies must give some thought to the "who" and "how" aspects of structural reform. Should public institutions *mandate* structural reforms for all or some category of corporate firms? Should the same institutions coax the emergence of such reform through a quasi-public cooperative regime? Or should the public institution leave structural reform to the private markets, intervening only when necessary to shore up information asymmetries or ensure robust competition? I take up this next set of questions below.

III. PUBLIC INTERVENTION OR PRIVATE ORDERING, OR SOMETHING ELSE?

It is one thing to say that structural devices can reduce time-inconsistent decision-making within corporate firms. It is quite another proposition to say that *the government* should mandate or even encourage those devices. Accordingly, in this section, I consider the next choice that most regulators would likely confront: public intervention or private ordering?

Utset suggests that the TI individual who seeks a "fix" for his inconsistency will be indifferent as to its source.[66] But as citizens, we are not indifferent to whether improvements in corporate governance emanate from public or private quarters. To the contrary, one of *the* major debates in corporate law scholarship is the extent to which public law ought to dictate governance relationships within the firm, or instead leave the negotiation of such relationships to a well-functioning private market.[67] Related to this inquiry is the question of how much the federal government ought to interfere in what was previously believed to be the state-province

---

[66] Utset, *supra* note 1, at 62.

[67] *See, e.g.*, William Bratton, *Unentrapped*, 77 GEO. WASH. L. REV. 677, 680 (2009) (listing private ordering versus regulation as one of the three major debates in corporate law).

of corporate governance. It is no accident, for example, that Congress enacted the two major statutes upon which Utset rests much of his focus.[68]

Finally, the time-consistency's prevalence—inside and outside of corporate firms—demands a theoretical basis on which one can justify public mandates and sanctions. Lots of people procrastinate and overeat, but they usually do not go to jail or pay fines for their costly behavior. If Utset seeks solutions that benefit society and reduce the incidence of corporate misconduct, then his TI theory is incomplete without a further consideration of who is best positioned to create the devices most likely to curtail TI-related problems.[69]

A. MARKETS AND PRIVATE ORDERING

In many instances, markets and private ordering should reduce the threat of time-inconsistent behavior. We all procrastinate commencing and finishing time-consuming projects, and many of us eat and drink too much and spend too much time in front of the computer or television when we could be doing something more productive with our time. But a number of entrepreneurs have created and marketed devices to cure us of these various habits. We can purchase gym memberships to commit ourselves to exercising; enter retail layaway programs to enforce household savings;

---

[68] "Federal law has long regulated discrete aspects of corporate governance, but regulating a firm's internal affairs—the relationship among its shareholders, directors, and officers—has traditionally been left to the states. That separation is eroding. New laws, principally at the federal level, directly regulate director and officer conduct—moving beyond the "enabling" feature of state corporate statutes to draw bright-line rules around corporate conduct that encroach on substantive areas traditionally beyond federal reach." Charles Whitehead, *Why Not CEO Term Limits?*, 91 B.U. L. REV. 1263, 1270 (2011) [hereinafter Whitehead, *Why Not?*]; *see also* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859 (2003); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591–92 (2003).

[69] This question might not be relevant if Utset premised his argument on a *retributive* theory of TI-related misconduct. Were Utset to argue, for example, that TI-related conduct is *wrongful* and therefore *deserving* of some form of condemnation or similar intervention by the state, then we could ignore the claim that markets and private ordering do a fairly good job of disciplining temporal inconsistency.

and agree to certain compensation deferral terms in order to demonstrate our long-term commitment to our employers.

In the corporate arena, markets can efficiently match TI-consumers with commitment device entrepreneurs.[70] The private ordering inherent in markets enables individuals and businesses to choose the pre-commitment devices that best fit their individual circumstances and attributes.[71] Moreover, it allows corporations and shareholders to test different types of devices, embracing the ones that improve corporate governance and backing away from the ones that do not.

Apart from private ordering, strongly competitive markets discipline TI-related misconduct by imposing swift and harsh sanctions on procrastination and over-consumption.[72] Simply put, the knowledge that someone else will take our place if we falter forces us to work harder and longer, and forces us to subdue our TI inclinations.

Movie stars are remarkably disciplined about their weight because they know excess pounds will cause the pool of available roles to dry up. Employees with at-will contracts know that if they fail to show up to work too many times, they may be swiftly terminated. A strong competitive market forces its participants to reign in their TI tendencies.

Despite the foregoing, markets do not drive out all TI related harms. Markets cannot discipline poor decision-making when market

---

[70] On the efficient coordination characteristics of markets, see generally THOMAS SCHELLING, MICROMOTIVES AND MACROBEHAVIOR 23 (W.W. Norton, 2006) (arguing that the market "does remarkably well in coordinating or harmonizing or integrating the efforts of myriads of self-serving individuals and organizations").

[71] On the benefits of private ordering generally, see D. Gordon Smith, Matthew Wright & Marcus Hai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORDHAM L. REV. 125, 128 (2011) (explaining that private ordering flows from the insight that "different firms have different attributes that require different governance structures"). The authors further argue that private ordering can improve corporate governance by enabling "each corporation to become a laboratory of corporate governance, experimenting with different models of shareholder participation and ultimately producing a diversity of governance forms and practices." *Id.* at 174.

[72] *See* Isabelle Brocas & Juan Carillo, *Rush and Procrastination Under Hyperbolic Discounting and Interdependent Activities*, 22 J. RISK & UNCERTAINTY 141 (2001) (providing a theoretical model demonstrating that competition reduces TI-related behavior).

participants have the ability to hide bad outcomes from the rest of the marketplace. Excess weight, unproductiveness and workplace absenteeism are relatively transparent; it is no surprise that competitive markets respond relatively quickly to these problems. Evidence of bad decision-making in other contexts, however, may be more difficult to detect. This is particularly likely when: (a) the decision in question involves a fair amount of discretion and (b) the decision-making takes place within a complex organization, whose operations may be opaque to outsiders.

The standard solution for this type of problem is the implementation of mandatory disclosure rules, along with sanctions that strengthen compliance with such rules.[73] Disclosure reduces information asymmetries, encourages market participation by consumers and investors, and enables investors to discipline poorly performing corporate managers.[74]

Other problems hamper market discipline. For example, a brisk market for corporate control ought to discipline managerial procrastination and overconsumption. If managers make enough bad decisions,

---

[73] Securities disclosure provides other related benefits, including "a more efficient allocation of resources in the economy as a result of improved corporate governance, increased capital market liquidity and the consequent reduction in the cost of capital, and the reduction in resources used by secondary market investors to gain advantages over each other in a race to discover information already known by issuers but unannounced." Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 252 (2009). Fox presumes that disclosure rules will be buttressed by penalties for nondisclosure and false disclosure. *Id.* at 273; *see also* Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U. L. REV. 1089, 1092 (2007).

[74] *See generally* Fox, *supra* note 73, at 255–59 (explaining how disclosure enables shareholders to cast informed votes for directors, bring lawsuits where fiduciary duties appear to have been breached, or to sell stock). Nevertheless, disclosure is not an unqualified good. Excessively costly disclosure rules will force some firms out of the market, which in turn will reduce competition and leave the field to larger (and more opaque) firms. *See, e.g.*, Jonathan Macey, *Public & Private Ordering and the Production of Legitimate and Illegitimate Legal Rules*, 82 CORNELL L. REV. 1123, 1135–36 (1997) (explaining how introduction of SEC disclosure rules caused smaller unlisted firms to bow out of capital markets, leaving field to larger firms that were already subject to disclosure requirements due to their listing on the New York Stock Exchange).

shareholders ought to sell their stock.[75] A low stock price, in turn, offers more enterprising managers the opportunity to purchase the company and extract more value.

Public lobbying by corporate managers, however, has reduced the effectiveness of the market for corporate control by making hostile corporate takeover contests more expensive and less likely.[76] This in turn reduces the beneficial effect of competition on TI-prone officers and directors.

By the same token, the cost of proxy contests and the difficulty of placing a dissident's name on the corporate proxy reduce competition for corporate director seats.[77] Officers maintain their position and their compensation, even when performance is sub-par.[78] Directors too maintain their positions, even when their oversight is weak.[79] The fault is not the market *per se*, but a number of laws that weaken shareholder and market-based discipline.

---

[75] Whereas disclosure's strongest proponents envision it as a means towards reducing the agency costs of opportunism and *inter*personal conflict (managers favor themselves over shareholders), the time-inconsistency literature demonstrates that it also reduces the costs created by *intra*personal conflict (managers fail to adhere to the socially desirable goals they previously set).

[76] JONTHAN MACEY, CORPORATE GOVERNANCE, PROMISES KEPT, PROMISES BROKEN 122–26 (2008).

[77] *See, e.g.*, Lisa Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 157–58 (2010) (explaining how incumbents' access to corporate proxy creates difficulty for shareholders to successfully nominate dissidents and challenge board seats).

[78] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE PAY (2004).

[79] "By making it easier for shareholders to replace directors, proxy access can contribute to making directors more accountable to shareholders and more attentive to their interests." Lucian Bebchuk, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 337 (criticizing current "no access" default rule for dissident shareholders who seek to challenge incumbent directors and citing empirical evidence that proxy fights and improved competition for director seats improve shareholder value).

Finally, markets may fail when market participants ignore and misjudge relevant information.[80] This was likely the case in the lead-up to the mortgage securities slump that triggered the 2008 financial crisis and ensuing recession.[81] As Michael Lewis's popular book, *The Big Short*, nicely depicts, a fair amount of publicly available information suggested—indeed established—the precarious nature of mortgage-backed securities.[82] The investors who star in Lewis's story all reached the conclusion that mortgage lenders had abandoned prudent lending practices[83] and that the various tranches of mortgage securities would become worthless as soon as real estate appreciation ceased and teaser rates on subprime mortgages reset to much higher rates, triggering defaults.[84] Nevertheless, these few individuals were sheer outliers, if not social outcasts in the social financial

---

[80] "Intervention in financial markets rests in large part on the assumption that investors—either due to hubris, cognitive bias or "irrational exuberance"—are naturally inclined to take on unwarranted investment risks, especially in economically prosperous times." Chris Brummer, *How International Law Works (And How it Doesn't)*, 99 GEO. L.J. 257, 268 (2011).

[81] *See, e.g.*, Langevoort, *Chasing*, *supra* note 47, at 1210. Steven Schwartz, *Understanding the Subprime Financial Crisis*, 60 S.C. L. REV. 549 (2011) ("[T]he making and monetization of subprime mortgages was not per se evil"). The alternate view of the crisis is that financial managers purposely hid information or at least failed to make the information "salient" to investors and corporate gatekeepers. *See* Langevoort, *Chasing*, *supra* note 47, at 1210–11; Frank Partnoy, *Don't Blink*, 77 BROOKLYN L. REV. 151 (2011) (criticizing financial institutions for failing to provide risk related information in a more salient manner).

[82] "The catastrophe was foreseeable, yet only a handful noticed." MICHAEL LEWIS, THE BIG SHORT 105 (2009).

[83] *Id.* at 26-28 (describing one hedge fund manager's detailed analysis of the securities and their underlying mortgages). Market failure may also partially explain why lenders entered increasingly complex mortgage contracts with purchasers who lacked sufficient income to pay: "In many cases borrowers were not reckless; they were imperfectly rational. In many cases lenders were not evil; they were simply responding to a demand for financing driven by borrowers' imperfect rationality." Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1075 (2009).

[84] *LEWIS*, *supra* note 82, at 30, 47. "The catastrophe was foreseeable, yet only a handful noticed." *Id.* at 105.

culture Lewis describes.[85] The rest of the market not only invested in worthless mortgages, but also sold credit default swaps,[86] guaranteeing the very financial institutions whose books would come to be filled with so much dreck. As *The Big Short* and other contemporaneous accounts demonstrate, much of the conduct that created systemic risk and produced catastrophic loss was fueled not by outright deception, but instead by some noxious mix of herd behavior, over-optimism, loss aversion, moral hazard, and yes, time-inconsistent behavior.[87]

The internal policing reforms outlined in SOX do not—and cannot—address these aforementioned behavioral issues.[88] For the above

---

[85] One of the investors profiled in Lewis's book diagnoses himself with Asperger's syndrome. *Id.* at 181. A second was infamous for his lack of social skills. *Id.* at 4. And a third triggered his mother's suggestion that he start taking Lithium when he predicted a global financial meltdown. *Id.* at 160. Langevoort poses a similar question: "We know that some investors bet aggressively on a coming crisis. They estimated correctly, so why did so many buyers trust the salespeople? Plenty of academics and journalists, moreover, warned about the subprime risk beginning early in the decade." Langevoort, *Chasing*, *supra* note 47, at 1211 (raising doubts that "sellers" systematically exploited information asymmetries to defraud "buyers" of subprime mortgage risk).

[86] "AIGFP's decision to enter the CDS market was based, in part, on computer simulations that indicated there was a 99.85% chance it would never be obligated to make a CDS payment." Whitehead, *Why Not?*, *supra* note 68, at 32; *see also* William Sojstrom, *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 958 (2009) (observing AIG's Financial Products unit may have been attracted to the credit default swap business because it superficially resembled its "casualty insurance business, a business in which it had been profitably engaging for years").

[87] "What shocked [hedge fund manager Steve] Eisman was that none of the people he met [at an investing conference] in Las Vegas seemed to have wrestled with anything. They were doing what they were doing without thinking very much about it." LEWIS, *supra* note 82, at 158. Steven Schwarcz has written several articles carefully analyzing the crisis and summarizing its causes into three general categories: "conflicts, complacency and complexity." *See* Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109 (explaining limitations of disclosure for complex products); Steven L. Schwarcz, *Markets, Systemic Risk, and the Subprime Mortgage Crisis*, 61 SMU L. REV. 209 (2008); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008).

[88] The exception may be SOX's internal controls requirement, although the types of controls necessary to identify and address legal noncompliance may differ from the types of controls necessary to identify and address excessive risk-taking. *Cf.* Steven

form of market failure, where most of the players fail to judge risks appropriately and create systemic risks that threaten the country's financial health, a different type of public intervention is necessary; it must go beyond the type of disclosure-oriented regulation that has, until now, characterized much of securities regulation. Given the risks that financial market failure poses—illiquidity and total market meltdown—we should expect financial regulation to feature a lot more structure and a lot less reliance on private markets, or for that matter, private policing.

B. MANDATORY STRUCTURES

Let us assume that at some point, a regulator concludes private ordering and markets are insufficient protection against TI-related misconduct. Our regulator might then ask, "how should I promulgate these rules or structures? Should I make them mandatory or offer institutions some choice or role in designing how these structures will function?"

A mandatory structure is one that leaves actors no choice but to adhere to it. A requirement that forces banks to set aside prescribed reserves, thereby reducing the risk of insolvency, is such a structure, as is a requirement that limits an institution's ability to trade on its own accounts.[89] The Dodd-Frank Act contains these types of structures, which are intended to protect against systemic meltdowns created in part by TI-related mistakes.[90]

Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967 (2009) (arguing the difference between legal compliance and enterprise risk management is one of degree).

[89] *See generally* John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 & n.3 (2011) (describing new oversight regulations and capital adequacy requirements); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 15–16 (2010). On proprietary trading, *see* Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349, 1382 (2011) (discussing limitation on trading by banks on their own accounts).

[90] *See generally*, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 1854 PLI/Corp 15 (2010) (Providing a 124-page summary of the Act).

Also embedded in Dodd-Frank are a number of corporate governance provisions, whose efficacy has been highly contested.[91] Nevertheless, one still can divine some value in the provisions insofar as TI-related misconduct is concerned. For example, Dodd-Frank's "say on pay" provision requires public corporations to submit to their shareholders a non-binding vote on the corporate officers' compensation.[92] By forcing directors to face a periodic vote on employee compensation—even a non-binding vote—the statute forces directors to confront officer non-performance when they might otherwise procrastinate doing so.[93]

Despite these modest benefits, I am less certain that temporal inconsistency can justify the various mandatory provisions contained in statutes as broad as SOX and Dodd-Frank. Some have argued that concerns fueling SOX's were overstated, and there exists at least one study indicating that corporate governance was not a cause of the 2008 financial crisis.[94]

More generally, large behemoth statutes would not appear to be the optimal vehicles for devising efficient structural solutions for TI-related misconduct. Governance is a tricky issue and temptations to shirk and over-consume may differ depending on the situation. Accordingly, some temptation-reducing structures promulgated by legislators and regulators may be unnecessary or overly costly, at least in regards to some firms.[95]

---

[91] *See, e.g.*, Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779 (2011).

[92] Although the vote is nonbinding, I characterize the say-on-pay rule as "mandatory" because the law forces public corporations to solicit their shareholders' voice on compensation matters.

[93] For a discussion of say-on-pay and Dodd-Frank's additional compensation-related disclosure obligations, see Roger Coffin, *A Responsibility to Speak: Citizens United, Corporate Governance and Managing Risks*, 8 HASTINGS BUS. L.J. 103, 116–17 (2012).

[94] *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, 1 (2009). On skepticism regarding the need for Sarbanes-Oxley, *see* Romano, *Regulating*, *supra* note 14, at 8; Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77 (2003).

[95] Many critics of SOX contended that its internal controls requirements imposed excessive costs on smaller public companies. For a summary of empirically-

Moreover, it is difficult to place faith in political actors who promulgate massive structures when those actors are themselves temporally inconsistent- and politically motivated.[96] Some regulators may adopt structures, not because they work, but because they please the public or special interest groups. Once in place, these structures may be difficult to remove. Path dependence, the political costs of overturning regulation, and the general preference for the status quo all may contribute to the cementing of structures that fail to cure TI behavior *and* impose various costs on corporate entities. At the very least, this ought to be cause for caution.

C. EXPERIMENTAL REGULATION

Prior to the financial meltdown, one of the more interesting developments in regulatory theory and practice was the move towards smarter, more responsive regulation.[97] This movement, collectively labeled "New Governance" in academic circles, recognized that regulators and private entities could collectively gain from sharing information and adjusting regulatory rules and penalties in response to that information over time.[98] The new regulatory approach reflected the insight that it is cheaper to persuade than it is to punish.[99] Accordingly, New Governance

---

based criticisms of SOX, *see* Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. REG. 229, 239–51 (2009).

[96] Steven Davidoff and David Zaring's account of the financial bailout as "regulation by deal" could just as easily be an example of regulation driven by the need for short-term results. *See* Steven Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

[97] *See, e.g.*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION (1992)

[98] For an overview and explanation of New Governance theory and regulatory approaches, *see* Jason Solomon, Book Review, *Law and Governance in the 21st Century Regulatory State*, 86 TEX. L. REV. 819 (2008) (book review); Michael C Dorf & Charles Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004).

[99] AYRES & BRAITHWAITE, *supra* note 97, at 26 (observing that "punishment is expensive; persuasion is cheap").

theorists called for private and public actors to join forces in finding mutually agreeable solutions and to step away from more adversarial, lawyer-heavy approaches to ongoing problems.[100] The New Governance approach promised to be more effective, more flexible and even more democratic, insofar as it permitted stakeholders and community members a place at some idealized continuous negotiating table.[101]

During the same time period, behavioral law and economics scholars demonstrated the importance of physical and intellectual architecture.[102] The placement of a statement on a form (in bold or regular font), the order in which one encounters dessert or fruit (or heaven forefend, vegetables) in a cafeteria, or the structure of the tax code, are all examples of how a public official can encourage or discourage private decision-making by individuals or business entities. For choice architecture proponents, the government's subtle alteration of private choices was largely cause for celebration and not concern. Left to their

---

[100] Under the rubric "experimentalism," Professors Sabel and Simon summarize New Governance's key tenets:

> In experimentalist regimes, central institutions give autonomy to local ones to pursue generally declared goals. The center then monitors local performance, pools information in disciplined comparisons, and creates pressures and opportunities for continuous improvement at all levels. The regimes' distinctive mechanisms for achieving both learning and coordination emphasize deliberative engagement among officials and stakeholders.

Charles F. Sabel and William H. Simon, *Minimalism and Experimentalism in the Administrative State,* 100 GEO. L.J. 53, 55 (2011).

[101] "The central tenet of new governance literature posits that traditional command-and-control, top-down regulation has been supplanted, to varying degrees, by new forms of collaborative and polycentric governance, often involving dynamic cooperation between the public sector (formerly the "governors") and the private sector (formerly the "governed"), and often characterized by an increased participation in governance by third-party nonstate actors." Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN L. REV. 783, 785 (2010).

[102] RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008); DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008).

own devices, private individuals make mistakes that are both personally and socially costly.[103] Choice architecture helps individuals avoid these mistakes.

As Orly Lobel and On Amir pointed out in a 2010 book review, choice architecture and New Governance complement each other.[104] New Governance provides regulatory architects with a platform in which to experiment with different "choice" structures. Because it is premised on cooperation and free flows of information, New Governance also provides choice architecture with some needed legitimacy; private actors know and actively aid public actors in putting in place the architecture that encourages and discourages certain choices. This is a key point; without private actors' participation in their creation, the devices appear more manipulative and paternalistic, and therefore more likely to fail.

Following both the financial accounting scandals at the turn of the century, and the later financial crisis in 2008, we might have expected an explosion of experimental, responsive, nudge-like structural suggestions by government actors as a means toward curing (or at least mitigating) TI-related behavior.[105] Indeed, several scholars suggested such an approach, with regard to both corporate compliance reform and financial institutional reform.[106] For the most part, however, Sarbanes-Oxley, Dodd-Frank and the SEC Enforcement Division's latest settlements with financial institutions appear rather conventional. Through some combination of

---

[103] *See generally* BEHAVIORAL LAW & ECONOMICS (Cass Sunstein ed., 2000).

[104] *See* On Amir & Orly Lobel, *Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy*, 108 COLUM. L. REV. 2098, 2131 (2008).

[105] For examples of New Governance–related proposals in regard to financial institutions, see Saule Omarova & Adam Feibelman, *Risks, Rules, and Institutions: A Process for Reforming Financial Regulation*, 39 U. MEM. L. REV. 881, 920 (2009).

[106] *See, e.g.*, Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411 (2011) (advocating self-regulation of risk within financial institutions by removing the financial industry's government-guaranteed safety net); Weber, *supra* note 101, at 786 (suggesting self-regulatory approach for determining capital adequacy requirements); Cristie L. Ford, *New Governance, Compliance, and Principles-based Securities Regulation*, 45 AM. BUS. L.J. 1, 28 (2008) (praising New Governance approach towards developing corporate compliance principles).

statutory fiat, regulatory rule-making, and enforcement-driven adjudication, the government is telling, and not asking or encouraging financial institutions and other corporations how to behave. Although much of this enforcement effort includes structural regulation, it does not reflect the cooperative, back-and-forth experimental approach championed by New Governance theorists.[107]

Why, in a moment of complex crisis, has the government moved away from choice architecture and New Governance, at least with regards to corporate governance issues? One explanation is that responsive regulation and choice architecture require trust, cooperation and a sustained willingness to experiment with various structures and devices.[108] Even in the best of times, it is difficult to sell such an agenda to the general public, who possess many of the same desires for immediate gratification as corporate actors.[109] In the worst of times, New Governance faces even greater hurdles. Skeptics understandably worry that cooperative regulation may be a prescription for cosmetic, but ineffectual regulation.[110] An angry public, meanwhile, shows more interest in punishing corporations than in creating useful and lasting structural reforms.[111] The characteristics that make New Governance so intuitively attractive are the same characteristics that make it particularly weak and

---

[107] I have argued this point in my critique of how the federal government uses deferred prosecution agreements to regulate corporate compliance. *See* Baer, *Governing*, *supra* note 42.

[108] *See, e.g.*, *id.*

[109] It also may be difficult to sell New Governance to traditionally trained lawyers. *See also* Solomon, *supra* note 98, at 852–55 (arguing for re-training of lawyers to reduce adversarial stances towards regulation and the setting of regulatory policy).

[110] *See, e.g.*, Coffee & Sale, *Redesigning*, *supra* note 14, at 712 (criticizing self-regulation as offering inadequate oversight of corporate and financial firms: "self-regulation has severe limitations and seems to work best only when the self-regulator's duties are clearly demarcated and it is in turn subject to close regulatory oversight"); Kimberly Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L. Q. 487, 491 (2003) (arguing that negotiated governance may simply allow firms to make cosmetic but not real changes in internal compliance).

[111] Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. REV. 577 (2012) (exploring the implications of the public's preference for punishment over regulation with regard to corporate governance policy).

unstable. Accordingly, it may be some time before New Governance emerges again as a strong regulatory alternative.[112]

CONCLUSION

I have focused on a series of choices that a well-intentioned and highly knowledgeable regulator might confront when dealing with pervasive time-inconsistent misconduct. As Professor Utset has shown in this Article and other contributions, TI theory helps us understand why otherwise sincere individuals stray from their initial intentions to comply with the law. It offers a richer account of why corporate misconduct arises and persists. What it does not do is tell us how policy makers should respond to such misconduct. It may be folly to rely solely on sanctions as a means of deterring TI-related misconduct, but that is only the beginning of the regulatory story. No doubt, Utset is right to assert that corporate actors engage in time-inconsistent decision-making. The larger question, however, is what the public ought to do about it.

[112] Ironically, this more traditional approach may be partially the product of modern legal education's emphasis on adversarial relationships. *See* Solomon, *supra* note 98, at 855 (commenting that New Governance's success depends in part on "the next generation of lawyers having the skills and inclination to overcome the culture of adversarial legalism that pervades policy implementation today").