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# COMMENT

## THEORY OF THE FIRM AND CORPORATE SENTENCING: COMMENT ON BAYSINGER AND MACEY

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The common theme in the Articles by Barry Baysinger and Jonathan Macey is that standard economic theories of the effect of incentives on individual behavior are inapplicable to corporate crime because organizations are complex entities.<sup>1</sup> Both authors conclude that proposed Sentencing Commission guidelines aimed at increasing vicarious sanctions will be ineffectual or counterproductive at stopping corporate crime. The Articles' importance is in making plain what we need to know for resolving the sentencing debate, rather than in providing a compelling resolution. This is because the policy implications of the new learning on the theory of the firm that they have incorporated into the debate cannot be identified with confidence in the absence of a formal model and empirical testing.

Although the authors start from the same vantage point, the economic theory of the firm, their critique of the ability of top management and enterprise sanctions to deter corporate crime differs. Before addressing their analyses, I should note a common problem. Both Baysinger and Macey ignore a fundamental insight, the theorem of Ronald Coase.<sup>2</sup> The Coase theorem suggests that the same efficient outcome will obtain whether liability is placed on the individual or the firm.<sup>3</sup> Transaction costs, such as the organizational problems Baysinger and Macey identify, undermine the operation of the theorem. Its insight is pertinent, however, if courts are not better than organizations at identifying wrongdoers or communicating incentives to employees. Neither Baysinger nor Macey demonstrates that the difficulties of internal communication and information processing in complex organizations will be eliminated if courts, rather than corporations, assume the role of aligning employee incentives. Indeed, under their analyses, an employee's discharge is a more effective sanction than individual liability because it is

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<sup>1</sup> Baysinger, *Organization Theory and the Criminal Liability of Organizations*, 71 B.U.L. REV. 341 (1991); Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U.L. REV. 315 (1991).

<sup>2</sup> Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

<sup>3</sup> See Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345, 1348-51 (1982).

more severe.<sup>4</sup> Because neither provides a formal model showing that top management and enterprise sanctions will not deter corporate crime, it remains problematic whether the corporate crime context vitiates the operation of the Coase theorem and thus throws the Commission's approach into doubt, as they contend.

Baysinger locates the organizational problem (and hence the ineffectiveness of sanctioning top management as a means of deterring corporate crime) in what he terms "excessively diversified corporations."<sup>5</sup> He makes a series of statements about an input—this particular organizational form—and an output—corporate crime—without specifying the function that relates the two. More important, he does not provide any data identifying the causal relation that has been casually asserted.<sup>6</sup>

The crucial question is whether Baysinger's hypothesis concerning corporate criminals should inform sentencing policy. To answer this question, it is necessary to know whether excessively diversified firms do indeed commit crimes more frequently than less diversified or undiversified ones. This proposition is capable of empirical verification, assuming that excessive diversification can be accurately defined.<sup>7</sup> In particular, an examination of the organizational structure of firms convicted of corporate crime would show whether they are excessively diversified, compared to other firms in their industries that did not engage in criminal activity. In addition, the 1980s saw the deconglomeration of American business. If Baysinger is correct, corporate crime should have decreased in recent years. I doubt that we would find such a trend, but again, this is a refutable proposition. The rate of growth of corporate crime can be computed and correlated with industry deconglomeration. To put it simply, a precise theoretical specification and empirical testing should and can be undertaken. Without it, there is nothing to support basing public policy on a hypothesized linkage between firm-level diversification and corporate crime.

Baysinger suggests that deterring corporate crime by punishing the corpo-

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<sup>4</sup> *E.g.*, Baysinger, *supra* note 1, at 354-55; Macey, *supra* note 1, at 326-27.

<sup>5</sup> Baysinger, *supra* note 1, at 356-57.

<sup>6</sup> Baysinger provides two inapposite examples, *id.* at 344, 362-63: the Challenger fiasco occurred in a government agency not subject to the same market constraints as for-profit firms, and U.S. automakers' inability to compete with Japan also provides little parallel to crime, for managers are less likely to be able to identify in advance behavior constituting successful innovation compared to that constituting criminal actions.

<sup>7</sup> This is a difficult task, and Baysinger does not attempt to offer a definition. Macey suggests that even if the term can be operationalized, the data will refute the hypothesis; he cites studies indicating that the overwhelming majority of corporate criminals are small privately-held firms. Macey, *supra* note 1, at 323-24. Given the valuable exposure from prosecuting a major corporation, including being showcased to the major corporate law firms defending such a client, these data are unlikely to be explained, as Baysinger implies, by prosecutorial incentives favoring the pursuit of smaller firms. *Cf. Captain Ahab Prosecutors*, Wall St. J., Dec. 29, 1988, at A6, col. 1 (editorial). At the least, a model of prosecutor behavior is necessary to resolve this question.

ration or top management may not be an impossible task but that the cost is simply too prohibitive to adopt such a policy.<sup>8</sup> This seems to me to be the most plausible of his critiques from organization theory of the efficacy of specific sanctions, but it is unfortunately not developed. Several questions need to be explored. For instance, what punishment level—treble damages, more, or less—would be necessary to create the appropriate incentives? Should the tradeoff of firms' compliance costs and the reduction in corporate crime be undertaken by the political process directly rather than by the Sentencing Commission? Are the costs prohibitive only in some cases, depending on the crime, and therefore should policy be more particularized? In this regard, a natural implication of Baysinger's thesis is that the Commission's guidelines are inappropriate only for excessively diversified firms, whose organizational form presents severe problems for vicarious liability. Is vicarious liability also inoperable as an incentive device for firms that are not excessively diversified and therefore not subject to the organizational difficulties that are thought to result in criminal activity? Baysinger does not develop this implication of his analysis, despite the data suggesting a higher incidence of crimes by such firms.

Baysinger assumes that corporate agents will seek to enhance the returns to the organization through criminal conduct.<sup>9</sup> He further assumes that the firm will reward, rather than punish, criminal activity.<sup>10</sup> Yet he does not demonstrate (theoretically or empirically) why any corporation would offer to promote or financially favor an individual engaging in criminal conduct. If a firm had such a policy, it would be a clear case for imposing vicarious penalties on the firm and top management to terminate the firm's perverse incentive structure. In fairness to his thesis, I believe that Baysinger would limit it to situations where top management does not intentionally reward criminal conduct. He maintains that top management in a diversified firm is uninformed, removed from the action and unable to alter internal incentives to prevent such criminal activity. The analysis on this point is, however, unsatisfactory. When the crime is detected, the employees will be severely sanctioned, and this will serve as a clear deterrent to others.<sup>11</sup> I am less convinced than Baysinger that corporate crime is rampant and thus undetected by top management and outsiders, an assumption that seems a necessary condition for the analysis. A rudimentary formal model, clarifying the assumptions that produce uncontrollable organizational deviance as equilibrium behavior, would ease my doubts on the analysis's coherence.

Moreover, the reasoning for why firms encourage middle managers to

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<sup>8</sup> Baysinger, *supra* note 1, at 363.

<sup>9</sup> *Id.* at 353-55.

<sup>10</sup> *Id.* at 354 ("[C]riminal behavior [may] lead[] to bonuses and career advancement.").

<sup>11</sup> For example, Salomon Inc. recently fired deviant employees, who had violated treasury auction rules, as well as the senior-most management, who did not disclose the misconduct to the government.

engage in illegal conduct is weak. Baysinger contends that using financial accounting performance measures for middle managers' compensation leads to a life of corporate crime.<sup>12</sup> While there is much to criticize in the use of accounting, rather than stock return, measures for executive compensation plans, there is no study that shows a connection between compensation policies and corporate crime. Baysinger provides no evidence, even anecdotal, in support of the contention. The thesis can, however, be tested. One could investigate what performance-based compensation plans, if any, were in effect for firms that engaged in criminal activity, and how they compared to the compensation plans of competitors that did not engage in criminal activity. Without such empirical investigation, the assertion has no force.<sup>13</sup>

Rather than focus on corporate-level diversification as Baysinger does, Macey emphasizes the divergent attitudes of managers and shareholders toward risk. The analyses are related, however. Corporate-level diversification is, arguably, a function of the incompatibility in risk preferences of the participants in the firm.<sup>14</sup> Despite the theoretical connection, the predictions of which corporations will commit crimes differ. Contrary to Baysinger's stress on large conglomerates, Macey predicts that small firms will be more likely to engage in criminal conduct.<sup>15</sup> This difference is, in part, a function of differing views of whose utility, principal (Baysinger) or agent (Macey), is maximized by corporate crime.

In the economic theory from which Macey's thesis derives, devices that increase managerial risk-taking benefit shareholders: portfolio diversification makes shareholders risk neutral and therefore desirous of firm level projects whose risk is greater than those that undiversified, and hence risk averse, manager-agents will voluntarily undertake.<sup>16</sup> Accordingly, it is inconsistent to argue, as Macey does, that criminal activity represents increased managerial risk-taking and that it does not benefit shareholders, unless the increased risk-taking is not related to increasing future cash flows. The latter caveat is an unlikely interpretation given Macey's concern that heavy penalties on corporate crime will stifle corporate innovation and creativity.<sup>17</sup> Macey's analysis, consequently, lacks coherence.

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<sup>12</sup> Baysinger, *supra* note 1, at 359-60.

<sup>13</sup> This is also true of his conclusion that corporate crime is related to management's focus on short-term financial performance, *id.* at 360: there is no evidence of such a connection. Although like diversification at the firm level or in accounting-based compensation plans, such a focus will not benefit shareholders; it is, at best, wishful thinking to associate such managerial conduct with criminality.

<sup>14</sup> See Amihud & Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981) (arguing that managers maximize their own utility by reducing firm-specific risk, to the detriment of shareholders' interest, by engaging in diversifying mergers).

<sup>15</sup> Macey, *supra* note 1, at 323.

<sup>16</sup> *Id.* at 320-21 (discussing the conflict of interest between shareholder/principals and manager/agents in terms of differing attitudes toward risk).

<sup>17</sup> *Id.* at 319.

Macey views the threat of bankruptcy as increasing managerial risk-taking and therefore leading to actions typically inconsistent with shareholder preferences.<sup>18</sup> Shareholder interests, however, are consistent with increased risk-taking prior to insolvency. Because of limited liability, they benefit from the upper tail of the distribution of returns from risky activities and do not bear the cost of the lower tail. This is a straightforward result of option pricing theory.<sup>19</sup> Moreover, shareholders prefer increased risk-taking by managers quite apart from the option pricing analysis because it steers the managers' preferences in the right direction, toward those of the risk-neutral shareholders. This is a strict result of the principal-agent models on which Macey bases his general argument.<sup>20</sup>

It is bondholders, however, who do not want managers to take on more risk, and it is their wealth that is transferred to shareholders from management's increased risk-taking. Consideration of how bondholders have fared upon default—depending on the seniority of the debt, from only one to two thirds of par value is recovered on average in recent years<sup>21</sup>—makes apparent that shareholders do worse in bankruptcy proceedings than Macey suggests, although shareholders are rarely wiped out.<sup>22</sup> It is thus unlikely that the minimal interest shareholders may retain will outweigh the expected value of increased risk-taking on the eve of bankruptcy. In any event, evidence that corporate criminals tend to be financially distressed firms would make this prediction more compelling. The evidence that most are small firms may be supportive, because the shareholder-manager conflict is reduced in that setting, but this is obviously inconsistent with Macey's argument concerning the divergence of interest.

To further his critique of increased enterprise sanctions, Macey posits several reasons why it is unlikely that shareholders benefit from corporate crime.<sup>23</sup> I have questions concerning two of the arguments he offers in support of this otherwise plausible proposition. First, Macey challenges the view that shareholders benefit from crime by asserting that crime does not

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<sup>18</sup> *Id.* at 326.

<sup>19</sup> S. ROSS, R. WESTERFIELD & J. JAFFE, *CORPORATE FINANCE* 589-90 (2d ed. 1990); Black & Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973).

<sup>20</sup> See S. ROSS, R. WESTERFIELD & J. JAFFE, *supra* note 19, at 421-24; Macey, *supra* note 1, at 320-22.

<sup>21</sup> See Altman, *Setting the Record Straight on Junk Bonds: A Review of the Research on Default Rates and Returns*, 3 J. APPLIED CORP. FIN., Summer 1990, at 82, 94-95 (stating that recovery rates on defaulted debt 1985-1989, measured by price just after default, averages 66% for secured debt, 55% for senior debt and 32% for subordinated debt).

<sup>22</sup> Eberhardt, Moore & Roenfeldt, *Security Pricing Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990) (stating that absolute priority rule was violated in 23 of 30 cases and that shareholders receive, on average, 7.6% of total awarded to all claimants where violation occurs).

<sup>23</sup> Macey, *supra* note 1, at 326-29, 334-36.

produce abnormal returns.<sup>24</sup> Crime, however, need not provide abnormally high returns to benefit shareholders. If securities are rationally priced, their purchase is a zero net present value transaction, and corporate activity (criminal or otherwise) must provide shareholders with only a normal rate of return adjusted for the activity's risk. Thus, maintaining that crime does not pay out abnormal returns is irrelevant to the question whether shareholders benefit from crime. Macey should instead maintain that shareholders will not be indifferent between criminal and legitimate activities that provide identical risk-adjusted returns. For instance, they may experience disutility from investing in criminal pursuits. In this case they will not benefit from corporate crime.<sup>25</sup>

Second, Macey suggests that criminality will be part of the repertoire of management's defensive tactics to avoid hostile takeovers.<sup>26</sup> A substantial body of literature shows that such tactics are detrimental to shareholders' interests.<sup>27</sup> Defensive tactics are, however, irrelevant to the Sentencing Commission's guidelines. There is absolutely no evidence that managements seeking to thwart a takeover bid engage in criminal conduct. Incumbents have access to a vast array of legitimate techniques to defend against a takeover as Macey admits.<sup>28</sup> While I am no fan of defensive tactics, I would want to know whether there is any correlation between engaging in criminal activity and resisting a takeover before I would brand entrenched management as putative criminals. Macey seems to recognize this, for he notes that crime is unlikely to be a successful defensive strategy,<sup>29</sup> but then he lapses by reintroducing it as a possibility in his conclusion.<sup>30</sup>

These comments should not obscure, however, my view that Baysinger and Macey have made a helpful contribution to our understanding of corporate crime sentencing. Their Articles are an excellent first step toward rationalizing the debate. A great deal more work remains to be done, however, before we will be able to identify with confidence the optimal sentencing policy for corporate crime.

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<sup>24</sup> *Id.* at 335.

<sup>25</sup> Macey also maintains that there is no benefit because shareholders are not compensated for the increased risk from corporate crime. *Id.* at 334. This argument is inconsistent with his analysis because such risk is firm-specific, which is a risk for which Macey's diversified shareholders do not require compensation.

<sup>26</sup> *Id.* at 327-28 (arguing that because the most effective way for a firm to avoid a hostile takeover is to show consistently high earnings, managers may cause their firms to engage in illegal activities to raise earnings and discourage outside bidders).

<sup>27</sup> *E.g.*, Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP., Winter 1988, at 49.

<sup>28</sup> Macey, *supra* note 1, at 327-28.

<sup>29</sup> *Id.* at 328 ("[T]arget firms are not likely to succeed at using illegal means to avoid takeover since discovery virtually guarantees a transfer of control.").

<sup>30</sup> *Id.* at 330.