ESSAY

HARNESSING LAW AND ECONOMICS TO DISINCENTIVIZE CORPORATE MISBEHAVIOR

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Top-level executive compensation has increased by over 1000% over the past four decades and is now primarily based on a corporation's market performance. The size and number of corporations is also at an all-time high, and corporate misbehavior has never been so profitable for the small handful of executives at the helms of the world's largest and arguably most important commercial entities. Yet at the same time, tracking down corporate misbehavior has become increasingly difficult—and much of what the majority of people would call misbehavior is not at the end of the day punishable. This Essay takes the position, as have a number of prominent researchers and professors of corporate law, that executive compensation is currently in a bubble driven by absentee shareholders, captured boards, and often corrupt executives. This Essay analogizes to the law and economics concept of the least-cost avoider in order to explain why accountability for profitable misconduct has been displaced from the C- Suite to an increasingly absentee pool of shareholders that cannot be reached effectively by the legal system without disrupting the limited liability regime so important to our modern investment economy. This Essay advocates taking steps to shift the analogical least-cost avoider back to the C-Suite where it belongs.

To accomplish this, this Essay proposes that Congress harness the compensation bubble and its attendant increased incentive for qualified persons to seek and accept executive-level positions: it recommends passing legislation increasing the criminal exposure of executives by making them criminally liable for a broader array of misbehavior. Most critically, this Essay advocates modifying the degree of

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mens rea required for criminal liability. This Essay concludes by presenting a model statute for the reader's consideration.

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INTRODUCTION

"I firmly believe that individual accountability drives behavior more than corporate accountability."

Jay Clayton,
Securities and Exchange Commission Chairman[1]

Between 1978 and 2014, average inflation-adjusted CEO compensation rocketed from $1.5 million to $16.3 million a year—an increase of over 1000%.[2] In a well-functioning executive employment market, we would expect CEO compensation to reflect value, in line with the *efficient pay*

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1 Peter Henning, *Why It Is Getting Harder to Prosecute Executives for Corporate Misconduct*, CLS BLUE SKY BLOG (Jun. 13, 2017), http://clsbluesky.law.columbia.edu/2017/06/13/why-it-is-getting-harder-to-prosecute-executives-for-corporate-misconduct/ [https://perma.cc/98L5-RZEY].

2 Lawrence Mishel & Alyssa Davis, *CEO Pay Has Grown 90 Times Faster than Typical Worker Pay Since 1978*, ECON. POL'Y INST. (Jul. 1, 2015), https://www.epi.org/publication/ceo-pay-has-grown-90-times-faster-than-typical-worker-pay-since-1978/ [https://perma.cc/4DD4-QHXH].

hypothesis formulated by Gabaix and Landier (suggesting that there is a "tractable and calibratable" relationship between CEO pay and managerial talent and ability).[3] Surely, then, today's CEOs are significantly more qualified than they were 40 years ago, or have more experience, or at least can be counted on for superior performance outcomes. As it turns out, this is not the case at all. In fact, there is mounting support for the *managerial power hypothesis* (postulated by Bebchuk and Fried in 2003[4]), which argues that the outsized increase in executive pay stems principally from self-interested executives who "are able to influence the level of their own compensation packages often at the expense of shareholders[,]" and that "the level and composition of pay are determined not by competitive market forces but rather by captive board members catering to rent-seeking entrenched CEOs."[5]

Troublingly (and relatedly, as we'll see), there is strong evidence that prosecuting executives for misconduct is becoming increasingly difficult.[6] What's more, there appears to be a correlation between executive prosecution and an *increase* in executive compensation.[7] In the course of their research on executive compensation, Professor Brandon L. Garrett and his co-authors "observed a *spike* in CEO bonuses in the year of prosecution—confirming concerns expressed by judges, prosecutors, lawmakers, and academics that corporate prosecutions do not sufficiently impact high-level decision-makers like CEOs."[8]

The touchstone of this Essay is the following problem:

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3 Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 1 Q. J. ECON. 49, 49 (2007), https://scholar.harvard.edu/files/xgabaix/files/why_has_ceo_pay_increased.pdf [https://perma.cc/F6UG-9PY7].

4 Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON PERSP. 71, 72–73 (2003), http://www.law.harvard.edu/programs/corp_gov/papers/2003.Bebchuk-Fried.Executive.Compensation.pdf [https://perma.cc/GT9Q-KB5B].

5 Francesca Fabbri & Dalia Marin, *What Explains the Rise in CEO Pay in Germany? A Panel Data Analysis for 1977-2009*, IZA Discussion Paper No. 6420 1, 3 (2012), http://ftp.iza.org/dp6420.pdf [https://perma.cc/UZ8M-CEWY].

6 *See* Henning, *supra* note 1.

7 *Id.*

8 Brandon L. Garrett, Nan Li & Shivaram Rajgopal, *Do Heads Roll? An Empirical Analysis of CEO Turnover and Pay When the Corporation is Federally Prosecuted*, Va. L. & Econ. Research Paper No. 2017-11; Columbia Business School Research Paper No. 17-54 1, 1 (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2966823 [https://perma.cc/U4HM-L8NM].

today, high-level corporate executives are better insulated from criminal prosecution than they have ever been,[9] yet the modern executive compensation model—which is tied to market performance and pays corporate executives orders of magnitude more than what was typical in the past[10]—provides powerful incentives to misbehave. This Essay first seeks to more clearly identify the underlying source of the problem by calling upon a law-and-economics concept usually applied in the tort context: the "least-cost avoider." It then proposes a legislative solution: Congress and/or state legislatures should take serious steps to increase the level of criminal exposure for corporate executives, either through a targeted rethinking of corporate veil piercing geared towards incentivizing boards and shareholders to compensate executives differently, or through statutorily expanding the *responsible corporate officer* doctrine to meaningfully increase executive accountability for employee misconduct. This Essay concludes by proposing and defending a model statute that might have exactly this effect.

I
LIMITED LIABILITY: WHY IT EXISTS, AND WHY IT MATTERS

Limited liability—that is, liability that does not exceed the amount invested—is an ancient concept. To our knowledge, it first appeared during the time of the Roman Empire (records suggest that back then it was employed only infrequently, typically as a personal favor to friends of those in power).[11] Before limited liability, investing was a dangerous enterprise: if one's investment failed, one risked total loss at best, and bankruptcy or debtor's prison at worst.[12] Passive investing was virtually impossible. After all, who would risk investing the equivalent of a few hundred dollars when doing so would put that person on the hook for all of the company's losses in the event it failed, as though the company were that person's own sole proprietorship? Limited liability enabled individuals to better-manage their investment risk, which in turn allowed a

9 Peter J. Henning, *Making Sure "The Buck Stops Here": Barring Executives for Corporate Violations*, 2012 U. CHI. LEGAL F. 91, 116 (2012) ("The oft-voiced complaint about the difficulty in holding senior executives accountable is that they are largely insulated from day-to-day wrongdoing within the organization. Pursuing a criminal prosecution against them is nearly impossible because of their lack of direct involvement in any corporate violations.").

10 *See* Mishel & Davis, *supra* note 2.

11 *The Key to Industrial Capitalism: Limited Liability*, THE ECONOMIST (Dec. 23, 1999), https://www.economist.com/node/347323 [https://perma.cc/M6Y7-EFL9].

12 *Id.*

larger number of people to invest a lot more money in a much wider array of companies and activities. Primarily because of its enormous impact in increasing global investment and liquidity, limited liability is rightly viewed as one of the great innovations of modern finance law.[13]

But limited liability is not without its downsides. One of the oldest concerns about limited liability continues to be relevant today: it can and does encourage dangerous levels of speculation,[14] which in turn increases the likelihood that investors will get scammed.[15] Limited liability enables and encourages investors to hold expansive portfolios—a logical move, because spreading one's investment dollars around also spreads (and therefore mitigates) the financial risk of investing. But the broader and shallower a portfolio is, the more difficult and cost-ineffective it becomes for an investor to develop a deep understanding of her investments. This makes investors vulnerable: time-strapped, non-expert investors may make riskier, less-educated investments; pump-and-dump schemes—which *are* regularly prosecuted—are emblematic of this problem.[16]

Corporate law has systems in place to mitigate this vulnerability, including by assigning persons and entities fiduciary duties. Because of the relative disengagement of shareholders in the modern corporate model, it is critical that

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13 *Id.*

14 Denis Boyle, *Historical Drawbacks of Limited Liability*, 2 J. EVOLUTIONARY STUD. BUS. 276, 278–79, 298–99 (2016), http://revistes.ub.edu/index.php/JESB/article/view/j020/19292 [https://perma.cc/T5TF-8YRZ].

15 Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1002–03 (1991-1992) ("Manipulation is not a necessary by-product of speculation, but it is clear that speculation creates a climate conducive to manipulation. Thus, one of the chief arguments against speculation continues to be that manipulation is likely to follow since it frequently is in the speculator's self-interest to manipulate the markets.").

16 David B. Kramer, *The Way It Is and the Way it Should Be: Liability Under 10(b) of the Exchange Act and Rule 10b-5 Thereunder for Making False and Misleading Statements as Part of a Scheme to "Pump and Dump" a Stock*, 13 U. MIAMI BUS. L. REV. 243, 245 (2005) ("In more recent years, a common securities fraud that has been perpetrated countless times with resounding financial success is a scheme known as a 'pump and dump.' The scheme itself is quite simple. The person carrying out the fraud first targets a publicly traded company that is generally small in size and thinly traded on either the Over The Counter Bulletin Board or the NASDAQ market and then purchases large quantities of this stock. After obtaining a sizeable position in the chosen stock, the perpetrator then launches a large scale campaign to disseminate as much false and misleading information about the company as possible to effectuate the desired result.").

the individuals hired to run the invested-in company have a legal obligation to work towards the success of the company (and thus towards the successful investment of the shareholders).[17] The fiduciary duties of corporate executives are a frequent focus of shareholder-executive litigation, and they do serve to regulate executive behavior to some meaningful degree.

The difficulty is that, as this Essay has already mentioned, shareholders have a strong incentive to act speculatively: their personal liability is limited. As a result, executives *also* have a strong incentive to act recklessly, in conformity with shareholder desires and expectations.[18] Corporate executive compensation reflects these expectations: today, compensation packages are usually tied almost entirely to the profit corporations generate for their shareholders.[19] By contrast, were it the case that shareholder liability was not limited, shareholders would have much less appetite for risk, and the long-term survival and stability of the company would be a considerably higher priority to them than short-term profits. Executive compensation packages would inevitably reflect this shift in priorities: compensation packages would be designed to incentivize stability over breakneck growth. This in turn would change executive behavior.

This Essay neither argues nor means to suggest that limited liability is a bad thing. It instead seeks to point out that, in our modern era of increasingly disconnected, profits-motivated, and diversified shareholders, it is important for governments, law enforcement, and investors to consider fully the downstream effects that limited liability can have on executive behavior. This Essay argues that these downstream effects have simultaneously created an executive compensation bubble and incentivized reckless (and at times criminal) behavior in corporations. It further argues that executives are in a unique position either to encourage or to eliminate that behavior, and as such, they should be made

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17 Success in *some* form. This Essay does not wade the murky waters of defining precisely what an officer's fiduciary duties are.

18 *See* Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 635 (2007).

19 *Equity Compensation*, CENTER ON EXECUTIVE COMPENSATION ("The majority of compensation of most executive pay packages comes in the form of equity, typically company stock or a derivative form of company stock."), https://execcomp.org/Basics/Basic/Equity-Compensation (last visited Mar. 6, 2020) [https://perma.cc/KEM8-VSA8].

legally responsible for it.

II
THE PROBLEM

A. The Executive Compensation Bubble

Harvard Business School professor Mihir Desai describes the current executive compensation bubble as the result of a massive overcorrection. "[W]e went from a world where [executives] didn't have any real significant performance incentives, to a world where there are remarkably crude performance incentives that are giving people the wrong incentives."[20] The current equity compensation model might seem perfect in its simplicity: when the company is profitable, the C-Suite gets compensated handsomely. But while this makes sense on paper, there's a kind of bait-and-switch going on: there are typically no measurable indications that a stock's price was caused—even in part—by the C-Suite's decisions, talent, or skill. On the contrary, companies in the market often rise and fall together, even if they should not.[21] This means that, at least sometimes, we are "compensating people in a windfall way for a rising tide."[22] Stock options contracts make up a large portion of executive compensation packages in the United States.[23] Yet indexation of stock options contracts—that is, explicitly *not* rewarding the natural rise and fall of the market, and instead rewarding only the marginal value an executive could conceivably have added—is virtually non-existent in U.S.-based company compensation packages.[24] This is just one manifestation of the compensation problem.

To be clear, not everyone agrees with Professor Desai—which might seem obvious: if everyone believed CEO pay was in a bubble, then surely the bubble would burst. (This assertion is debatable, given the powerful influence of emperor's-new-clothes dilemmas and other potential first-

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[20] *How CEO Pay Became a Massive Bubble*, HARV. BUS. REV., Interview Transcript, https://hbr.org/2012/02/how-ceo-pay-became-a-massive-b [https://perma.cc/38N9-WS6J].

[21] Jeff Sommer, *Tech Stocks Often Rise and Fall Together. They Shouldn't.*, N.Y. TIMES (Dec. 13, 2018), https://www.nytimes.com/2018/12/13/business/tech-stocks-together.html [https://perma.cc/LUP9-RP99].

[22] *See supra* note 20.

[23] *See supra* note 19.

[24] *See supra* note 20 (Professor Desai explains that "[indexation is] something that we see very, very little of in the United States today.").

mover problems, which this Essay doesn't get into.) The common argument against the idea that executive pay is in a bubble is simple: the market is efficient (meaning it accounts for all of the important data), so executive pay, whatever it is, must be "just about right."[25] Put differently, because our market for executives is more data-driven and more mobile today than it has ever been, it must therefore be more efficient than it has ever been. The problem with this argument is that it assumes an efficient executive market without proving it; it may be that we are not reading and incorporating the data correctly—precisely the assumption that Professor Desai and others dispute.[26]

This Essay takes the position that there is indeed a bubble, but its principal argument does not require one. It suffices that executive compensation has risen nearly 1000% over the past four decades, and that it has done so without any meaningful increase in executive civil or criminal legal exposure[27] nor any discernable justification beyond vague assertions of healthy executive competition (dubious notions, indeed: it is not true, for example, that the best CEOs of today are able to generate consistent profits at a higher level than the best CEOs of the 1970s).

B. The Low Cost (and High Return) of Misbehavior

Securities and Exchange Commission Chairman Jay Clayton's view that "individual accountability drives behavior more than corporate accountability"[28] is widely accepted. Perhaps ironically, it is equally accepted that successfully prosecuting individual executives is becoming increasingly difficult. This is true even while the Department of Justice has made it clear that singling out those responsible for wrongdoing is a priority in corporate criminal investigations. For example, in 2015, former Deputy Attorney General Sally Yates said at a major white collar conference that "in order for a company to receive any consideration for cooperation under the Principles of Federal Prosecution of Business

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[25] RJ Bannister, *Executive Compensation is Right Where It Should Be*, CFO (Apr. 21, 2017), https://www.cfo.com/compensation/2017/04/executive-compensation-right/ [https://perma.cc/EE8N-ANXM].

[26] *See supra* note 20.

[27] *See* Henning, *supra* note 1.

[28] Dave Michaels & Andrew Ackerman, *SEC Chairman Nominee Jay Clayton Calls for Scaling Back Regulations to Encourage IPOs*, WALL ST. J. (Mar. 23, 2017, 5:19 PM), https://www.wsj.com/articles/sec-chairman-nominee-jay-clayton-says-past-wall-street-work-is-a-strength-1490281093 [https://perma.cc/CN67-9KPQ].

Organizations, the company must completely disclose to the Department all relevant facts about individual misconduct."[29] Former Attorney General Eric Holder also noted that prosecuting individuals enhances accountability, and stressed that "corporate misconduct must necessarily be committed by flesh-and-blood human beings," so "wherever misconduct occurs within a company, it is essential that we seek to identify the decision-makers at the company who ought to be held responsible."[30] But as Professor Henning succinctly puts it, "[t]here are any number of reasons why top management is largely immune from prosecution. The most important may be that executives who set the direction of an organization but don't implement corporate policy or transactions have little to do with day-to-day conduct that might violate the law."[31]

And this really is the meat of it. In the United States, a corporate executive might encourage profitable misbehavior in a hundred different ways. She might declare that hitting financial targets is a critical priority; that doing so will lead to great bonuses; or that failing to do so will lead to layoffs. She might set unreasonable targets that are unlikely to be met without misconduct. Or she might intentionally design her information intake around learning abstract, "big picture" information while scrupulously avoiding more specific information to maintain deniability. The ways that executives might tacitly promote misbehavior is limited only by their imaginations.

We have known for years now that the "tone at the top" matters.

> Whatever tone management sets will have a trickle-down effect on employees of the company. If the tone set by managers upholds ethics and integrity, employees will be more inclined to uphold those same values. However, if upper management appears unconcerned with ethics and focuses solely on the bottom line, employees will be more prone to commit fraud because they feel that ethical conduct is not a focus or a priority within the organization.[32]

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29 Sally Q. Yates, Deputy Att'y Gen., U.S. Dep't of J., Remarks at the New York City Bar Association White Collar Crime Conference (May 10, 2016), https://www.justice.gov/opa/speech/deputy-attorney-general-sally-q-yates-delivers-remarks-new-york-city-bar-association [https://perma.cc/S8TU-ELS5].

30 David S. Krakoff, Lauren R. Randell, Veena Viswanatha & Mehul N. Madia, *Individual and Coordinated Prosecutions Accelerate—Along With the Challenges*, 30 CRIM. JUST. 1, 2 (2015).

31 *See* Henning, *supra* note 1.

32 *Tone at the Top: How Management Can Prevent Fraud in the Workplace*,

Currently, to successfully prosecute an executive for illegal misconduct, the nexus of the illegal action needs to be squarely on that executive's shoulders: she or he needs to have personally committed some illegal act with the requisite intent, and often with scienter.[33] Large corporations with multi-tiered hierarchies have the ability to set incentives (explicitly and implicitly) in such a manner as to encourage misbehavior while giving the appearance of acting innocuously. As a result, the vast majority of executive bad-faith actions likely go unproven and unpunished (and indeed are probably unpunishable).

Back when CEO pay averaged in the low seven figures at most, and when compensation was primarily cash (rather than market performance-based), it may have been of no moment that executive prosecution was difficult. Executives didn't make enough money to justify voluntarily taking on significant exposure to criminal liability, nor were they strongly financially incentivized to engage in misconduct—in fact, quite the opposite. But today's executive compensation norms completely flip the script. Not only is executive compensation often in eight- and nine-figure territory, but the majority of that compensation is performance-based—and not in the sense that an individual's leadership, knowledge, and personal ability are rewarded, but rather by the far more crude measure of the corporation's raw stock market performance.[34] This change in incentive structure justifies a significant change in the law and in its enforcement.

C. The Least-Cost Avoider Hot Potato: Executive Misbehavior and Shareholder Limited Liability Through the Lens of Law and Economics

The problem comes down to this: executive misbehavior is too easy to commit, too difficult to prosecute, too profitable to trivialize, and too dangerous to ignore. Because shareholders' primary (and often sole) concern is profit, executive compensation is tied to the raw market value of the companies they run. Consequently, because executives stand to gain (or lose) so much, there is an enormous incentive to do whatever it takes to make a company's stock price go up[35]—including incentivizing illegality. Furthermore, because executives are

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ASS'N OF CERTIFIED FRAUD EXAMINERS 1, 1, https://www.acfe.com/uploadedFiles/ACFE_Website/Content/documents/tone-at-the-top-research.pdf [https://perma.cc/L3ZK-JJT7].

33 Henning, *supra* note 9, at 104–05, 118 n.86.

34 *See supra* note 20.

35 *See supra* note 19; *see also* Langevoort, *supra* note 18.

so difficult to prosecute,[36] there are few meaningful disincentives to encourage (and to personally commit) misbehavior. But it isn't just corporate executives for whom the system provides inadequate incentives—and as we'll see, this nest of brambles is far more historically rooted.

Law and Economics provides powerful tools with which to analyze the problem. The torts concept of the "least-cost avoider" is especially helpful in understanding why the modern executive needs to be treated so much differently from the executives of the 1970s and before. The concept is simple and powerful: for any given harm, we should locate liability for that harm in the party that was in the best position to fix it (which is to say, the party that would have incurred the "least cost" to prevent the harm).[37] While this concept is most appropriately applied to issues sounding in tort, we can analogize to it to useful effect.

Let's start with the following proposition: at least in part, criminal law exists to rebalance the incentive structure for committing harmful acts. Imagine for a moment that there were no criminal laws against burglary or breaking-and-entering. Further suppose that Remi Robber passes by a closed bookstore, sees an ornate set of five books in the display window written by his favorite author and worth $100, and realizes the glass would be easy to break. Robber breaks the glass and takes the book set; Ida Innocent, the store owner, discovers the theft in the morning.

Taking this one harm in isolation, who was in the best position to prevent it? It's easy to say that Remi Robber was: all he had to do was not take the books. But let's dig deeper: the burglary actually had a very high cost. There are the easy-to-measure harms: the cost to replace books and the glass, for example. Then there are the harder-to-measure ones: the risk that other store items will be stolen before the glass can be replaced; the loss of customers while the window is repaired; the harm to the surrounding businesses; and the emotional harm to Ida Innocent and people in that city or area. (You can probably think of other harms, too.) Taken together, these harms far outweigh the $100 worth of books that Remi Robber stood to gain. Ida Innocent could have prevented this harm, of course: she could have hired a 24-hour security guard or put

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36 *See* Henning, *supra* note 1.

37 Paul Rosenzweig, *Cybersecurity and the Least Cost Avoider*, LAWFARE (Nov. 5, 2013, 11:41 AM), https://www.lawfareblog.com/cybersecurity-and-least-cost-avoider [https://perma.cc/HL2Z-ZQTK].

bars on the windows. But doing so would have come a cost much higher than $100—and let's not forget the difficult-to-measure costs (such as worsened aesthetics) that come with things like window bars and guards. Taken together, it is Remi Robber who would have incurred the least cost to prevent the harm of the burglary: the high costs (actual and social) of the robbery far outweigh his $100 gain. Remi Robber is the least-cost avoider.

But let's imagine instead that the set of books was actually a rare collection worth $1,000,000 that the bookstore had an insurance policy to protect. In that hypothetical, things aren't so clear; there's a good chance that Remi Robber would stand to gain a great deal more than what Ida Innocent would stand to lose. (Remember: in this hypothetical, burglary and breaking-and-entering aren't crimes.) In this case, Ida Innocent is probably the least-cost avoider: putting bars on the windows may not make financial sense to protect a $100 set of books, but to protect a $1,000,000 set, the choice seems obvious. (Indeed, Innocent's insurance company would probably require her to have bars or guards!)

Of course, as a society we have an interest in disincentivizing burglaries regardless who the least-cost avoider is; enter criminal law. In recognition of the serious harm that burglary presents, the punishment for committing a burglary (like the one Remi Robber committed) is quite high. Indeed, if Remi Robber were faced with two options only—stealing the books and risking punishment, versus not stealing them and not risking punishment—Robber would experience a net *gain* by not committing the crime; criminal law offers a powerful incentive to *not* steal that far outweighs the benefit of stealing. In the case of the million-dollar burglary, criminal law serves to rebalance the scales to ensure that Remi Robber, not Ida Innocent, is the analogical least-cost avoider and is the one held responsible for the harm caused by the robbery.

Obviously, the least-cost avoider doesn't perfectly fit atop criminal incentives and disincentives, in greatest part because the concept exists primarily as a means of determining which individual or entity should be held liable for negligent, unintentional harms. But the model is still useful for our purposes, because not only can it help us to identify cases in which a criminal law regime might not be designed to sufficiently disincentivize a particular kind of behavior, but even more usefully, it can serve to reveal which entity or entities *are* in the best position to prevent a particular harm.

In the case of corporate misbehavior, I argue that, perhaps surprisingly, the economic analysis leads us to the conclusion that it is the shareholders, and *not* corporate executives, who in our current system are analogous to the least-cost avoider. This helps to explain why the current prosecutorial regime resorts to deferred prosecution agreements and non-prosecution agreements with such frequency.[38] First, let's look at how the least-cost avoider analogy plays out in the context of corporate executive misconduct.

The outsized increase in executive pay, coupled with the failure to commensurately increase the criminal or civil legal exposure to executives, has shifted the analogical least-cost avoider from the C-Suite (where it arguably belongs) to the shareholders. For any given *individual* corporate misdeed, the person analogous to the least-cost avoider is almost always the wrongful actor her or himself. For example, a low-level employee who commits a crime in order to gain benefit X is the least-cost avoider: in *not* committing the crime, they would not gain benefit X, *but* neither would they be at risk of criminal punishment for it. Of course theoretically, the punishment is sufficiently severe as to outweigh the potential benefit, so by not committing the crime, the employee takes the least-cost action to avoid the harm: in the binary terms of gaining X and being punished on the one hand, versus not gaining X and not being punished on the other, not committing the crime is not merely least-cost; it's the clear winner. Likewise, a CEO who commits a crime for benefit Y would theoretically be faced with punishment commensurate with her or his crime and would similarly be in the best position to avoid the problem at the least expense by simply not committing the crime. But in practice, given the amount of power executives can exert without any overtly illegal actions (see the earlier discussion of the myriad ways executives can influence corporate behavior through tone- setting and the establishment of various incentives),[39] it would appear that in many cases, the modern corporate executive stands much more to *gain* from the above behaviors than she or he stands to lose from them—suggesting that in fact, they are *not* the analogical least-cost avoider, which we should view as a serious problem. Let's discuss why.

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[38] Wulf A. Kaal & Timothy Lacine, *The Effect of Deferred and Non-Prosecution Agreements on Corporate Governance*, HARV. L. SCH. ON CORP. GOVERNANCE (Sept. 23, 2014), https://corpgov.law.harvard.edu/2014/09/23/the-effect-of-deferred-and-non-prosecution-agreements-on-corporate-governance/ [https://perma.cc/9VLY-E8RK].

[39] *See supra* subpart II.B, ¶ 2.

Prior to modern executive pay and performance-contingent compensation structures, there would have been few incentives for executives to act in ways that might encourage lower-level employees to commit crimes. Thus, while it would be true that an executive who tacitly encouraged lower-level employees to commit crimes would be the analogical least-cost avoider, that would only be because the executive would lose little or nothing by not encouraging misbehavior: the executive's compensation wouldn't be tied to lower-level-employee performance, so there would be little or no personal incentive for the executive to encourage that action (nor anything to lose by not encouraging it).

Things are very different now: today, executives have *everything* to gain from encouraging illegal activity. By tacitly and indirectly encouraging or incentivizing lower-level employees to take illegal action, or by intentionally looking the other way or avoiding certain information, an executive might in fact have as much as tens of millions of dollars to gain. Further, if executives are able to do so with only a miniscule chance of being convicted of any wrongdoing, then there may be no practical incentive for them to do any differently. To frame the issue in the context of a formalist least-cost avoider calculation, subtracting the value of criminal punishment (criminal penalty multiplied by the risk of getting caught) from the value of the act(s) of encouraging profitable misbehavior (compensation gained through lower-level misbehavior multiplied by the percentage chance of not getting caught) may well result in the cost of *not* encouraging misbehavior being incredibly high. The main reason for this is the *combination* of the enormous financial value of encouraging the misbehavior, coupled with the extremely low chance that the executive will experience any legal repercussions. Furthermore, the harms caused by the illegal acts are likely extremely diffuse and nearly impossible to measure.

In this modern scenario, who *is* the analogical least-cost avoider, then? It would have to be the shareholders themselves. At the end of the day, even though the misbehavior may be very unlikely to be directly linked to the executive, that doesn't mean misbehavior and illegal activity isn't taking place and isn't getting discovered. Indeed, the number of non-prosecution agreements and delayed-prosecution agreements, the enormous fines that often follow from them, and the cost of subsequent crashes in corporations'

stock are all costs that ultimately fall to the shareholders.[40]

A number of factors come together to make this so. First and foremost, the shareholders, through the board, have the ultimate responsibility of hiring executives and approving their compensation packages.[41] Second, the shareholders taken as a *group* have the highest financial exposure: any and all discovered criminal activity and its attendant consequences (both economic and legal/punitive), regardless who does it, will get factored into the stock price.[42] Finally, if it is true that there is an executive compensation bubble as Professor Desai suggests, there is a significant gap between current executive compensation and efficient executive compensation.[43] Taken together, this all suggests that shareholders are most analogous to the least-cost avoider in this situation: if shareholders (through a corporation's board) were to (1) reduce corrupting incentives such as market-incentivized pay/bonuses and instead go to a cash model, (2) significantly decrease overall executive compensation in recognition of the existence of the compensation bubble, and perhaps even (3) incentivize executives on the basis of long-term corporate health through comprehensive auditing and internal reports, shareholders could minimize their own expenses and costs by significantly reducing both executive expense and costs related to criminal activity.

III
THE SOLUTION: A STATUTORY APPROACH

A. If It's That Easy, Then Why Haven't We Fixed the Problem Yet?

One major problem with the shareholder-driven solution described in the previous section is that it assumes long-term, highly invested shareholders—which brings us all the way back around to the concept of limited liability. For better or for worse, there is no evidence that all shareholders are

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40 DAVID O. FRIEDRICHS, TRUSTED CRIMINALS: WHITE COLLAR CRIME IN CONTEMPORARY SOCIETY 315 (1996) (Arguably, "deferred prosecution agreements are a device whereby government prosecutors can 'bully' corporations into accepting costly terms (for innocent shareholders, among others), without having to prove a case of corporate wrongdoing in a court of law.").

41 Investopedia Staff, *The Basics of Corporate Structure*, INVESTOPEDIA (Feb. 9, 2020), https://www.investopedia.com/articles/basics/03/022803.asp [https://perma.cc/VZP5-EX4S].

42 *See* Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J.L. & ECON. 757, 773 (1993).

43 *See supra* note 20.

interested in the profitability of a given company five or fifteen years down the road. Thus, what might be good for "Shareholders" (capital "S") isn't necessarily seen as good for all individual shareholders. It should perhaps come as no surprise, then, that we have an executive compensation bubble, and that shareholders do not, on the whole, appear to be especially interested in their investments operating to the highest ethical and legal standards: they, too, tend to be most-interested in short-term profits, as opposed to the long-term health and stability, of a corporation.[44]

Additionally, because shareholders represent a diversified group with varying degrees of knowledge, investment purposes, backgrounds, and financial vulnerability, we tend to be more interested in protecting shareholders from the bad behavior of their executives than we are of holding those shareholders accountable for the bad actions of the people they hire to run the corporations—*even when* those shareholders benefit from the bad actions of those hired executives (as many of them inevitably do, for example when individual shareholders sell stock at high prices, when the "high," unbeknownst to them, was the result of the corporate misbehavior of the company's executives).[45]

We do indirectly punish shareholders, of course: by holding the corporation itself criminally liable (either through direct prosecution or through a DPA or NPA), we *are* going after the shareholders. However, the impact on them manifests as a financial loss rather than any personal criminal penalty, and is significantly mitigated by shareholder limited liability.[46] And while this certainly has an enormous impact on Shareholders (again, capital "S"), the impact on any *individual* shareholder—especially a sufficiently diversified one—is often a mere financial setback at worst.

So what can be done? Above, I try to make clear that even while the Shareholders are the clear analog to the least-cost avoider with respect to major corporate misconduct, they also

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44 Finbarr Toesland, *CEOs Struggle to Balance Shareholder Returns and Growth*, RACONTEUR (Nov. 29, 2017), https://www.raconteur.net/hr/ceos-struggle-balance-shareholder-returns-growth [https://perma.cc/UX96-3ACR].

45 *See* Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigation and Reform*, 66 FLA. L. REV. 1, 25 (2015), http://scholarship.law.ufl.edu/flr/vol66/iss1/1 [https://perma.cc/GC6G-ZX5Y] (suggesting that large public corporations have more diverse pools of shareholders that, for that reason, are more deserving of protection than less diverse pools of shareholders, as might be found at smaller companies).

46 *See supra* note 11.

are the most difficult group to influence without disrupting financial cornerstones like limited liability. Thus, if Shareholders refuse to make the changes to executive hiring and compensation described above, we should augment the legal regime to make corporate executives the analogical least-cost avoiders once again. This Essay recommends doing that by modifying the *responsible corporate officer* doctrine as applies to corporate executives, *and/or* by forcing shareholders' hands and outlawing or handicapping derivatives- and market-based compensation structures.

B. The Responsible Corporate Officer Doctrine and a New Statutory Regime

The *responsible corporate officer* doctrine (RCO) is simple in concept. Under this doctrine, a defendant can be found criminally liable if he or she had, "by reason of his [or her] position in the corporation, responsibility and authority either to prevent in the first instance, or promptly to correct," the underlying crime.[47] The doctrine originated in the forties:

> In [*United States v.*] *Dotterweich*, a drug company and its president were prosecuted for the shipment of misbranded and adulterated drugs. The company was acquitted, but the jury convicted the company's president. In affirming the *Dotterweich* conviction, the U.S. Supreme Court acknowledged that the president had no role in or knowledge of the company's wrongful acts. Nonetheless, the Court determined that it was "in the interests of the larger good" to place "the burden of acting at hazard upon a person otherwise innocent but standing in responsible relation to a public danger."[48]

This powerful doctrine has been seldom used, and has been tightly cabined to apply only in a very limited set of circumstances. Specifically, the underlying crime must be a strict liability crime, *and* there are four factors that traditionally must be met: (1) the underlying statutory crime has no intent requirement; (2) the penalty is small; (3) a conviction would not gravely impact an individual's reputation; and (4) there's no suggestion that an intent requirement should be imputed.[49]

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[47] United States v. Park, 421 U.S. 658, 673–74 (1975).

[48] Lisa Krigsten, *Criminalizing Management Decisions: Prosecuting the Responsible Corporate Officer*, A.B.A. (Dec. 22, 2010), https://apps.americanbar.org/litigation/committees/criminal/articles/122210_responsible-corporate-officer.html [https://perma.cc/G6TJ-RYG8].

[49] Holdridge v. United States, 282 F.2d. 302, 310 (8th Cir. 1960).

This Essay argues that this doctrine should be used as a starting-point model for a new, codified doctrine of corporate executive responsibility. While the specific contours of any such statute are beyond the scope of this Essay, it should, at minimum, have a core framework similar in structure and effect to the following:

Model Responsible Corporate Executive Officer Statute:

1. A corporate executive is criminally liable for the illegal actions of individuals within a corporation when:
    a. The corporate executive has the requisite *mens rea* as defined by 2(a-c),
    b. Such action benefits the company,
    c. The benefit to the company could, in isolation or in the aggregate with other similar actions, positively impact the corporate executive's compensation or employment,
    d. The illegal actions were or are discoverable with reasonable internal processes, AND
    e. Such illegal actions are shown to be *either*:
        i. Widespread,
        ii. Substantial, AND OR
        iii. Severe
2. The corporate executive's liability is tied to her or his degree of knowledge of the illegal actions.
    a. A corporate executive whose lack of knowledge of the illegal action(s) is *negligent* is criminally liable *if* the illegal action(s) satisfy 1(d)(i), 1(d)(ii), *and* 1(d)(iii).
    b. A corporate executive whose lack of knowledge is *reckless* is criminally liable *if* the illegal action(s) satisfy 1(d)(i) *and* 1(d)(ii) *or* 1(d)(iii).
    c. A corporate executive who has knowledge of the illegal action(s) is criminally liable *if* the illegal action(s) satisfies *any* of 1(d)(i-iii).
3. Definitions:
    a. "reasonable internal processes" in 1(d) are those that promote and/or incentivize transparency, and promote information liquidity up and down the corporate chain of command
    b. "widespread" in 1(e)(i) means the illegal action is engaged in with some regularity by a number of individuals

c. "substantial" in 1(e)(ii) means the illegal action has had or has the potential to have a measurable financial impact on the corporation

d. "severe" in 1(e)(iii) means the illegal action is of a particularly egregious criminal nature.

This statute deviates significantly from the common-law doctrine in a number of significant ways. First and most importantly, it does not limit itself only to strict-liability offenses. To offset this, it reintroduces a *mens rea* requirement for the corporate executive her or himself and requires that the illegal activity actually be discoverable. The statute then "offsets the offsets" by tying different degrees of *mens rea* to different magnitudes of illegality. The main (and certainly the most controversial) innovation of the statute is that a corporate executive can be held criminally liable where she or he was *negligently unaware* of the criminal activity, in those rare cases when the illegal activity was widespread, substantial, *and* severe.

C. Why Criminally Punishing Executive Negligence is Okay, and Why the Statute Above Will Work

In the United States criminal system, we rarely confer criminal liability on those who have acted negligently.[50] This usually makes sense: we tend to think of negligent actions as being in some way accidental, and therefore undeserving of criminal punishment and public approbation. We might (rightly) worry that criminal liability for negligence would sweep up those who are merely careless and might not realize (through a lack of intelligence, lack of common sense, or both) that their actions might lead to severe consequences. For these and other reasons, we have mostly decided that civil penalties are sufficient to deal with the majority of negligence-related misbehavior.[51]

In the context of corporate executives acting in their professional capacities, however, we shouldn't have these same concerns. First, corporate executives tend to be highly educated and, most importantly, supposedly possess an exceptionally above- average degree of judgment.[52] None of the arguments reflecting a concern for those who are negligent

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50 George P. Fletcher, *The Theory of Criminal Negligence: A Comparative Analysis*, 119 U. PA. L. REV. 401, 401–04 (1971).

51 *Id.*

52 Sir Andrew Likierman, *The Elements of Good Judgment*, HARV. BUS. REV. (Jan.–Feb. 2020), https://hbr.org/2020/01/the-elements-of-good-judgment [https://perma.cc/JWX4-3RM6].

through a lack of intelligence or common sense apply here. Further, the degree of harm that can arise as a result of an executive's negligence is *incredibly* high, potentially impacting Shareholders on the order of millions or billions of dollars, and impacting customers in a myriad of other ways (consider, for example, the ongoing Wells Fargo proceedings, and the thousands of customers whose financial lives and credit scores have been wrecked as a result of employee misconduct).[53] Finally, as this Essay has already discussed at length, executive compensation is enormously high, and appears to have increased multiple orders of magnitude without any commensurate increase in legal exposure.[54] This matters, because the current state of executive pay means that *even if* we were to drastically increase the criminal legal exposure of corporate executives, executive compensation is so high that the deterrent effect of the increased liability would not meaningfully reduce, let alone eliminate, the supply of qualified corporate officers. In fact, it would have a highly positive impact: it would tend to incentivize individuals who view themselves as fundamentally law-abiding and ethical to apply for executive roles, and disincentivize those who might otherwise be inclined to act unethically or to encourage profitable misconduct.

Put differently, executives would view the statute above as being a factor to take into account when entering into a contract with the corporation, but it would certainly not eliminate the supply of qualified executives. Perhaps in the 1970s, when compensation averaged just above the $1,000,000 mark, such a statute would have had a negative value that exceeded executive compensation. But today, with the prospect of earning eight and sometimes nine figures a year, the value of compensation is much more likely to outweigh the risk of criminal prosecution.

A corollary effect of the above statute is that many executives and companies will choose to bypass the statute altogether and shift to cash compensation models. This is just as desirable, because it would equally serve to eliminate the primary incentive to encourage misbehavior—specifically, market performance-based bonuses. I might note that the

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53 Matt Krantz, *Wells Fargo Scam Latest in a String of Infractions*, USA TODAY (Sept. 11, 2016), https://www.usatoday.com/story/money/markets/2016/09/11/wells-fargo-scam-latest-string-infractions/90139724/ [https://perma.cc/4ETC-8W57].

54 *See* Mishel and Davis, *supra* note 2.

above statute could certainly be modified to find a middle ground: it could be written in such a manner that it only implicated executives who had some percentage (say, 20% or more) of their compensation tied up in the market. Alternatively, it could be written to implicate only those executives whose compensation packages were above a certain raw dollar amount. Suffice it to say that while this Essay would advocate the strict statute above, it can be moderated without eliminating its efficacy.

IV
FULL CIRCLE: THE EXECUTIVE-AS-ANALOGICAL LEAST COST AVOIDER ONCE AGAIN

Some version of the above statute, though seemingly extreme on its face, would be enough to shift the analogical least-cost avoider back from the shareholders to the C-Suite. It would significantly increase the risk of criminal prosecution for corporate executives, and it would quickly lead to a shift in corporate culture. No doubt it would have a number of negative consequences for corporate efficiency as well. Executives would be *constantly* concerned about the prospect of criminal liability, and they would probably spend an outsized amount of time worrying over this—at least at first; once the dust settled and corporations learned the ropes of the new regime (and once DOJ made clear the frequency and fervency with which they utilized the statute). The internal audit and investigation departments at most major corporations would swell, and the smart companies would expand their HR departments in order to keep an eye on employee satisfaction. Employee incentive structures would be carefully scrutinized, and executives would be perhaps *too* hesitant to encourage certain profit-seeking behaviors.

But on the other hand, the "tone at the top" would be a culture of compliance. In time, such a culture is likely to save the company money through reduced litigation costs, a reduced frequency of internal investigations, and an increase in executives who are interested in or willing to take reduced cash compensation over outsized market performance-based compensation. Most importantly, if this regime is applied across *all* corporations, then the nature of the entire system would adapt. And, ideally, corporations would stand to save a great deal of money through avoiding DPAs and NPAs: because individuals would be so much more exposed to criminal liability, prosecutors would be highly likely to shift some significant portion of their focus from the corporations to the

executives—who, after all, are the individuals that prosecutors usually most want to go after in the first place. The analogical least-cost avoider would once again be located in the active decision-makers: the executives themselves.

CONCLUSION

This Essay made a number of arguments, culminating in a pointed recommendation. First, the Essay took as its priors that executive compensation has increased by orders of magnitude over the past four decades, without any appreciable increase in individual legal exposure to corporate executives, and without any measurable increase in the *quality* of those executives. Second, the *nature* of executive compensation has shifted perilously from a cash-based compensation model to a market performance-based model, which fails to properly take into account obvious mitigating variables such as indexation and also is not based upon data on actual executive ability. These two things combine to create terrible incentives for corporate executives, which, coupled with their extremely narrow legal exposure, risks leading corporate executives to encouraging profitable misconduct. This Essay further supports this claim by analogizing to the law and economics concept of the least-cost avoider to show that the entity for whom preventing illegal activity costs the least is no longer the corporate executive as it ought to be, but rather is the Shareholders as a whole—a group that, because it is comprised of a hugely diverse pool of individuals with different investment strategies and no real group coherence, is unlikely to make the changes necessary to fix the problem of profitable misconduct. As a generally undiscussed side point, because of this same disconnect, corporate boards are ultimately likely to end up captured by executives, rather than properly accountable to the Shareholders.

By way of a solution, this Essay argues that we need a new statute, based in part (or at least in principle) on the doctrine of the *responsible corporate officer*. The statute would allow for various degrees of criminal liability based upon a combination of different mental states and different magnitudes of crimes. Finally, the Essay points out that because of the outsized level of executive compensation, the introduction of such a statute into the executive employment market would not destroy the supply of competent corporate officers but would in fact have a positive impact on it. While this would have *some* suppressive effects on corporate efficiency, it would save corporations money in the long-term,

and significantly reduce the number of DPAs and NPAs that corporations are subject to.

It is no wonder Americans have so little faith in corporations nowadays. Whether true or not, what most people see in the news is corporations doing what appears to be evil, and no one going to jail for it. Though general public policy was not a touchstone of this Essay, it could nonetheless justify its proposal. Americans will not soon forget that only one bank executive went to jail during the financial crisis.[55] If we believe in well-regulated capitalism as the best economic system we've yet devised, then we need to take steps to ensure that it is *indeed* well regulated. Taking steps to increase the legal exposure of the individuals most responsible for a corporation's actions is little more than a long-overdue, necessary first step.

[55] Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, N.Y. TIMES MAG. (Apr. 30, 2014), https://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html [https://perma.cc/W6LW-DWQD].