Akratic Corporations and Dysfunctional Markets

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INTRODUCTION

Manuel Utset presents a new approach for thinking about corporate criminal sanction. He examines the effect of criminal sanction on corporate actors with time inconsistent ("TI") preferences and shows that traditional approaches to deterrence will under-deter these corporate actors. He concludes that "TI corporate actors—and thus corporations—will be systematically under-deterred by the sanctions that are optimal for TC actors [i.e., actors with time consistent preferences]."[1]

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[1] Manuel Utset, *Corporate Actors, Corporate Crimes and Time-Inconsistent Preferences*, 1 VA. J. CRIM. L. 269 (2013).

Modeling firms with TI preferences, Utset "shows that principals, gatekeepers, and regulators . . . will underinvest in monitoring and detection." To encourage the proper level of investment, he supports certain provisions in Sarbanes Oxley that "reduce[s] the immediate costs of compliance . . . and reduce[s] the immediate rewards from violating the law."[2] He also supports "commitment devices" found in the Dodd-Frank Act.

My contribution to Utset's interesting and important research starts with three observations. First, the market economy places on TI corporate actors *dynamic* pressures that differ from those human actors face. For humans, punishments set at levels appropriate for actors with time consistent behavior (TC-ers) will *not* deter TI-ers. Human TI-ers will persist in their behavior, imposing (long run) costs on themselves and others—unless they are incarcerated for long periods of time, executed, or otherwise effectively deterred.

In distinction to human beings, TI corporate actors face market pressures. Because TC-designed criminal sanctions under-deter them, they will commit more crimes and, *ceteris paribus*, face more sanctions. The corporate actors with TI preferences, therefore, face a competitive disadvantage relative to their competitors with TC preferences. Thus, unlike TI human actors, TI offenders' competitive disadvantages make "capital" punishment through acquisition or bankruptcy quite real. This possibility renders questionable the need for specially designed punishments for corporate actors with TI preferences.

Second, market failure or inefficient agency/institutional structure, on one hand, and TI preferring behavior, on the other, is difficult to disentangle. Borrowing from Richard Posner's recent work on the financial debacle,[3] I argue that what appears to be TI preferring behavior may simply be behavior with TC preferences responding to market failure and/or sub-optimal institutional design.

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[2] *Id.* at 8.

[3] *See generally* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

Third, akratic tendencies[4] in individuals often excuse or partially excuse in the criminal law applicable to human subjects. The most prominent example of these crimes is heat-of-passion murder. Such crimes are akratic acts because most people who do them do so under a momentary lapse in which they use an inconsistent discount to value the expected utility from killing a person, e.g., their spouse in flagrantes, against 20 years imprisonment.[5] Utset, on the other hand, argues for *increasing* punishment so as to deter the akratic actor—or at least creating different sorts of punishment to catch the akratic actor.

I. TIME INCONSISTENT PREFERENCE, CRIMINAL SANCTION, AND AKRATIC CORPORATIONS

Time inconsistent (TI) preferences emerge when one entity has different discount values for utility at different points in time. Time inconsistent preferences can be used to explain "akrasia," the ancient Greek term for momentary lack of control that leads one to act in a way that conflicts with his or her "better judgment" or "true" preferences—or at least those preferences the individual has most of the time.

Addiction, typically characterized as akratic, arguably exemplifies TI preferences. Addicts persist in using drugs or alcohol even though they "know" such usage is bad for them. As they sometimes will say, addicts really "do not want to" to take drugs. In other words, most of the time, addicts value the benefits of soberness more than those of drug use. But, at moments of temptation, they value the utility from: (1) the high, buzz, and drunkenness at too low of a discount; and (2) staying clean and sober at too high of a discount. This renders the high/drunkenness of greater utility than soberness—at least for a brief time. At the moment at which the addict decides to takes drugs, the drugs offer greater utility than abstaining—thus the addict takes drugs. If, on the other hand, the actor discounted the value of the high and abstinence at the *same rate*, the actor

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[4] George Ainslie uses the classical term "akratic" or weakness of the will to refer to hyperbolic discounting, which leads to time inconsistent preferences. *See* GEORGE AINSLIE, BREAKDOWN OF WILL 17 (2001).

[5] *See* JOSHUA DRESSLER, UNDERSTANDING CRIMINAL LAW (LexisNexis, 5th ed. 2009).

would have TC preferences—and would abstain. The value he places on his short term preferences would be consistent the value he places on his long-term values.

Or, to use the example that Utset employs for much of the paper, consider the procrastinator. At the moment when he should choose to do something he should do, e.g., go to TurboTax and do his taxes, he prefers to play video games—even if he's due for a big tax return that year! In other words, the activity with the bigger payoff, doing your tax return and getting a few thousand bucks, has a *felt* lower utility—at least temporarily—than playing another round of *Angry Birds* because, well, *Angry Birds* is so enticing. Utset concludes that "this asymmetry between long-term and short-term impatience that leads people to procrastinate and overconsume."

Criminal sanction, from an economic perspective, ensures that expected punishment exceeds any gain from criminal activity—thus making criminal activity undesirable from a rational perspective.[6] To use an example, although you might enjoy the $1,000 that you steal from your boss, you might find that option undesirable when you include the likelihood of sanction. What's $1,000 compared to 5 years in a state penitentiary?

All criminal sanction creates a discounting problem. As Utset points out, there is always a "temporal gap between the time the offender commits a crime and the first possible moment in which she will experience the disutility from criminal sanctions. . . . [T]he benefits from misconduct are received (or the offender expects to receive them) before the time when she can be punished."[7]

Utset is concerned that criminal punishment that is designed to make behavior undesirable for those with standard discount rates will fail to deter those with TC preferences. Utset identifies the following types of TI offenders:

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[6] Richard A. Posner, *An Economic Theory of the Criminal Law*, 85 COLUM. L. REV. 1193 (1985); Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

[7] Utset, *supra* note 1, at 27.

1. one shot TI offender who will engage once in TI preference, even though his long run welfare will be diminished;[8]
2. the nibbler who has long-range preferences to behave rationally but on occasion indulges TI preferences;[9] and
3. the "compliance procrastinator" who procrastinates implementing action to reduce misconduct.[10]

His solution is to increase the "salience" of delayed sanctions. Utset identifies the Sarbanes-Oxley Act of 2002 certification process or high visibility IRS raids as methods to create greater salience.[11] He also suggests "targeting immediate benefits" by focusing on enforcement once a crime is detected, thus reducing immediate benefit. He also suggests reducing total benefits from misconduct and increasing the immediate costs of misconduct—which will also deter TI-ers.[12] Or, he suggests commitment devices—which he argues the Dodd-Frank Act creates.[13]

The following makes three arguments that suggest re-examining specially designed punishments for corporations with TI preferences. First, there is no "right" discount rate; firms compete on picking the right discount rate when making business investments. This competition applies to the selection of the appropriate rate for discounting the possibility of potential sanction. Because firms with TI-ers will *ceteris paribus* face greater punishment, they will be at a competitive disadvantage and thus suffer and perhaps in the long run cease to exist. In the long run, at least, TI-ers' competitive disadvantage thus might solve the problem Utset identifies without special sanctions. Second, what appears to be TI behavior may be quite rational TC behavior—but rational behavior working under market failure or institutions with inefficient agency structures. The solution should be market reform or reform in corporate

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[8] *Id.* at 29-31.

[9] *Id.* at 31.

[10] *Id.*

[11] *Id.* at 40-44.

[12] *Id.* at 44.

[13] *Id.* at 44-47.

governance, not criminal sanction. Third, we examine why criminal law for akratic behavior for individuals, i.e., heat-of-passion murder, acts as an excuse and how that insight affects Utset's proposal for criminal law.

II. DISCOUNT RATES AND THE COMPETITIVE DISADVANTAGE OF CORPORATIONS WITH TI PREFERENCES

As an initial matter, there is no "right" discount rate; firms (as well as individuals and nation states) in a sense compete on picking the "right" rate when making business investments—or in the case of individuals or nation-states, personal career choices or national macroeconomic policy, respectively. Because TI corporations will face *more* criminal sanctions than TC corporations, TI corporations will be at a competitive disadvantage. In the long run, this competitive disadvantage might work effectively to eliminate firms with TI-inconsistent preferences.

Discount rates are predictions about future value—but, as Yogi Berra reminds us, it's tough to make predictions, especially about the future. Utset says, "people are impatient in that they prefer to receive benefits as early as possible and delay incurring costs until future periods."[14] But that is a problem only if your bank offers a high enough rate of return. If it's high enough, investment (and delay of gratifications) makes sense. A sufficiently high payoff for delay will overcome any finite preference for immediate gratification; if it is not high enough, immediate gratification may be preferable.

In other words, there is no "correct" discount rate when people talk about the "cost of money," or the risk-adjusted value of money; these values merely reflect guesses as to future interest rates, economic growth, and returns on investment. Under certain rates of return, you will be better off in the long run saving at an advantageous rate of return. But, not if there is hyperinflation or a war—in which the potential, indeed, possibility, of a "long run" is quite diminished. "Eat, drink and be merry for tomorrow we die" is that utility maximizing strategy when we hear the sound of cannons.

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[14] *Id.* at 12.

Second, markets, nations, and individuals compete on picking the correct discount rate—and only time can tell which discount value maximizes utility in the long run. For instance, some firms do not invest in the future and are so-called cash cows offering regular, high dividends; other firms invest and promise long-term increases in value. But, investment stocks are only desirable if the firm stumbles upon marketable technological or scientific advancement; otherwise, stick to Proctor & Gamble.

Third, firms compete on the "correct" discount rate for criminal or other sanctions. As Utset points out, all criminal sanctions present a time inconsistency problem, as punishment follows the crime—and may or may not occur.[15] Firms must devote resources to avoid criminal and regulatory sanction. The correct amount of resources depends, of course, on the "correct" discount rate. But, as argued above, there is no "correct" rate; only guesses—guesses on which firms compete.

Firms with TI preference will *ceteris paribus* face more criminal sanctions because the TI actor will commit more crimes. Utset recognizes this point: while "a TI actor will engage in misconduct *at least* the same number of times as her TC counterpart," such actor "may also engage in misconduct in instances when the TC actor is optimally deterred."[16]

Utset concludes that "[i]n a world with TC and TI corporate actors, it is impossible to rely solely on delayed sanctions to achieve optimal deterrence."[17] This is undoubtedly true in the short run. But, it may not be in the long run. If TI actors always must bear the costs of additional punishment due to law breaking, they will face a competitive disadvantage, perhaps leading to take-over, bankruptcy or some other type of corporate "capital punishment."

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[15] *Id.* at 28.

[16] *Id.* at 52.

[17] *Id.* at 53.

III. Akratic Corporations or Market Failure?

In the long-run, or so the previous section argues, the market may correct for firms with TI-preferences by making them relatively worse compared to competitors. However, this hard *laissez faire* attitude seems to contradict reality. There are situations, as Utset points out, in which firms, in an endemic manner, appear to act upon TI preferences. Most prominent in our collective minds is, of course, the recent financial debacle in which major financial institutions appeared to value short-term gain over long-term disaster.

But, even if many financial institutions behaved as if they had TI preferences, and Utset is probably right that they did so behave, one must still determine whether this corporate bad behavior resulted from TI preferences *or* flawed market or institutional structures. It is at least conceivable that flawed market or institutional structures created incorrect incentives that, in turn, made it rational, even when using TC discounting, to behave in ways that are destructive or inefficient in the long term. Disentangling TI preferences from the flawed market structures which create such preferences can be very difficult.

In his analysis of the financial crisis, Judge Richard Posner identifies numerous instances of firms exchanging long-term benefit for short-term benefit. These firms assumed excessive risk and introduced systemic risk to the entire financial system. Posner, however, does not attribute this (in hindsight erroneous) behavior to irrationality or incorrect discounting. He defends the rationality of the highflying i-bankers. Rather, he points his finger at market, institutional, and regulatory failure.

In particular, Posner argues that when interest rates are low, it is rational to engage in risky leveraging during a bubble—given the high profits to be made. He says: "The enormous returns that financial firms can make by borrowing heavily when interest rates are very low and lending into an expanding market provided a rational incentive for a firm to increase its leverage to a point at which bankruptcy was a non-negligible, though small, perceived risk."[18] Thus, given the promise of high returns, there is no irrational economic behavior—discounting or

[18] Posner, *supra* note 3, at 88; *id*. ("Especially when interest rates are low, riding a bubble can be rational even though you know it's a bubble.").

otherwise—in preferring immediate payoff in exchange for risk of a much greater downside.

Regulation failed to correct these skewed incentives and, in fact, encouraged greater risk, taking short-term gain at the expense of long-term risk. In particular, a federal bank deregulatory policy since the 1970s—coupled with a policy to maintain federal deposit insurance—allowed non-regulated banks to offer banking-like products and gave banks the incentives to take excess risk with their funds. Posner writes,

> Despite the bad experience with the S&Ls, 'safety first' regulation of commercial banks continued to be whittled down . . . . Brokerage firms and investment banks, such as Merrill Lynch and Lehman Brothers, which were not regulated as banks, along with other nonbank financial intermediaries such as finance companies, money market funds, and hedge funds, were increasingly permitted to offer financial products similar or even identical to those of banks. . . . But federal insurance of [banks'] demand deposits remained . . . further encouraged risk taking.[19]

Securities law (and innovative securitization) also encouraged excessive risk-taking—as well as taking initial profits in the short term in exchange for a high risk of later catastrophe. Indeed, if one were a clever banker, one took the initial benefit and then "sold" the risk to another party—a practice that innovative finical instruments facilitates. Posner writes, "What made leverage even more dangerous for banks during the housing bubble was that rather than retaining the mortgages they had originated or bought, they sold most of them in exchange for securities backed by those mortgages . . . [which] became a part of banks' equity capital."[20] These securities, moreover, were incorrectly rated. Federal securities laws' reliance on rating agencies—a clear regulatory failure given that they are paid by those issuers whose securities they rate.

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[19] POSNER, *supra* note 3, at 45–46.

[20] *Id.* at 48.

Further, the complexity and novelty of securities—and the derivatives based upon them—rendered their riskiness and value opaque even to the most sophisticated market participant. "The emergence of the organizational problems that I have mentioned coincided with the creation of the new financial instruments—the mortgage-backed securities and credit-default swaps . . . . Organizations stressed by rapid expansion were further stressed by the analytical challenges posed by the new instruments . . . ."[21]

These problems suggest that actors, in fact, applied the proper discount given the market structure that they faced—a structure that rewarded short-term profit taking in exchange for long-term and systemic risk. To use an example, consider the investment banker who takes her short-term cash deposits but buys mortgage-backed securities, even though she knows there is a systemic risk to these securities. The returns are enormous, and the risk that she will lose money on any one deal is quite small. If her trades blow up in her face, she will not bear the majority of the losses: her employer, as well as markets at large, will.

Under these conditions, it makes sense for the banker to value immediate gain over long-term well-being. The banker is acting rationally. And, the eventual collapse is not a failure of his discounting factor. It is arguably not flawed discounting—but regulatory failure.

Punishing TI-inconsistent behavior could re-weigh this balance, correcting the incentives under which our trader works. But, criminal sanction as a remedy presents its own problems. Most of the market behavior Posner describes was perfectly legal. Thus, to correct it would require a significant expansion of the criminal law. Indeed, Utset sees the criminal law counteracting behavior that has been created or exacerbated by failed regulatory regimes. But, Utset's approach seems roundabout, tending to add another layer of law to a complex regulatory structure, rather than simply fixing the regulation.

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[21] *Id.* at 81.

IV. AKRATIC CORPORATIONS OR INSTITUTIONAL FAILURE?

One question that emerged from the financial crisis is *how in the world* did the entire banking industry allow the real estate bubble, and the practices built upon it, to persist? Or, to put the matter more practically, why didn't the principal at the bank at which our investment banker (the one discussed in the above example) worked stop this TI-preferring behavior before it bankrupted her firm? After all, the principals had the incentive to do so, as their interests were longer term compared to their employees. Their interests were allied with their bank's long-term success, not merely their annual bonuses.

Utset would, I think, argue that TI-preferences, both by the actors and those principals and managers entrusted to create monitoring regimes, are to blame. It was simply too easy to either take the quick money or procrastinate in putting in enforcement mechanisms.[22] The corporations acted akratically.

Posner presents an alternate view. He identifies poor compensation schemes as part of the problem. He writes:

> The tendency of corporate management to cling to a bubble and hope for the best—or, equivalently, the tendency to maximize short-run profits—is strengthened if, as on Wall Street during the boom, executive compensation is both very generous and truncated on the downside. For then every day that you stay in you make a lot money, and you know that when the bubble bursts you'll be okay because you have negotiated a generous severance package with your board of directors.[23]

Further, banking firms' structure—and banking firms' ability or lack of ability to attribute profit—encourages banking management to undervalue risk management and overvalue input from successful, often risky, traders. Posner writes, "a financial firm will tend to give more

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22 Utset, *supra* note 1, at 6–7.

23 POSNER, *supra* note 3, at 93.

weight to the views of successful traders than to those of risk managers,"[24] given that traders' contributions to the bottom line are clear and easily attributable. The financial industry's rapid expansion in the early 2000s exacerbated firms' monitoring costs because "an organization expands rapidly [and] there is bound to be some loss of control over subordinates, which exacerbates the problem of having a less experienced staff."[25]

Posner identifies institutional causes for risky, apparently risky TI behavior. Disentangling flawed institutional structure from flawed incentives and preferences is a chicken and egg problem—just like disentangling flawed market structures from flawed incentives and preferences. Given this interdependence, perhaps the most efficient fix would be to correct the regulation of institutions as opposed to expanding the criminal law given the latter's costly and often unwieldy enforcement costs.

V. TI PREFERENCES, MORAL JUDGMENT, AND THE CRIMINAL LAW

In general, the criminal law treats actors with TI preferences with lenity or, at the very least, does not single them out for special, extra deterrence. For instance, heat-of-passion murder is arguably an akratic act. As classically described, the husband sees his wife and her paramour in flagrante. Overcome by an uncontrollable and totally unexpected anger, he kills his wife and her paramour. He regrets his act immediately; he did not "want" to do it. Rather, he—at the moment he came upon his wife—had a TI preference to kill her, or so one might argue.

The law does not specially deter the heat-of-passion murderer. To the contrary, our cuckold receives a lighter sentence than murder (at least under the classic, unreformed version of heat-of-passion murder).[26] Analogously, partial diminishment, the "uncontrollable impulse" test in

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[24] *Id.* at 80.

[25] *Id.*

[26] D. Barret Broussard, Comment, *Principles for Passion Killing: An Evolutionary Solution to Principles for Passion Killing: An Evolutionary Solution to Manslaughter Mitigation*, 62 EMORY L.J. 179, 201 (2012).

insanity, and even the drunkenness defense in specific intent crimes can be viewed as lenient treatment for those acting from TI preferences.

These crimes, which are arguably caused by the defendant's TI-preferences, suggest that as a moral matter, we are lenient towards actors acting on the basis of TI-preferences. The criminal law is apparently interested in judging the "whole" person—not fleeting preferences. Indeed, beyond pure moral arguments, some have suggested that the excuse or partial excuse of crimes proceeding from TI-preferences reflects the *higher cost* of deterring such crimes on the individual level—suggesting that it is efficient to have weaker penalties and thus less deterrence.[27]

Utset, however, goes in the opposite direction. Rather than excuse or partially excuse the actor acting from TI preferences—thus lowering deterrence, he advocates specially designed laws specifically targeted to deter such actors. To those who argue for a morality-based approach to criminal law, this move needs further justification. Those who defend heat-of-passion murder usually argue that certain circumstances try even the best of people—and that it is unfair to hold individuals to the standards of the criminal law at all times.[28] It is a concession towards or recognition of human frailty. The question for Utset is why do we not also recognize corporate frailty? Or, why should we *only* recognize human frailty?

CONCLUSION

Building on an import series of works, Utset is examining an important new approach to the examination of the criminal law. Given the apparent pervasiveness of extremely bad decision making throughout financial markets during the last decade, his re-examination of the basic assumptions of criminal corporate sanction seems essential. Taking into account corporate behavior that proceeds from TI-preferences seems an important step in this re-examination and points to a valuable set of insights that can be brought to legal reform.

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[27] Adam Candeub, *An Economic Theory of Criminal Excuse*, 50 B.C. L. REV. 87 (2009).

[28] *Id.* at 124 n.232.