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# "LEFT BEHIND" AFTER SARBANES-OXLEY

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# "Left Behind" after Sarbanes-Oxley

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## I. Introduction

According to a recent issue of Business Week,[1] many hotshots of American industry are fleeing publicly traded corporations for "the money, freedom and glamour of private equity." Among the reasons cited for their departure is the Sarbanes-Oxley Act of 2002,[2] which not only dramatically escalated penalties for white-collar crimes, but also diluted the *mens rea* (or "guilty mind") requirement for criminal regulatory offenses. More and more activities, especially of publicly traded corporations, fall within the potential scope of the criminal law; and whether they actually do is left ever more unpredictably to the discretion of prosecutors and juries.

When Outback's long-time and much-praised CFO, Bob Merritt, resigned two years ago, he criticized the multiplying regulations that have made his professional life such a misery:

> [O]ver the last two years I've found myself spending more time and resources on regulatory matters than supporting the management of the company and improving the businesses we operate. Because I'm a business-development oriented person, and

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[1] Emily Thornton, *Going Private*, BUSINESS WEEK, February 27, 2006, at 52.

[2] Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter, Sarbanes-Oxley].

> administration is not my strength, I believe there are other people out there who can do a much better job at managing in this environment than I.[3]

Merritt's suggestion, seconded by others in the journalistic and academic community, is that entrepreneurial-minded executives are being replaced by "bean counters"—that is, those who delight in the minutia of regulatory compliance. To be sure, this is part of the story, but the truth may be more complicated.

Ours is a story about adverse selection. Economists have deployed the idea of "adverse selection" in contexts as varied as health and car insurance,[4] financial market imperfections,[5] and employment decisions by firms;[6] but it has seldom been used in the study of the criminal law. In broad strokes, adverse selection refers to the fact that in any given group of people, with various risk profiles and moral dispositions, there is the risk that some will choose to exit the group; and further, that those remaining in the group will be, in some way, the less wholesome of the bunch. To prevent the better sorts from leaving, there must first be some mechanism to identify them, and then to accord them preferential treatment. *Mens rea* played such a sorting function with respect to the enforcement of the criminal law.[7] Because the law operated, at least traditionally, only against those who had formed a specific mental intent to do harm, or *mens rea*, persons inclined to be law-abiding could signal their efforts to obey the law by investing in precautions to avoid violating a statute. Those charged

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[3] Merritt's Statement, St. Petersburg's Times, April 22, 2005, at http://www.stpetetimes.com/2005/04/22/Business/Merritt_s_statement.shtml.

[4] *See, e.g.*, Georges Dionne et al., *Adverse Selection in Insurance Markets, in* HANDBOOK OF INSURANCE 185 (Georges Dionne ed., 2000); George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

[5] *See, e.g.*, Joseph Stiglitz and Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

[6] *See, e.g.*, Adriana D. Kugler & Gilles Saint-Paul, *How Do Firing Costs Affect Worker Flows in a World with Adverse Selection?* 22 J. LAB. ECON. 553 (2004).

[7] *See generally* Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741 (1993) (arguing that *mens rea* serves as a mechanism that allows informationally constrained prosecutors to distinguish those who invested in care from those who did not, thereby allowing law-abiding individuals to avoid an overinvestment in precautions that would be commonplace in a strict liability regime).

with enforcing the criminal law could then distinguish such individuals from those who acted reckless of the law's demands.

Although the common law's embrace of a *mens rea* requirement in the criminal law reflected an advance—on both moral and efficiency grounds—over ancient law, recent legal developments suggest an unfortunate return to what are, in effect, strict liability crimes. Some modern criminal laws have explicitly abandoned any *mens rea* requirement, creating *de jure* strict liability; more commonly and insidiously, criminal laws applicable to many regulated industries are so ambiguously drafted, and entail such severe penalties, that the effect of the law is what we call *de facto* strict liability. In this article, we argue that these two trends–soaring penalties for corporate crimes and dilution of a *mens rea* requirement–could have the paradoxical consequence of creating *more* corporate crime and not, as the standard story goes, less. And the reason is that a form of adverse selection may now be operating in which some of the best (most law-abiding) entrepreneurs are fleeing the scene, leaving the less wholesome sorts behind.

With the Sarbanes-Oxley Act of 2002, Congress stepped closer towards life imprisonment as the maximum sentence for white-collar crimes. (And really, why stop at life imprisonment: why not hang a white-collar criminal now and again?[8]) Sarbanes-Oxley did not simply increase penalties, however; it also continued the already mentioned trend in American law, diluting the *mens rea* requirement for various criminal offenses. The combination of indeterminate criminal liability and steep penalties has created areas of *de*

[8] *See* John Tierney, *Making Them Squirm*, N.Y. TIMES, July 12, 2005, at A21 (suggesting in jest that a cost-benefit analysis argues in favor of executing computer hackers); Michael K. Block & Joseph G. Sidak, *The Cost of Antitrust Deterrence: Why Not Hang a Price-Fixer Now and Then?* 68 GEO. L. J. 1131 (1980) (arguing that because of judicial and enforcement error, threats of exorbitant penalties are not socially beneficial).

*facto* strict liability. For example, one of the most notorious provisions in Sarbanes-Oxley,[9] section 302, requires chief executives and chief financial officers to certify that all financial filings contain no "untrue statements" and "fairly present all material respects the [company's] financial condition."[10] According to one observer, "[t]he personal responsibility imposed on the signing officers in section 302 makes this among the most draconian sections of the Sarbanes-Oxley Act."[11] Other scholars have argued that section 302 is more about atmospherics than meaningful change in the pre-existing law on disclosure.[12] Even to the extent that this is true, the atmosphere is important—try to breathe without it—and the atmosphere is becoming increasingly noxious for corporate executives who excite the interest of federal prosecutors: The maximum penalty for violating section 302 is five million dollars and twenty years in prison.

Our model begins with a crucial fact, ignored or slighted in much of the recent law and economics literature on criminal law: Most people are neither risk-averse nor risk lovers; we are both. In certain aspects of life, we are risk averse (hence we buy insurance), but in other aspects of life, we are risk lovers (we play the lottery).[13] Indeed, what we will call "the ideal entrepreneur" has a conflicted attitude towards risk: In business matters, she is risk-neutral: she will forego projects with certain 4% gains for riskier projects with expected returns in excess of 4%. Yet with respect to compliance with the criminal law, the ideal entrepreneur is risk-averse: She will pay the certain costs of compliance rather than risk

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[9] For a critique of Sarbanes-Oxley, *see* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE (2006).
[10] Sarbanes-Oxley, *supra* note 2, at § 302.
[11] Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159 (2005).
[12] *See, e.g.*, Lawrence Cunningham, *The Sarbanes Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work*, 35 CONN. L. REV. 915, 955 (2003) ("This preliminary certification requirement captivated news analysts, investors, and corporate watchers during Summer 2002. It is, however, a yawn.").
[13] *See* Milton Friedman and J.J. Savage, *The Utility Analysis of Choices Involving Risk*, 279 J. POL. ECON. 279 (1948) ("It seems highly unlikely that there is a sharp dichotomy between the individuals who purchase insurance and those who gamble. It seems much more likely that many do both.").

being found guilty of a crime, *even when* a purely rational (or risk-neutral) individual would engage in the criminal behavior because the low probability of detection renders the expected penalty less than the cost of compliance.

We conceive of the competition for corporate control as waged by three human "types"—the ideal entrepreneurs, the swashbucklers and the bean counters. From society's perspective, the optimal environment is one that allows the ideal entrepreneur to thrive. Unlike bean counters, she is willing to take entrepreneurial risks that benefit society. Unlike the swashbucklers, she is hard-wired to comply with the criminal law even at substantial cost. But as the criminal law becomes increasingly draconian, and its application unpredictable—that is, as it becomes one of strict liability—our model demonstrates that she will flee for other environments. Who, then, will be "left behind" as CEOs and CFOs?[14]

First of all, ideal entrepreneurs whose spirits are drained out of them and who become risk-averse with respect to *both* business and law; these "bean counters" will happily avoid any possibility of legal trouble by parking capital in low-risk enterprises and then spending 80 hours a week crossing every t, and dotting every i. Also thriving, however, are the swashbucklers—that is, people who are risk-neutral and possibly even risk-loving with respect to business matters *and* legal compliance. Such persons are not particularly deterred by the increase in penalties. Crunching the numbers, they may discount punitive statutory penalties due to a perceived low rate of detection and conviction. As every increase in criminal penalties more thoroughly drives away the ideal entrepreneurs, adverse selection operates, and the swashbucklers more completely dominate the field. The ultimate irony is

[14] According to the doctrine of "rapture," the cornerstone of a series of apocalyptic novels by Jerry Jenkins and Tim LaHaye, true believers will be snatched away, in body and soul, to heaven, but the unrighteous will be "left behind." *See* Luke 17:34 ("I tell you, in that night there shall be two men in one bed; the one shall be taken, and the other shall be left behind.").

that the indeterminate widening of the scope of white-collar criminal law, and the penalties that attach for its violation, may drive away the very people most susceptible to being deterred by the criminal law. Those "left behind" may truly be the "unrighteous"—those who are not, and, absent absurdly draconian penalties, cannot be deterred.

Our plan is as follows: Part II presents a psychological profile of the ideal entrepreneur, focusing on her attitude towards risk in both entrepreneurial and legal compliance issues. She is what we will call a "global rational calculator" in the sense that she has made a one-time decision, good for all time, to obey the criminal law, thus removing compliance issues from the ordinary mix of variables that are subject to cost-benefit analysis. Part III introduces the idea of adverse selection. Traditionally, a *mens rea* requirement functioned as a crucial sorting mechanism, staving off the problem of adverse selection; it allowed enforcers of the criminal law to distinguish between those determined to comply with the criminal law (such as the ideal entrepreneur) and those indifferent to the law's strictures (such as the swashbucklers). This sorting mechanism is absent in a world of strict liability crimes. Part IV provides a brief historical tour of American criminal law, emphasizing the movement away from a *mens rea* requirement and towards strict liability crimes. This Part also examines the various ways in which a strict liability regime could influence the ordinary decision-making of a CEO. In Part V, we offer a simple mathematical model to predict how the ideal entrepreneurs and swashbucklers will fare, in their competition for corporate control, as we move from a *mens rea* world to one governed by strict liability crimes.

## II. Risk and the Ideal Entrepreneur

The best corporate executives are not the like the typical reader of this article. Our typical reader attends, or has attended law school, which marks her as relatively risk-averse in financial matters. She, like both of us, prefers a steady, if unspectacular, income to the uncertainty, both upside and downside, of a life as an entrepreneur. In this section, we first explore how an entrepreneur's "animal spirits," or instinctive risk-neutrality, is beneficial, both to herself and society. We then explore how the person we call the ideal entrepreneur compartmentalizes her risk-neutrality. With respect to business decisions, she coolly compares the expected value of various activities. With respect to legal compliance, however, she does not engage in such hard-headed (or stone-hearted) calculations. Instead, she will be risk-averse, preferring to incur the costs of legal compliance even when they are more costly than the expected sanction.

### A. "Animal Spirits" and Entrepreneurial Attitudes Towards Risk

In most of our individual decisions we are, due to our diminishing marginal utility of consumption, risk-averse.[15] Yet a thriving market economy depends on the existence of a core of entrepreneurs and corporate managers whose utility function and psychic composition

[15] Risk aversion arises from the diminishing marginal return from wealth, captured by the utility function $U = \sqrt{x}$. Imagine that such a risk-averse individual is faced with two possible endeavors: the first pays $50 with certainty; the second pays $100 with probability ½ and $0 with probability ½. Each endeavor pays the same expected amount: $50. The difference is that the first pays the $50 with certainty, while the second pays that amount as the average of two possible outcomes. The first project yields a utility level of $\sqrt{50}$ =7.07, while the second project yield an expected utility of $\frac{1}{2}\sqrt{0} + \frac{1}{2}\sqrt{100}$ =5. The individual will prefer the first project over the second, as the first gives a higher level of expected utility than the second project, even though the expected levels of income are the same.

are such that they are risk-neutral in financial matters.[16] That, in a nutshell, is our argument in this section.

John Maynard Keynes famously used the phrase "animal spirits" to describe why some people, in the face of so many obstacles and reasons for pessimism, nonetheless *act*:

> [I]f the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die;--though fears of loss may have a basis no more reasonable than hopes of profit had before.... [I]t is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance.[17]

In a sense, Keynes is simply making the point that entrepreneurs have more *spirit*—that is, a more acute taste for adventure and greater tolerance for adversity and uncertainty—than the typical law professor or economist.[18] But insofar as Keynes suggests that this spirit is opposed to our "rational selves," we think he may mischaracterize the matter. Actually, entrepreneurs with "animal spirits" may be more rational than the rest of us, at least in the sense that they more coolly and mathematically prefer those enterprises with higher expected values. It is not, as Keynes writes, that their "naive optimism" allows them to dispel from their minds "the thought of ultimate loss." To the contrary, that possibility is considered in all its brutal reality, but when offset by the possibility, even slim possibility, of large success, the entrepreneur makes the purely rational, or risk-neutral, judgment.

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[16] Imagine an individual whose utility function is captured by $U = x$. This individual receives the same utility from income (or consumption) regardless of her current level of income. The second dollar gives her as much satisfaction as the first. Presented with the possibility discussed in note 15 (100% chance of $50 or 50% chance of $100), such a person is truly indifferent.

[17] JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 162-63 (1964).

[18] This is the sense in which Jane Austen uses the phrase "animal spirits" in Pride and Prejudice:

> Lydia was a stout, well-grown girl of fifteen, with a fine complexion and good-humoured countenance; a favourite with her mother whose affection had brought her into public at an early age. She had high animal spirits, and a sort of natural self-consequence, which the attentions of the officers, to whom her uncle's good dinners and her own easy manners recommended her, had increased into assurance.

JANE AUSTEN, PRIDE AND PREJUDICE.

Even if we lack the venture capitalist's "animal spirits," which may largely amount to her risk-neutrality, as members of society we benefit greatly from the existence of such men and women—both as investors and as consumers.

As risk-averse investors, we should seek out companies managed by executives who do not share our risk profile. Suppose, for example, that the opportunity arises to invest in Project A, which will yield $1 million profit with certainty, or Project B, which will yield $0 with probability ½ or $3 million with probability ½. If presented with these options as individuals, most of us would presumably pick Project A, despite its lower expected return.[19] Yet as investors who hold a diversified portfolio we should expect corporate managers to opt for Project B, due to its considerably higher expected payout.[20]

As consumers, furthermore, we are better off when there are some individuals in society with enough tolerance for risk that they stake their fortunes on positive payout ventures with a high variance of outcomes. James Glassman notes in this context the story of Ruth Fertel, a divorced mother who quit a job as a lab technician in 1965, mortgaged her house, and invested her life savings in a steakhouse. Forty years later, Fertel's original investment of $22,000 has become a company (Ruth's Chris Steak House) that has gross annual revenues of over $250 million.[21]

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[19] Although the expect payout of Project B is $ 1.5 million, we must recall the consequences of the diminishing marginal utility of consumption.

[20] *See generally* ZVI BODIE & ROBERT C. MERTON, FINANCE (2003); THOMAS E. COPELAND & J. FRED WESTON, FINANCIAL THEORY AND CORPORATE POLICY (3d ed. 1998) (introducing, among other ideas, the concept of portfolio diversification, which states that investors should own a portfolio of investments of varying risk in order to achieve the highest level of return).

[21] http://www.ruthschris-toronto.com/html/about/about_ruth.shtml; http://www.techcentralstation.com/062102M.html

The idea that entrepreneurship is critical for the development and growth of any economy was popularized long ago by Joseph Schumpeter.[22] He argued that entrepreneurs spark economic growth by introducing new products, developing novel methods of production, and discovering previously untapped sources of raw materials.[23] Various studies have supported Schumpeter's thesis, which perhaps explains, at least in part, the differential growth rates among countries.[24] We owe many of the notable innovations of the past century to small firms headed by innovative and risk-taking entrepreneurs.[25]

In sum, much of what distinguishes those men and women who serve society by innovating and thereby creating wealth, from the rest of us, who are content humbly to perform assigned tasks, is a propensity for taking calculated and rational risks.[26] Entrepreneurs are willing to gamble, often quite reasonably, that a particular market can be conquered or that a new product will take off or that their facility will dramatically lower costs. The gamble may well be a "reasonable" one, given the finite downside risk and the momentous upside potential.

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[22] JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST AND THE BUSINESS CYCLE (1911 original translated in 1934 reprinted in 1964).

[23] *Id.* at 66. *See also* Peter J. Boettke & Christopher J. Coyne, *Entrepreneurship and Development: Cause or Consequence?*, 6 ADVANCES IN AUSTRIAN ECON. 67 (2004) (arguing that entrepreneurship is a prerequisite for economic development).

[24] *See, e.g.*, PAUL D. REYNOLDS, MICHAEL HAY, & S. MICHAEL CAMP, GLOBAL ENTREPRENEURSHIP MONITOR (1999) (finding a correlation between entrepreneurial activity and economic growth).

[25] Jason Henderson, *Building the Rural Economy with High-Growth Entrepreneurs*, 87 FED. RESERVE BANK OF KANSAS CITY ECON. REV., 45, 48 (2002) (finding that most of the economic growth during the 1990s was due to entrepreneurs operating small and medium sized growth businesses).

[26] *See, e.g.*, Kimmo Hyrsky, Mika Tuunanen, & Matti Koiranen, *Innovativeness and Risk-Taking Propensity: A Cross-Cultural Study of Finnish and U.S. Entrepreneurs and Small Business Owners*. 48 LIIKETALOUDELLINEN AIKAKAUSKIRJA (FINNISH J. BUS. ECON.) 238 (1999) (documenting the differences in attitudes towards entrepreneurship in Finland and the United States).

### B. Legal Compliance Risk

Although some individuals may be risk averse, and others may be risk-preferring,[27] nothing in theory precludes an individual from being both.[28] The reader is probably familiar with someone who is conservative in professional decisions, but adventurous in personal endeavors. Such an individual may be cautious when investing in stocks or bonds, and then hop off a cliff, tied to a bungee cord of course, on weekends. Conversely, an individual might be quite adventurous in financial matters, and extremely conservative in personal matters.[29]

Now we come to a vital point in our argument: The ideal entrepreneur is risk-neutral when deciding whether to open a new restaurant or factory. Yet when considering whether to comply with a law that criminalizes a failure to prevent e-coli contamination or certain chemical pollution, she will not be risk neutral, but risk-averse.

Entrepreneurs, we should recall, are hired to manage companies because of their talent at taking calculated risks that yield the highest possible rates of return. Corporate executives should thus be risk-neutral when choosing among business opportunities: Instead of investing in the sure thing with a small return, the best managers will fund projects with a

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[27] People may be generally risk-averse, reflected by a utility function of $U = \sqrt{x}$, *see supra* at note 15, there may be contexts in which individuals have idiosyncratic utility functions, such that they are actually risk-preferring. To take a simple example, one of the authors of this article is the parent of two small children. It is, of course, agreeable when our family receives one toy, but there are inevitable complications ("Mine!" "No, Mine!", etc.), so two toys are *more than twice* as good as one toy. This idea can be captured by the utility function, $U = x^2$. The first toy confers one util of satisfaction, but the second confers 4 utils. If this author were presented with the certainty of receiving one toy or the 40% likelihood of receiving two toys for his children, the expected value of the first option (1 toy) exceeds the expected value of the second option (.4 x 2 + .6 x 0, or .8 toys), but he would still prefer the second option, given his idiosyncratic utility function. In such a circumstance, he would be said to be *risk-preferring*.

[28] For example, many people purchase life insurance and also buy lottery tickets. Purchasing life insurance reflects risk-aversion, while purchasing lottery tickets seems to reflect a risk-preferring mindset, as lottery tickets always cost more than their expected payout. *But cf.* Lloyd Cohen, *The Lure of the Lottery*, 36 WAKE FOREST L. REV. 705 (2001) (arguing that lottery ticket purchasers do so not for the investment value but for other psychic reasons).

[29] John D. Rockefeller seems to have fit this profile. *See* RON CHERNOW, TITAN: THE LIFE OF JOHN D. ROCKEFELLER (1998).

higher variance of outcomes, at least when there is a higher expected return than the safer projects. They are, again, risk-neutral. Some of the standard law and economics literature on white-collar crime assumes that the corporate managers' risk neutrality will bleed over into decisions about compliance with the criminal law.[30]

In fact, however, we demand that the very same corporate managers who are risk-neutral with respect to business matters be risk-averse when confronted with the criminal law. Professor (formerly Judge) William Allen has written that "corporate directors will not direct management to calculate the costs and benefits of compliance with criminal law. Nor will their lawyers advise them that they may safely do so. The pedagogic message of criminal sanctions is 'take all necessary steps to avoid the proscribed act.'"[31] It is important to see that civil sanctions do not impose similar duties on citizens to "take all necessary steps" *regardless of cost* to comply with the law. In its classical understanding, the civil law regulates activities that entail both costs *and benefits* to society, and therefore the law should not entail penalties (and opprobrium) so punitive as to eradicate those activities; the criminal law, by contrast, is intended to eliminate altogether certain activities, the premise being that at least in theory the activities in question are inherently undesirable. John Coffee has neatly captured this insight in his observation that the civil law "prices," but the criminal law sanctions.[32]

For what we call the ideal entrepreneur, it is better to be certain and compliant with rules than chance getting caught, however remote the possibility. She is, in a sense, a "global

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[30] *See, e.g.,* Richard Murphy and Erin O'Hara, *Mistake Of Federal Criminal Law: A Study Of Coalitions And Costly Information*, 5 SUP. CT. ECON. REV. 217, 226-230 (1997).

[31] William T. Allen, *Commentary on the Limits of Compensation and Deterrence in Legal Remedies,* 60 LAW & CONTEMP. PROBS. 67 (1997).

[32] *See, e.g.,* John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models--and What Can Be Done About It,* 101 YALE L.J. 1895 (1992); *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law,* 71 B.U.L. Rev. 193 (1991).

rational calculator." By that we mean that she has made a one-time decision, "Obey the law," or perhaps more cynically, "Obedience to the law is the best policy," which she does not revisit whenever a profitable opportunity to break the law arises.

Consider the following: While walking home one night we might pass a 7-11, where we see an elderly salesperson counting hundreds of dollars in cash. Do we, at that moment, calculate the odds that the store video camera is really working, that that the salesperson has a gun under the counter, that a police cruiser might pull up, etc., against the expected payout of punching the fellow in the nose and taking the money? Of course not. We have made a one-time and final decision to comply with the criminal law, which obviously frees up vast amounts of time and mental energy: We are not continually running over in our minds the pros and cons of every violation of the criminal law.

The idea that people should obey the law as a matter of course, and not as the result of discrete calculations, is reflected in the case, *Pennsylvania Department of Environmental Resources vs. Tri-State Clinical Laboratories*.[33] There, a corporation was fined for criminal acts (involving the disposal of waste products) after it had petitioned for bankruptcy. The state agency argued the criminal fines should be given priority as an administrative expense under the bankruptcy code. The agency's logic was that, had the company incurred expenses to comply with the criminal law, those debts would be administrative expenses and enjoy priority. The Third Circuit rejected the agency's argument:

> We refuse to adopt an analysis of administrative expenses that is based upon the assumption that legitimate businesses engage in a "cost-benefit" analysis to determine if they will comply with criminal laws that protect the very public that the owners and operators of those legitimate businesses are part of. It is neither reasonable nor necessary for a commercial enterprise to violate criminal laws and endanger the

[33] 178 F.3d 685 (3d. Cir. 1999).

> public to preserve the estate or to conduct legitimate business operations, and we refuse the . . . invitation to hold otherwise.[34]

One might reject as naïve the Third Circuit's refusal to contemplate "the assumption that legitimate businesses engage in a cost-benefit analysis to determine if they will comply with criminal laws." For many people in business, laws, including criminal laws, are just another obstacle, just like Chinese imports and recalcitrant unions. These people, whom we call "swashbucklers," are risk-neutral through and through. Just as the decision whether to open a new store at a particular location has its financial risks for the company, so too the decision whether properly to declare the latest financial reports to the SEC has its financial risks. After all, misstated financial reports will affect the wealth of shareholders, the ability to raise funds from creditors and shareholders, and the ability to compensate company executives. These swashbucklers apply the same cost-benefit analysis to all of the choices facing the company. They are thus discrete rational calculators in the sense that every opportunity to comply with or violate the criminal law is considered afresh.

Perhaps another way of viewing the difference between the ideal entrepreneur and the swashbuckler is to consider the difference between risk and uncertainty. Remember that an entrepreneur has an expertise in certain tasks, such as software development, manufacturing or cooking. Complying with the myriad of state and federal regulations, however, is not her specialty. She can hire an army of lawyers to help her understand the law and take steps to comply, but this comes at a great expense. Even with all the legal advice, which will usually be nuanced and with few assurances, her legal exposure may be largely unfathomable: the entrepreneur is simply unable to quantify the risk she faces. She may have a clear sense of the business risks she faces, but is altogether at a loss in assessing the latest legal risk. This is

[34] *Id*. at 689.

known to economists, since it was first proposed by Frank Knight, as the difference between risk (known and quantifiable) and uncertainty (unknown).[35] Faced with such uncertainty, some entrepreneurs may well abandon a seemingly profitable enterprise.[36] The difference between ideal entrepreneurs and swashbucklers may eventually boil down to the latter's greater acceptance of true uncertainty.

As opposed to the swashbuckler and the ideal entrepreneur, one might also imagine a thoroughly risk-averse person—a person who is not only risk-averse in legal compliance matters but risk-averse as well in business decisions. Were public corporations ever to become dominated by such bean counters, utterly lacking in "animal spirits" but occupied instead by dotted i's and crossed t's (out of fear of the severe punishment that awaits a missed i or t), the result would surely be economic stagnation.

## III. Adverse Selection and *Mens Rea*

Those charged with enforcing the criminal law, just like insurance companies, face a heterogeneous pool of people. They need to distinguish those who try to obey the law (such as the ideal entrepreneurs) from those who act either reckless of the law's demands or with an actual intent to break it (such as the swashbucklers). In this section we show that the *mens rea* requirement traditionally played such a sorting function, thus warding off the problem of adverse selection. We then contrast a *mens rea* regime with one of strict criminal liability, either *de facto* or *de jure*, where the law fails to distinguish between the ideal entrepreneurs and the swashbucklers.

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[35] FRANK H. KNIGHT, RISK, UNCERTAINTY, AND PROFIT (1921).

[36] *See, e.g.*, Joshua Aizenman, *Investment in New Activities and the Welfare Cost of Uncertainty*, 52 J. OF DEVELOPMENT ECON. 259 (1997) (demonstrating that uncertainty discourages investment in productive activities).

### A. Mens Rea Wards Off Adverse Selection

Insurance companies pool the risk of drivers of varying skill levels. Drivers with high skills (who are unlikely to get into accidents) receive relatively fewer benefits from belonging to the pool and thus are relatively less likely to pay insurance premiums. Imagine that the State of Lone Star statutorily requires all drivers to purchase liability insurance at a given rate; in such a world, even the safest of drivers is nonetheless required to purchase insurance. Now imagine that the state eliminates that requirement; such an event will herald a parade of consequences. Very safe drivers who receive relatively little benefit from liability insurance will be the first to stop buying it. Insurance companies would then face what is called an adverse selection problem as rates rise and more and more drivers self-insure, resulting in a cascade in which all the but the worst drivers remain in the risk pool, eventually forcing insurance companies out of this line of business. How to ward off adverse selection? Insurance companies could try to distinguish among types of drivers. They would look at driving histories (and other indicators of driving quality), and then charge lower premiums for good drivers and higher premiums for bad drivers. In other words, insurance companies ward off the problem of adverse selection by using a sorting mechanism.

Our suggestion is that the with respect to laws against corporate crime (and perhaps crime generally) the *mens rea* requirement provides that sorting mechanism to stave off adverse selection. To defend this claim, we need to step back and sketch what is intended by *mens rea*.

Under the common law, a guilty mind or *mens rea* [37] was an essential feature of the traditional *mala in se* crimes.[38] Thus, at common law, no one could be convicted of a crime

[37] The term *mens rea* has evolved over the centuries before it settled on the definition that was accepted at the founding of the Nation. *See* Francis Bowes Sayre, *Mens Rea*, 45 HARV. L. REV. 974 (1932).

without evidence of a "vicious will," that is, a clearly formed intent to do a bad act. As Blackstone wrote in his *Commentaries*:

> Indeed, to make a complete crime, cognizable by human laws, there must be both a will and an act. … And, as a vi[c]ious will without a vi[c]ious act is no civil crime, so on the other hand, an unwarrantable act without a vi[c]ious will is no crime at all.[39]

American common law and constitutional law embraced this view through the nineteenth century.[40] *Mens rea* was both a substantive requirement and a constitutional guarantee; there were no strict liability crimes.[41]

The insistence on a *mens rea* requirement in the criminal law can be seen as an advance over early Anglo-Saxon laws, which apparently included no such *mens rea* requirement.[42] It is relatively easy to grasp that societies in which such laws prevailed had relatively more primitive notions of punishment and morality than are common today. Without laboring the point or indulging in philosophical reflections, it is relatively uncontroversial today that an individual cannot be morally accountable, and punished accordingly, unless he knowingly and intentionally committed an act that would result in some harm.

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[38] Negligent homicide and felony murder are other variations on common law and statutory innovations.

[39] 4 WILLIAM BLACKSTONE, COMMENTARIES *20-21.

[40] *See generally* William Bader, *Some Thoughts on Blackstone, Precedent and Originalism*, 19 VT. L. REV. 5 (1994) (documenting Blackstone's influence on American law in the nineteenth century); *see also* JOHN HASNAS, TRAPPED: WHEN ACTING ETHICALLY IS AGAINST THE LAW 35 (2005) ("Traditionally, criminal law required either intentional or reckless conduct to sustain a conviction for a crime. There was no strict liability at common law, and many jurisdictions that did permit criminal convictions for negligent behavior. Among those that did, ordinary civil negligence could not sustain a conviction. A more culpable form of negligence, criminal negligence, was required. Criminal negligence requires that the negligence of the accused must be culpable, gross, or reckless, that is, the conduct of the accused must be such a departure from what the conduct of an ordinary prudent or careful man under the same circumstances as to be incompatible with a proper regard for human life.") (footnotes and quotations marks omitted).

[41] *See generally* Ann Hopkins, Comment, *Mens Reas and the Right to Trial by Jury*, 76 CALIF. L. REV. 391, 397 (1988) (concluding that at the time the Constitution was ratified, the right to a jury trial right implied that every defendant would have to be found "morally blameworthy" by a jury, and also that before 1850 "proof of some form of *mens rea* was a prerequisite to conviction for almost all crimes"). There were exceptions, such as statutory rape, which was a strict liability crime.

[42] *See generally* Martin R. Gardner, *The Mens Rea Enigma*, 1993 UTAH L. REV. 635, 652 ("Because the early law focused so heavily on the perceived interests of outraged victims and would-be avengers in hopes of dissuading them from pursuing private vendettas, it likely paid little attention to niceties of culpability once it was shown that the accused caused harm to the victim.").

But the adoption of a *mens rea* requirement for criminal law is not simply a reflection of more sophisticated notions of morality; it is can also be defended on efficiency grounds. As Jeffrey Parker has argued, a *mens rea* requirement allows individuals to signal their intent to comply with the law by investing in precautions, [43] similar to the investment in safe driving by skilled drivers. Once having so invested, people can engage in activities that may entail some risks of harm but which are, on net, socially advantageous. When the picture one has in one's mind is *mala in se* crimes, such as murder, this point may be opaque, because the underlying activity giving rise to the harm is so devoid of socially redeeming features. For example, imagine a world in which anyone responsible for another's death could be found liable for murder in the first degree, and punished accordingly. Faced with such penalties, one must assume that there would be far fewer barroom fights. Yes, some individuals, so liquored up or inflamed with passion, will be undeterred,[44] but many others will check themselves before throwing a punch, as the prospect of life imprisonment flits through their consciousness.[45]

Now some might argue that this is all to the good, given that there is nothing beneficial about bar room fights: If harsh penalties and *de jure* strict liability eliminated such activity, so much the better. There are difficulties with this argument,[46] but fortunately that is not our battle today. Our concern here is with regulatory or *mala prohibitum* crimes. Such

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[43] Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741 (1993).

[44] *Cf.* Joanna M. Shepherd, *Murders of Passion, Execution Delays, and the Deterrence of Capital Punishment*, 33 J. LEG. STUD. 283 (2004) (demonstrating empirically that even crimes of passion can be deterred by high penalties, such as the death penalty, and that the shorter the delay between the crime and the punishment, the larger the deterrent effect of the penalty).

[45] *Id. See also* Moin A. Yahya, *Deterring Roper's Juveniles: Using a Law and Economics Approach to Show That the Logic of Roper Implies That Juveniles Require the Death Penalty More Than Adults*, 111 PENN. ST. L. REV. 53 (2006) (arguing that higher penalties are needed for risk-loving individuals such as juveniles in contrast to the milder penalties needed for risk-averse individuals).

[46] If the crime rate really were reduced to zero, this would necessarily mean that the state cast its web too widely and that many innocent people were criminally prosecuted.

crimes, we should recall, govern activities that frequently are, unlike bar room fights, socially advantageous. Consider driving a car. Under current law, people can avoid criminal liability for driving accidents if they invest in a reasonable level of precautions—complying with speed limits, maintaining their cars in good condition, etc. Now imagine a brave new world in which anyone who injured another in a car accident would be subject to criminal penalties, including imprisonment. Some individuals would continue to drive, albeit with excessive caution: they are said to be overinvesting in precautions.[47]

Professor Parker gives the example of someone who picks up the wrong umbrella in a restaurant.[48] As a society, we would want people to spend at best a minute or so discerning whether the umbrella they have picked up is really theirs (especially if it is a cheap one). If the penalty for picking up the wrong umbrella is imprisonment (that is, a strict liability larceny regime), people would spend hours confirming that the umbrella in their possession is really their own. Or worse, some people might no longer deposit their umbrella in the appropriate stand, preferring to traipse through the restaurant with the soggy instrument, with the attendant unpleasantness for all other patrons. Likewise, in a world where auto accidents automatically gave rise to criminal liability, many people would simply stop driving. These people may be said to have exited the sphere of activity altogether.

This brings us back to the problem of adverse selection. Those charged with the enforcement of the criminal law, just like insurance companies, face a heterogeneous pool of people. Some are good drivers, while others are not; some cherish obedience to the law (the ideal entrepreneurs), while others do not (the swashbucklers). A sorting mechanism can distinguish the groups. Insurance companies look at driving records, identify the safe drivers,

[47] *See* Parker, *supra* note 43, at 754-55.
[48] *Id.* at 781-82.

and then reward them by charging lower premiums. Safe drivers thus choose to remain in the pool. Likewise, at least traditionally, the *mens rea* requirement had played a sorting mechanism for those enforcing the criminal law. The machinery of justice would only be brought to bear against those who had formed a specific intent to commit whatever harm occurred. The law-abiding could demonstrate their good intentions by pointing to the precautions they had incurred; even if some bad result had come to pass, no penalties would attach. Law-abiding individuals could thus continue to engage in the regulated activity. In effect, *mens rea* helped the enforcers sort those determined to comply with the law (the ideal entrepreneurs) from those indifferent to the strictures of the criminal law (the swashbucklers).

When insurance companies are no longer able to distinguish safe from unsafe drivers, and price the premiums accordingly, they will likely charge rates that will result in the best drivers opting out of the pool. Likewise, when the criminal law regulating certain spheres of activity is stripped of a *mens rea* requirement, law-abiding ideal entrepreneurs will no longer be able to signal their intent to comply with the law. Some may respond by exiting the regulated activity altogether.

This last statement should not be controversial. In the realm of tort law, many scholars have argued that the current product liability regime stifles the entrepreneurial spirit.[49] Some new products will not be brought to market and other useful one will be discontinued in the face of a strict liability tort regime that over-punishes mistakes.[50] Exit from a sphere of activity should be even more pronounced when entrepreneurs face potential

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[49] *See, e.g.*, Deborah J. La Fetra, *Freedom, Responsibility, and Risk: Fundamental Principles Supporting Tort Reform*, 36 IND. L. REV. 645, 647 (2003) (citing MICHAEL E. PORTER, THE COMPETITIVE ADVANTAGE OF NATIONS 649 (1990)).

[50] *Id.* at 648. *See generally* PETER W. HUBER, LIABILITY: THE LEGAL REVOLUTION AND ITS CONSEQUENCES (1988) (documenting how changes in the tort regime have increased liability for businesses and *lowered* overall safety for society by, for example, preventing pharmaceutical companies from introducing new drugs, deterring some doctors from practicing gynecology, and causing ambulances to avoid certain neighborhoods altogether).

*criminal* liability. Thus, the crucial, though sometimes neglected, point is that the movement from a *mens rea* regime to a strict liability regime will induce some individuals to overinvest in precautions and *still others to abstain from the activity completely*. Our contribution is in focusing attention on the kind of entrepreneurs driven away when the law regulating corporate crime is stripped of a *mens rea* requirement and becomes one of strict liability. As fleshed out below, we argue that a form of adverse selection is apt to occur—a variation of Grisham's law in which those reckless of the criminal law (swashbucklers) will drive away those respectful of the law (the ideal entrepreneurs).

### B. Adverse Selection Under De Jure and De Fact Strict Liability

The previous section argued that the movement away from a *mens rea* regime and to a strict liability criminal law regime may unleash an adverse selection cascade. In this section we argue that strict liability can take one of two forms.

First, of course, would be a law creating explicit, or *de jure*, strict criminal liability for those who injure another in car accidents. Now this might be deemed too silly even to be countenanced by legislators trolling for votes from outraged constituencies. More plausibly, then, imagine that legislators alter the driving laws, though not as radically as first proposed. The legislature of Lone Star eliminates specified maximum speeding limits, instead imposing criminal fines whenever a person "drives faster than appropriate." It is possible that the ambiguity of the law, as written, will be dispelled, at least in part, by consistency or lenity in enforcement. But let us assume that no predictable guidelines emerge. Police officers, judges and juries between and within the counties of Lone Star all have different notions of the "appropriate speed." At one time, there might be a more relaxed enforcement of the law, but at another time, in the wake of a high-profile accident, enforcement might tighten.

In such a world, drivers in Lone Star will surely change their behavior, but as long as the penalties for violating the law are negligible, the effect will be modest. But now imagine that, in the aftermath of a fatal car crash, there is a clamor (or the perception of a clamor) for "more to be done." Legislators ramp up the fines and even introduce imprisonment as a possible punishment. The situation is now one of ambiguously defined laws ("appropriate speed"), unpredictable enforcement (varying from one jurisdiction to another) and steep penalties (large fines and even jail time). This state of affairs is one of what we will call *de facto* strict liability. We are no longer in a world of risk, but one of uncertainty;[51] and when the uncertainty is yoked to steep penalties, the inevitable consequence, just as in a world of *de jure* strict liability, is an overinvestment in precautions for some and the decision by others to stop driving altogether.[52] This exodus will likely be pronounced among those who are most worried by the risk of violating the criminal law and most determined to be law-abiding.

In short, then, extremely high penalties, tied to ambiguously written laws, have the practical effect of eliminating *mens rea* as a legal requirement for criminal law. The law itself is not clear as to what is actually prohibited and what is not. This uncertainty, coupled with high penalties, essentially converts all regulated activities into what we call *de facto* strict liability crimes. The businessman who invests in a factory may find out that his interpretation (and his lawyers') of "substantial" leakage does not align with the interpretation of the court of appeal presiding over his factory. The investor may forego

[51] On the distinction between risk and uncertainty, *see supra* note 35. *See also* Daniel Ellsberg, *Risk, Ambiguity, and the Savage Axioms*, 75 Q.J. ECON. 643 (1961) (documenting how otherwise rational individuals behave irrationally in the face of uncertainty).
[52] *See* Block & Sidak, *supra* note 8.

potentially profitable investments if there is even an infinitesimal threat of imprisonment or exorbitant criminal fines.[53]

## IV. Towards Strict Liability in Criminal Law

The previous section was very theoretical. Now we fill some historical facts into that theoretical framework. We sketch the trend in American criminal law over the past century. It is a movement away from a *mens rea* regime to one increasingly dominated by strict liability regulatory crimes, typified by the Sarbanes-Oxley Act of 2002.

### A. A Brief Historical Tour

At least in the nineteenth century, courts noted that an erosion of a *mens rea* requirement for regulatory criminality would drive away the better sort of entrepreneurs. To take one example, in 1888, a federal judge dismissed a criminal indictment against a bank director, who certified a false bank statement, when there was no proof that the director had known that the statements were false.[54] A bank cashier had made the false statements, and the prosecutors had failed to prove a conspiracy between the director and the cashier. Explaining his dismissal, Judge Sage stated that to impose liability in such circumstances "would make it practically impossible to obtain as Directors men in whom the community would have confidence …."[55] After all, a finding of criminal liability when the state had failed to prove that the defendant himself had intentionally broken the law would "prevent men fit for the office of Director from assuming it, and the result would be to cripple the entire banking interest of the United States …."[56] It is somewhat disconcerting to note that

[53] *See* MARTIN J. OSBORNE & ARIEL RUBINSTEIN, A COURSE IN GAME THEORY 246 (1994) (discussing what game theorists refer to as trembling hand equilibria).
[54] *Consoling For Directors; Not Criminally Liable For The Acts of Dishonest Cashiers*, New York Times Feb 6, 1888 at 1.
[55] *Id.*
[56] *Id.*

the crux of our argument was anticipated over 120 years ago, long before the last century's experience with expanding criminal liability.

Despite this initial judicial resistance to weakening the *mens rea* requirement, around the turn of the twentieth century, a few cases in state courts began to approve of the elimination of the *mens rea* requirement for certain crimes,[57] and the Supreme Court first hinted its approval in 1921, in *United States v. Balint*.[58] In *Balint*, the Court upheld the conviction of a defendant who sold opium under a federal statute that did not require knowledge that the act was illegal.[59] According to Chief Justice Taft, Congress could do away with a scienter requirement when the purpose of the statute is "the achievement of some social betterment rather than the punishment of crimes as in cases of mala in se."[60] The Court seemed to offer its approval of strict liability *crimes*, at least in regulated markets. Its opinion stated that "where one deals with others and his mere negligence may be dangerous to them, as in selling diseased food or poison, the policy of the law may, in order to stimulate proper care, require the punishment of the negligent person though he be ignorant of the noxious character of what he sells."[61]

During the Progressive and New Deal eras, newspapers abounded with morality tales about rapacious businessmen and exploited consumers.[62] The solution, at least to the

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[57] *See, e.g.*, Commonwealth v. Mixer, 93 N. E. 249 (Mass. 1910) (holding that a driver carrying illegal liquor did not have to know that he was carrying illegal liquor in violation of a statute); State v. Kinkead, 17 A. 855 (Conn. 1889) (holding that defendant who sold liquor where minors were roaming did not have to know that they were minors).

[58] 258 U.S. 250 (1922).

[59] The statute provided: "it shall be unlawful for any person to sell, barter, exchange, or give away any of the aforesaid drugs. . . ."

[60] *Id.* at 252. Crimes that are *mala in se*, are the traditional crimes such as murder, burglary, rape, etc. They are to be distinguished from regulatory crimes, or *mala prohibitum*. LAFAVE & SCOTT, CRIMINAL LAW § 3.7-8 (2d ed. 1986).

[61] *Id.*

[62] The pages of the Nation's newspapers were full of such stories. Illustrative of this are the following stories in the New York Times concerning fraud on Wall Street starting as far back as 1877: *Afraid Of Wall-Street*, NYT, Apr 5, 1877 at 4 (highlighting the perils of investing in the stock market because of the prevalent fraud). By the

editorial page writers of the New York Times, was clear: expand the white-collar criminal law. Indeed, the title of one editorial in 1906 left nothing to the reader's imagination: *Put Everybody in Jail.*[63] The editorial semi-seriously argued that anyone even tenuously responsible for a wide variety of malfeasances in the securities industry should simply be thrown in jail. The first few decades of the twentieth century saw the enactment of sweeping regulation, such as the Pure Food & Drug Act, the Food, Drug, and Cosmetics Act, the Securities Act, that were passed in response to perceived corporate malfeasance. And striking in many of these laws is a weakening of a *mens rea* requirement for a finding of criminal liability.[64]

It was not long before this strategy culminated in a constitutional challenge. In *United States v. Dotterweich*[65] the United States Supreme Court, in a 5-4 decision, upheld the conviction of the president of a pharmaceutical company whose company shipped

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1930s, these stories were quite common: *Corporation Law is Called Faulty; W. C. Breed Disputes Theory of the State's Guardianship of Investing Public; Sees Frauds Protected; Lawyer Tells N.Y.U. Forum Best Safeguard Lies in Penalizing Deceptions in Sales*, NYT, Feb 10, 1933. at 29; *Stock Frauds Cost $48,352,465 In Year; $11,000,000 Drop From 1931 Is Laid By Bennett Largely To Martin Act Enforcement; Prosecution Set Record; Publicity of Convictions Coupled With Sad Experience Has Taught State Investors, He Says*, NYT Jan 29, 1933 at 8; *Stricter Curbs on Fraudulent Brokers Urged By Ward Aide in 5 Martin Act Amendments*, NYT, Dec 21, 1930 at 1; *The Responsibilities of Directors*, NYT, Sept. 6, 1903 at 6. In the area of food and drug adulteration, representative headlines include: *Era Of Adulteration Menaces Public Health; Dr. Leon L. Waiters Sounds a Note of Warning; Foods And Medicines Impure; American Association for Advancement of Science Hears Serious Charges Voiced*, NYT, Dec 31, 1904. at5; *Adulteration Of Food; Senate Committee Reports on Its Investigations and Recommends Legislation*, NYT, Mar 1, 1900 at 9; *Pure Food Investigation; Dr. Piffard of This City Testifies About the Adulteration of Bromo Seltzer*; NYT, May 12, 1899 at 3; *The Adulteration Of Food*, (letter to the editor by W.W. Hallock), NYT, Feb 18, 1899 at 6 (claiming that all foods and drugs are adulterated); Ohio's Druggists Raided; A Vigorous Crusade By The State Food Commission; Stringent Laws to be Enforced and the People to be Protected Against Adulterations -- Food Products, Wines, Liquors, Patent Medicines, and Even the Milk Being Rigidly Inspected -- Paskola, Vin Mariani, and Other Eastern Articles Under Fire in Cincinnati -- Many Arrests Made and More to Follow; Ohio's Druggists Raided, NYT, Oct 18, 1894 at 1.

[63] *Put Everybody In Jail*, NYT, Jun 26, 1906 at p. 6 (a semi-serious call for imprisoning all who are responsible for a variety of market misfeasances).

[64] Some states even started to remove the *mens rea* requirement long before the *Balint* decision. *See e.g. Ohio's Law Of Adulteration; It Assumes Guilty Knowledge On The Part Of Violators. Justice Winkler Overrules the Demurrer in the Case of Vester -- The First of Four Prosecutions Against Druggists of Cincinnati -- The Dairy and Food Commission Preparing to Proceed Against Grocers -- The Public Must Be Protected*, NYT, Oct 21, 1894 at 9.

[65] 320 U.S. 277 (1943).

adulterated and mislabeled drugs in violation of the Federal Food, Drug and Cosmetic Act. The Court held that even though the shipments were accidental and the defendant did not know of them, he could be held criminally liable as the result of his position within the corporation. Writing for the Court, Justice Frankfurter described the defendant as a "person otherwise innocent but standing in responsible relation to a public danger."[66] Frankfurter admitted that the statute might bring hardship upon those whose "consciousness of wrongdoing [is] totally wanting," but when "[b]alancing [the] relative hardships, Congress has preferred to place it upon those who have at least the opportunity of informing themselves of conditions imposed for the protection of consumers," whom he described as "innocent" and "wholly helpless."[67] The Court engaged in what it regarded, dubiously, as a cost-benefit analysis, weighing the cost of imprisoning the innocent against the benefit for the public, and concluded that given that these statutes were for the "public welfare" it was reasonable to eliminate any requirement of *mens rea*, since this will protect the innocent and helpless public. The Court's rhetoric is consistent with a jaundiced view of capitalism (that it is brutal, inhuman, destructive of human relationships, etc.) predominant, at least in some quarters, at the time.[68] One need only gaze upon the statue outside the Federal Trade Commission building in Washington, D.C., built in this period, to understand the then-prevailing view. The statue depicts a man trying to tame a wild horse, a metaphor for government efforts to repress the wild and unruly capitalist system.

The growing use of criminal penalties for regulatory purposes was not lost on those who would suffer the consequences; indeed, many at the time noted the heavy penalties (both civil and criminal) and indeterminate nature of the crimes. For example, when the House of

[66] *Id.* at 281.
[67] *Id.* at 284.
[68] *See supra* note 62.

Representative passed the Securities Act, the Merchants Association of New York worried that the bill's wording concerning civil and criminal penalties "might also make every seller of a security a potential criminal, merely because of an omission to state a material fact concerning a security …."[69] After the Act was passed, the criticism intensified. A representative of the Investment Bankers Association complained that under the Act "the obligations … upon underwriters are very great, and it seems … not unreasonable to expect that responsible private bankers may hesitate to accept the hazards of these obligations – hazards that *by the greatest of care cannot definitely be determined in advance of the event*."[70] Again, as in Judge Sage's opinion, the implication is that even, or we would suggest especially, the "responsible" sort of businessmen would hesitate to continue in a regulated environment governed by indeterminate criminal laws.

Lawyers at the time voiced similar concerns. A special committee of the American Bar Association (ABA) noted that the new act was "extraordinary complex" and the "interpretation of many of its provisions is very vague and uncertain."[71] This, the ABA argued, would cause many officers and directors to leave the industry because of real and sincere concerns regarding potential liabilities.[72] "It is immaterial whether this unwillingness [to accept liabilities] is based on exaggerated fears, as has been alleged."[73] The ABA further

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[69] *Merchants Protest; New Yorkers Ask for Hearing on the Securities Bill*, NYT, May 9, 1933 at 3.
[70] *Securities Law Worries Bankers; Underwriters Reluctant to Assume Obligations Imposed by Measure; Liability Clause Drastic; Public Is Likely to View Sanction of a Flotation as an Approval by Commission; Securities Law Worries Bankers*, NYT, Jul 9, 1933. at N5/N11 (emphasis added).
[71] *Bar Asks Changes In Securities Act; National Committee Declares Law Rides Roughshod Over Known Legal Principles; 14 Amendments Proposed; These Would Clear Up Definitions and Exempted Issues -- Limits to Liability Urged; Bar Asks Changes In Securities Act*, NYT, Mar 26, 1934 at p. 27/30.
[72] *Id.*
[73] *Id.*

argued that the Act, was "a definite brake on recovery."[74] Nor were such concerns purely alarmist. Much like the CFO of Outback, who decided to quit after the enactment of Sarbanes-Oxley,[75] Harry H. Fair, who was the respected president of an investment bank for nearly two decades, retired in 1933; he announced that his firm had been "legislated" out of business by the Securities Act.[76]

Congress, however, was undeterred by these protests. Over the course of the past several decades, Congress has enacted dozens of criminal laws, all nominally designed to secure the public welfare. This development is already the subject of vast commentary.[77] As of 2005, there were 4,000 federal regulatory offenses that carry a criminal penalty,[78] and obviously countless more state crimes. Only a tiny fraction of these crimes existed at common law; overwhelmingly, these crimes are regulatory in nature, and a remarkable number qualify as *de jure* strict liability crimes. Nor do these crimes exclusively regulate matters that, at least at first glance, raise matters of grave public concern. For example, the public interest in meticulous financial records for dealers in livestock necessitates the elimination of a *mens rea* requirement from the applicable criminal law:

> Every packer, any swine contractor, and any live poultry dealer, stockyard owner, market agency, and dealer shall keep such accounts, records, and memoranda as fully and correctly disclose all transactions involved in his business, including the true ownership of such business by stockholding or otherwise. Whenever the Secretary finds that the accounts, records, and memoranda of any such person do not fully and correctly disclose all transactions involved in his business, the Secretary may prescribe the manner and form in which such accounts, records, and memoranda shall be kept, and thereafter any

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[74] Id. See also Ballantine Urges Issue Act Changes; He Favors Freeing Underwriters of Liability for 'Honest Mistakes'; Sees Fund Flow Checked; Ex-Treasury Aide Tells Wisconsin Bar Law Leaves Directors in State of Doubt, NYT, Dec 9, 1933. at 24.
[75] *See* note 2 *supra*.
[76] *Firm Quits, Blames Securities Act* NYT, Jun 10, 1933 at 19.
[77] *See generally* John S. Baker, *Measuring the Explosive Growth of Federal Crime Legislation, prepared for the Federalist Society available at* http://fed-soc.org/Publications/practicegroupnewsletters/criminallaw/crimreportfinal.pdf (documenting the growth in the number of federal crimes, many of them lacking any *mens rea* requirement); James DeLong, *The "Criminal" Classes: Legal Sanctions and Business Mangers*, in GO DIRECTLY TO JAIL: THE CRIMINALIZATION OF ALMOST EVERYTHING 12 (Gene Healy ed., 2004) (exploring the expansion of the federal criminal law, particularly in the corporate, environmental and health-care fields).
[78] *See* Baker, *supra* note 77.

> such person who fails to keep such accounts, records, and memoranda in the manner and form prescribed or approved by the Secretary shall upon conviction be fined not more than $5,000, or imprisoned not more than three years, or both.[79]

The statute makes no reference to the defendant's intent: The packer is strictly liable for any faulty records no matter how blameless he is.[80]

Some criminal statutes preserve a shorn remnant of a *mens rea* requirement: they require knowledge of the relevant act, but not knowledge that the relevant act was illegal. Under such statutes, the prosecution has only to prove that the act was done "knowingly" but not "willfully." For example, 16 U.S.C. § 707, which criminalizes the sale of migratory birds, requires the prosecution to prove that the defendant knew that he was selling a migratory bird, but not that he knew that such a sale was illegal.[81] Although the old adage that ignorance of the law is no excuse makes sense when the law prohibits murder or rape—since it is fair to assume that anyone other than a sociopath understands that these acts are wrong—regulatory crimes do not necessarily involve any such transparent wrongness.

And then there are the dozens, and possibly hundreds of criminal laws that represent what we have called *de facto* strict liability—that is, ambiguously defined terms, uncertain enforcement strategies and steep penalties. Others have catalogued the manifold laws that qualify as *de facto* strict liability, and at this point we will simply gesture to this exhaustive and exhausting literature.[82] But to take one illustration: consider the Clean Water Act (CWA) with its 130 sections.[83] The preamble of the CWA states that the objective of the CWA "is to

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[79] 7 U.S.C. § 221 (2002).
[80] Likewise, 7 U.S.C. §2009aa-1 and 7 U.S.C. 2009bb-1 enacts strict liability crimes for those unfortunates who become entangled with the Delta Regional Authority and the Northern Great Plains Regional Authority.
[81] *See* United States v. FMC Corporation, 572 F.2d 902, 904 (2d Cir. 1978).
[82] *See, e.g.*, JOHN HASNAS, TRAPPED: WHEN ACTING ETHICALLY IS AGAINST THE LAW 35-44 (2005) .
[83] 33 U.S.C. §§ 1251 – 1387.

restore and maintain the chemical, physical, and biological integrity of the Nation's waters."[84] An admirable goal indeed; but the devil is in the details.

In actual practice, the CWA has resulted in criminal liability—and prison sentences—for people whose crimes seem to have been ones of garden-variety negligence. Two examples: First, in *United States v. Hanousek*,[85] the defendant, an employee of a railroad company, hired an independent contractor; that contractor's negligent use of a backhoe resulted in a broken oil pipeline, which then resulted in an oil spill. The reader may have noticed the multiple degrees of separation between Hanousek and the spill, but he was nonetheless criminally charged with violating the CWA. Hanousek was convicted and sentenced to six months in jail. Citing *Balint* and *Dotterweich*, the Second Circuit affirmed, holding that "a public welfare statute may subject a person to criminal liability for his or her ordinary negligence without violating due process."[86]

Second, in *United States v. Hansen*,[87] the government prosecuted three managers of a chemical plant for illegal discharges. The Court of Appeals' lengthy recitation of the facts makes clear that the company, which teetered on, and eventually collapsed into, bankruptcy, was aware of various operational problems and made efforts, sometimes vigorously, sometimes not so vigorously, to address them. One of the defendants, Alfred Taylor, was not even a manager for part of the relevant period. By the government's own statement of the case, he made diligent efforts to alert management to difficulties and to remedy them:

> During his tenure as manager, Taylor stressed safety and strict adherence with [the company's] training and safety programs, and assured employees the right to refuse to perform any activity if the employee felt it to be unsafe. When the wastewater overran the cellroom berms and streamed outside the building, the

[84] 33 U.S.C. § 1251.
[85] 176 F.3d 1116 (9th Cir. 1999). Justices O'Connor and Thomas dissented from the denial of certiorari in this case.
[86] Paul Kamenar has coined the phrase "designate felon" to refer to middle managers like Hanousek who seem to be offered up as sacrifices to prosecutors determined to find criminal liability for some mishap.
[87] 262 F.3d 1217 (11th Cir. 2001).

> overflow was reported to the . . . Board by letters signed by Taylor. The amounts reported in the letters were consistent with the data that the plant had at that time. During the spring of 1993, Taylor attended a company meeting with Randall and Croom in which they discussed the condition of the Brunswick plant and possible solutions. Taylor and Croom recommended "either shutting the plant down or shutting it down long enough to salvage one cellroom and rebuild the second cellroom, and then starting back up with just one cellroom." Taylor worked up "the figures and costs" and submitted it to Randall, but Randall later advised them that "[t]hey won't let me do it."[88]

Although Taylor would eventually resign in protest over the company's failure to take action sooner to address the problems, federal prosecutors charged him with a few dozen criminal violations, including conspiracy to commit environmental violations. The prosecution cited Taylor's protests as evidence of his knowledge of the criminal discharges. Taylor was convicted and sentenced to five years in prison.

By the Government's own account, Alfred Taylor took seriously the demands of the criminal law and strove, within the confines of a financially strapped company, to comply. But this was not good enough. In the future, will the Alfred Taylors of the world bother to make efforts to improve the compliance records in such companies—or will they simply flee? And who will be left behind to take their place?

### B. Sarbanes-Oxley and Day in the Life of a Twenty-First Century CEO

The Sarbanes-Oxley Act of 2002 is simply the latest in the growing barrage of federal (and state) regulatory efforts aimed at combating the growth of perceived corporate misbehavior. The logic behind this law, like each of the anti-corporate corruption laws that preceded it, is that an expansion of liability and increase in penalties will deter criminal activities.

To appreciate its impact on the life of a Chief Executive Officer (CEO), consider the following scenario. After toiling for years at a consulting company, you have just been picked to be the CEO of Zeus, Inc. Your dream job! Or is it? Zeus settled upon you after a

[88] *Id*. at 1228-29 (emphasis added).

spate of resignations in top management. Market share is eroding; patents are expiring; financial analysts are downgrading. The severity of the problems facing Zeus only became clear after your few first few weeks on the job. All those stock options no longer seem so alluring.

One day early in your tenure, the CFO, a lifer at Zeus and whose command of the financials well exceeds yours own, strolls into your office. "Sign this," he announces. "This means that we both can go to jail." He laughs; you don't. The latest 10-Q--it's pretty grim. If you can just make it through the next few quarters, you know sales will pick up. How do you know? You just know. You've been a businessman for thirty years. Your intuition has served you extraordinarily well so far, and why not now? You skim through the 10-Q. There's that one footnote that's worded ambiguously; the lawyers signed off on it, if that is a consolation. You flip to the end of the 10-Q; two dozen executives have signed "sub-certifications." If it's any consolation, a lot of people will be joining you in prison—or lining up to rat you out. You pick up the pen and . . .

Welcome to a CEO's life after Sarbanes-Oxley. It's not simply Chinese imports and recalcitrant unions that can give you ulcers. The "certification" provisions generated a great deal of press after the law's adoption, with some in the regulatory community and white-collar defense bar trumpeting its draconian quality,[89] and others in the academy skeptical of just how new it all was.[90] Section 302 orders the SEC to issue new rules requiring officer certification of the accuracy of financial statements; section 404 requires an annual report disclosing management's internal controls; and section 906 requires both the CEO and CFO to certify that the company's periodic financial reports complies with sections 13(a) and

[89] *See, e.g,* Michael S. Pasano and Thierry Olivier Desmet, *Sarbanes-Oxley Puts Teeth Into Criminal Sanctions*, CHAMPION, 18-WTR Crim. Just. 16 (2004).
[90] *See, e.g.,* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn*, 35 CONN. L. REV. 915 (2003).

15(d) of the Securities Exchange Act of 1934 and "fairly represents, in all material respects, the financial condition and results of operations of the issuer." A "knowing" violation is punishable by ten years in prison and a $1 million fine; for a "willful" violation, the stakes are twenty years and a $5 million fine.

If one were at all inclined to be literal-minded, it is hard to know how any CEO of a large company, in good conscience and without terror, could certify a financial statement after Sarbanes-Oxley. The certification requirement means compliance with GAAP is not good enough; the statement must "fairly represent[]" the company's "financial condition." As Pamela Bucy has written, "Avoiding chicanery is not enough; under [section 906], a corporate officer will go to prison for failing to tell about all possible financial problems, failing to reveal all possible financial problems, and failing to disclose all possible financial problems."[91] How different this all is from the previous state of affairs has been debated. (The very fact that one can debate how different the current law is from the previous law is a remarkable fact—and revealing of how ambiguous the law is and was.) With respect to both willfully and knowingly false statements, Sarbanes-Oxley seems to have significantly multiplied the pre-existing penalties. Some have argued that the creation of a knowing violation "may well dilute the *mens rea* required to find criminal liability," [92] but others have argued that knowingly false violations already created liability under mail and wire fraud statutes. And whatever the precise truth of the matter, the certification provisions, which require CEOs to sign not only 10-Ks but all 10-Q as well, have surely concentrated their minds. Although some commentators have touted public statements by named executives

[91] Pamela Bucy, *Carrots and Sticks: Post-Enron Regulatory Initiatives*, 8 BUFF. CRIM. L. REV. 277 (2002).
[92] Steven M Salky, Sarbanes-Oxley and the Criminal Law, American Law Institute October 7-8, 2004.

that the provisions were "non-events," anonymous polls of executives one year after the law's adoption suggest a growing degree of dissatisfaction and fear.[93]

After you wave goodbye to the CFO, the director of Human Resources barges in. "Remember the trouble-maker in the plant in Tucson whom we agreed to fire? Well, she says she's going to the EPA about our pollution controls. What do we do now?" Section 1107 of Sarbanes-Oxley imposes criminal liability on those who "knowingly" retaliate against a person providing truthful information to a law enforcement officer "relating to the commission or possible commission of any Federal offense." Prior to Sarbanes-Oxley, there were scattered whistle-blower statutes protecting employees in a few sectors;[94] now all executives must muddle through the problem of the incompetent "whistle-blower."[95] Of course, entire bureaucracies and consulting relationships have been created to try to insulate you from these problems as much as possible, and you are able to dispose of the Human Resources Director without directly taking any action.

In walks the chief accountant with a question about document destruction. The SEC made noises about an investigation a few months ago, but it seems to have cleared you, at least to the extent the SEC ever clears a company. Zeus's policy is to shred some of the documents the accountant just asked about, which surely would be convenient. What do you do? Once again, Sarbanes-Oxley complicates your life.[96] Of course, the destruction of documents has perennially raised potential criminal penalties, but sections 802 and 1102

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[93] A poll conducted by Pricewaterhouse Coopers found that 71% of executives think they face more risk under the Sarbanes-Oxley certification provisions than under the previous legal regime. http://www.barometersurveys.com/production/barsurv.nsf/vwAllNewsByDocID/371625BAEFB125EF85256D6B006FA37D

[94] Marc I. Steinberg and Seth A. Kaufman, *Minimizing Corporate Liability Exposure When the Whistle Blows in the Sarbanes-Oxley Era*, 30 J. CORP. L. 445, 445-46 (2005).

95 *Id*. Retaining incompetent employees can lead to inefficiencies that affect productivity and profitability. Nonetheless, when employers fail to adhere to the Sarbanes-Oxley whistleblower provisions, they become subject to civil and criminal liability exposure.

[96] *See* Gary Grindler and Jason A. Jones, *Please Step Away from the Shredder*, 41 AM. CRIM. L. REV. 67 (2004).

amorphously enlarged what constitutes a crime. Whereas the pre-existing law had required that an "official proceeding" be actually pending, liability now extends to any destruction that occurs "in relation to or in contemplation of" such a proceeding. What that means is anyone's guess. A dictionary definition of "contemplation" is "have in mind as an intention or possibility."[97] As some commentators have noted, "Such a liberal interpretation could ensnare innocent conduct."[98] Obviously, you have in mind the possibility of an SEC action; they made noises for months. So would the destruction now raise the possibility of criminal penalties—and significant ones at that, twenty years in prison, or quadruple the pre-existing penalties?

One could continue on in this manner through miscellaneous other provisions of Sarbanes-Oxley. For example, Section 807 increases the penalties for knowing securities fraud, defined with ambiguous expansiveness, to twenty-five years in jail.[99] Some commentators have suggested that Section 807 will in practice do little to ease the task of prosecutor in obtaining convictions,[100] others have suggested the "mens rea requirement in [Section 807] is quite minimal,"[101] and still other have confessed some uncertainty as to what precisely the provision, which employs language and terminology used nowhere else in the securities laws, really means.[102] Section 807 in fact nicely illustrates the new criminal provisions in Sarbanes-Oxley in that it is not quite clear how much, if at all, the law marks a departure from previous law in its substantive scope. In that sense, with respect to criminal

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[97] Webster's Unabridged Dictionary, quoted in Grindler, *supra* note 96, at 79..
[98] Id. at 80.
[99] Sarbanes-Oxley § 802 (codified at 18 U.S.C. § 1519).
[100] *See* Frank O. Bowman, *The Curious History and Distressing Implications of the Criminal Provisions of the Sarbanes-Oxley Act and the Sentencing Amendments That Followed*, 1 OHIO ST. J. CRIM. L. 373, 4040 (2004) ("Section 807 may make criminal securities fraud cases slightly easier to bring, but it does not materially expand the reach of previous law.").
[101] Bucy, *supra* note 91, at 288.
[102] Carol Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scienter*, 52 U. KAN. L. REV. 147, 168 (2004) ("it is unclear how the word "knowingly" in § 1348 will be construed").

liability, one is moving from a world of risk to one of uncertainty;[103] the only thing that can be said with confidence is that maximum penalties are treacherously steeper.

## V. A Model of Adverse Selection

This part presents, in three models, the competition between the swashbuckler and the ideal entrepreneur. We begin by observing that in a perfectly efficient market, without any of the uncertainty created by the criminal law, if one group of managers generates infinitesimally higher returns than another, the first would prevail in a rout; after all, why would boards of directors and investors choose even terrific managers, who earn returns of 19.9%, when another group of managers generate returns of 20%?

We then introduce the second model, which describes a world with clearly defined criminal laws and strict *mens rea* requirements. For the swashbuckler, criminal fines arouse no particular anxieties; they are simply costs of doing business. For the ideal entrepreneur, criminal fines are to be avoided; and she is prepared to invest in burdensome precautions even if the costs involved exceed the expected criminal fines. At first glance, this would seem to put the ideal entrepreneur at a disadvantage in her competition with the swashbucklers. But to the extent that her marginally lower returns result from precaution costs incurred to comply with the criminal law, prosecutors will credit these efforts; and boards of directors and investors may prefer her to swashbucklers, who forever risk entanglement in the criminal law.

In the third model, we strip the criminal laws of any *mens rea* requirement: welcome to the world of strict liability crimes. Now, the ideal entrepreneur continues to invest in precautions, the cost of which exceed the expected fine; but there is no advantage in so doing. Facing soaring criminal fines, the ideal entrepreneur tries to do the right thing by investing in more and more care, but ultimately abandons business projects with indeterminate legal

[103] *See* Knight, *supra* note 35.

exposure. She either behaves like a bean counter, investing in safe projects with modest returns, or she flees the scene altogether, leaving the swashbucklers behind.

### A. A World Without Criminal Law or Uncertainty

Imagine a perfectly efficient market with no uncertainty or criminal laws. It is a world of perpetual blues skies; the shadows cast by the clouds of the criminal law never mar its postcard beauty. The thunderbolt of an indictment poses no threat, the hailstorm of a New York Times headline pronouncing, "Corruption at Zeus, Inc.!" instills no fear. For this world's happy inhabitants, there is none of the horrible uncertainty generated by the criminal law.

Now imagine that there is one group of exceptional managers, who generate returns on capital of 19.95%; and there is another group of managers, who are nearly as superlative, but manage returns of only 19.90%. The signal, albeit unintentional, that is sent by managers generating returns of 19.90% is that they are relatively not as competent as the group squeezing out 19.95% returns. In any event, that is the message heard by boards of directors and investors, who will act accordingly in their selection of corporate managers.

In a perfectly efficient market, boards of directors and investors would *always* choose executives in the first group to run their corporations. The Efficient Capital Markets Hypothesis[104] asserts that stock prices incorporate all relevant information, and the performance capacity of the corporate manager is certainly relevant to the stock price. A board of director that selected a manager from the latter category would see its company's stock price fall as investors realized that it was performing below its potential. That corporation would then become a prime target for a takeover bid by those who could then fire

[104] Eugene F. Fama, *Efficient Capital Markets II*, 46 J. FIN. 1575 (1991); *Efficient Capital Markets*, 25 J. FIN. 383 (1970).

the lower-producing manager, hire a manager who would increase the corporation's return to 19.95%, and reap the benefits of the rise in stock prices which would follow. Over time, boards of directors gain knowledge regarding which managers fall into which of the two groups, and in order to retain control will never hire from the lower-returns group.

### B. The Competition between Ideal Entrepreneurs and Swashbucklers: a *Mens Rea* World

Criminal laws against corporate corruption introduce storm clouds of uncertainty. Boards of directors and investors still want the highest rates of returns, but they now fear the criminal penalties and scandals that ensue when executives are caught breaking the law. Boards and investors may be prepared (assuming they are also risk-averse with respect to the criminal law) to tolerate slightly lower rates of return provided that those returns correspond to a lower probability of corporate corruption and corresponding losses to the corporation. To return to our earlier dichotomy, they might prefer ideal entrepreneurs to swashbucklers precisely because the lower rates of return generated by the former are recognized as the result of their more diligent efforts to comply with the criminal law. This latter claim would be true, we should immediately add, if and only if the criminal law (and those charged with enforcing it) credited such compliance efforts as a complete defense against the criminal law.

The ideal entrepreneur, we should recall, invests in compliance efforts out of a desire to avoid wrongdoing, and those efforts allow him to rebut any claims that he had intended to commit a crime. This might mean that he tells the accountant to double-check the books or the waste manager to use more expensive filtration systems. The swashbuckler, on the other hand, has no moral qualms regarding illegal activity, and is therefore careless in accounting and indifferent in waste management. In one sense, then, the ideal entrepreneur is at a disadvantage in his competition with the swashbuckler, because he is incurring precaution

costs that the swashbuckler is not; and as long as those precaution costs are greater than the expected penalties, the ideal entrepreneur will be generating lower returns than his swashbuckling counterparts.

Let's put this all in mathematical terms. Consider a law that creates criminal penalties for the intentional discharge of chemicals. We define the expected criminal fine as *f*, which is the probability of detection multiplied by the probability of conviction multiplied by the actual imposed fine. If the probability of detection is 10%, the probability of conviction is also 10%, and the imposed fine is $5,000?, then *f* would be (.1) x (.1) x $5,000, or $50. The expected criminal fine enters the swashbuckler's maximization problem, identified by the equation:

(1) $r = I + P - f - \mathrm{pc}$[105]

where *r* represents the return, *I* represents the initial investment in the project, *P* represents the profit and *pc* represents the precautionary measures taken to avoid chemical spillage. We assume an initial investment of $100,000 and an expected profit rate of 20%, and precautionary expenditures of $100 to guard against this spillage. The swashbuckler crunches the numbers and scoffs at the safety-mongers pestering him to invest in additional filtration devices; after all, the expected fine ($50) is less than those precautions ($100). Choosing not

[105] A more sophisticated way of saying much the same thing is that each manager faces the following maximization problem:

(1a) $\max R = P(s, I) - c(f(p), p)$

R is the return achieved by the manager. The manager will utilize her managerial skills, *s*, in order to turn some initial investment, *I*, into profit, *P*. As noted above, she will also consider the potential that profit-making actions will run afoul of criminal laws, and will react to the criminal laws by choosing some level of precautionary measures, *p*, which can be seen as *ex ante* compliance with criminal laws, and which have positive costs, $c > 0$. Any positive level of compliance reduces the likelihood of discovery and conviction, and thus reduces the expected criminal fine, or *f*. Some level of compliance, $\overline{p}$, will be sufficient to convince prosecutors that there was no criminal intent, and reduce the expected fine to zero.

to engage in precautionary measures, the swashbuckler would achieve a return of $119,950, or 19.95%.[106]

The calculation is different for the ideal entrepreneur. He also faces a return determined by equation (1), but he is, as we said before, hard-wired to comply with the criminal law. This disposition manifests itself as an investment in precautions even if their cost exceeds the expected criminal fine. Facing the same values as the swashbuckler, the ideal entrepreneur chooses to engage in precautions costs, and achieves a return of $119,900, or a return of 19.9%.[107] Note that for the ideal entrepreneur invests in the filtration device (at a cost of $100) but faces an expected fine *f* of $0;[108] if some spillage occurs, he will be able to point to the precautions he incurred (the filtration device) to escape any criminal penalties. Alternatively put, even if some environmental spillage occurs, the prosecutor will not bring the criminal law to bear against the ideal entrepreneur: The latter's investment in precautions demonstrates the lack of a "vicious will."

Boards of directors and investors are also likely to take note of the precaution costs incurred by the ideal entrepreneur. Everything else equal, of course, they would prefer the managers generating returns of 19.95% to those generating 19.9%, but everything else is not equal. The signal sent by the ideal entrepreneur's investment in precautions—an intent to comply with the criminal law—is heard loud and clear by boards of directors and investors, who will be disposed to prefer them (with their marginally lower returns but clear compliance with the criminal law) to swashbucklers (with their marginally higher returns but ever-present risk of entanglement with the criminal law).

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[106] $r = I$ (initial investment of $100,000) + $P$ (profits, calculated as .2 * $100,000)– $f$ [expected fine of $50] – $pc$ [precautions costs of $0] = $119,500.
[107] $r = I$ (initial investment of $100,000) + $P$ (profits, calculated as .2 * $100,000)– $f$ [expected fine of $0] – $pc$ [precautions costs of $100] = $119,000.
[108] *See supra* note 107.

Compliance with the criminal law is important to boards of directors because of the overall costs to the corporation arising from a corporate scandal. Although the swashbuckler considers the expected value of the criminal fine, he does not consider the total cost to the company in the event of a corporate corruption scandal. Criminal convictions of corporate managers affect the corporation's reputation, the morale of workers, and even share prices, by reducing demand among law-abiding investors. The magnitude of these costs depend upon a number of variables which cannot be known with certainty *ex ante*, such as the political atmosphere of the country, the number of corporate corruption scandals in the recent past, etc. To a board of directors, the ideal entrepreneur's precautions offer a refuge from such heavy uncertainty and associated costs, and boards will be willing to accept some lower level of return in exchange for less uncertainty.

### C. The Competition between Ideal Entrepreneurs and Swashbucklers: a Strict Liability World

Let us now move to a world of strict liability crimes. Criminal penalties attach *whenever* there is spillage.[109] Or perhaps the law is ambiguous as to what chemicals are intended and how much of a discharge constitutes a "spillage."[110] Is it one part per thousand or one part per million? The law is unclear, and the supposedly clarifying regulations provide at best diffuse illumination. The ideal entrepreneur wants to comply with the law, but how? Engineers suggest a filtration device, but the lawyers can provide no guarantees that it will insulate the company, and even the managers personally, from criminal liability. In other words, it is no longer clear that any level of precautionary measures can reduce the expected criminal fine to zero.

[109] This would be *de jure* strict liability.
[110] This would be *de facto* strict liability.

Imagine that there are two projects that corporate managers can implement: Project A is perfectly safe, giving rise to no legal complexities, and yields a 5% return on an investment of $100,000. Project B yields a 20% return, but exposes the entrepreneur to criminal liability. For example, it may entail a new manufacturing process that uses potentially toxic chemicals, and the criminal laws governing these chemicals are ambiguously drafted.[111] The criminal fine is unchanged, as are the probabilities of detection and conviction, so that the expected criminal fine is also unchanged, at $f$ = (.1) x (.1) x $5000, or $50. Engineers employed by the corporation might mention a filtration device which would reduce the likelihood of spillage, but which would also cost $100.

The swashbuckler scoffs: as expected, he treats the criminal fine as just another cost variable, of no more importance than the cost of any other input in production. (In any events, his lawyers, if he bothered to consult them, would tell him that the filtration device would not provide any certain protection against criminal liability.) For the swashbuckler, then, the return on an investment in this case in the second project would again be 19,950, or a return of 19.95%.[112]

For the ideal entrepreneur, the situation is quite different. Disposed to comply with the criminal law, he invests the $100 in precautions recommended by the engineers, but these precautions no longer insulate him from criminal liability. If a spillage occurs, prosecutors may construe the law to apply to him, and juries may subsequently convict. Alternatively put,

[111] Alternatively, consider Sarbanes-Oxley compliance. If a manufacturing company opens a new product line, it increases the odds of a regulatory lapse, such as an improper accounting report. The manager may earn a portion of the firm's profits through stock options or incentive laden managerial employment contracts; but the manager could also face a fine or prison time for any such violations.

[112] *See supra* note 106.

the ideal entrepreneur hopes that his investment in precautions signals an intent to comply with the criminal law, but in a strict liability world that message falls on deaf ears.

Here we need to re-iterate an important point. *For the ideal entrepreneur, criminal fines are not regarded as "just another cost"*: He contemplates criminal penalties with great trepidation. We will model this risk-aversion by squaring the expected criminal fine; in other words, the experienced "cost" of *f* is not \$50, but $\$(50)^2$. Thus, when calculating which project to undertake, the ideal entrepreneur will assess the return of Project B using the following formula:

(2) $r = I + P - f^2 - pc$[113]

Inputting the numbers, we get: $\$100,000 + .2(100,000) - (50)^2 - 200$, which is equal to \$117,240, or a return of 17.240%. This is still a quite healthy return and the ideal entrepreneur will clearly prefer Project B to Project A (with an expected return of only 5%).

Yet note that in his competition with swashbucklers for corporate control, the ideal entrepreneur is now disadvantaged. The ideal entrepreneur pointlessly invested in precautions; the swashbuckler did not. In a *mens rea* world, the ideal entrepreneur's slightly lower returns signaled an intent to comply with the criminal law, which prosecutors respected and which investors and boards of directors recognized as a valuable protection against entanglement in the criminal law. Now, however, boards of directors and investors are likely to question why they should prefer ideal entrepreneurs with lower returns if the meticulous precautions they incurred do not protect the company from entanglement in the criminal law. In a sense, then, we are returning to the first hypothetical world, without the criminal law

[113] A more sophisticated model, drawing upon the formula in note 105 would be:

(2a) $\max R = P(s, I) - (p + f^2)$.

altogether, in which even the slightest difference in achieved rates of returns will be severely punished in an efficient market.

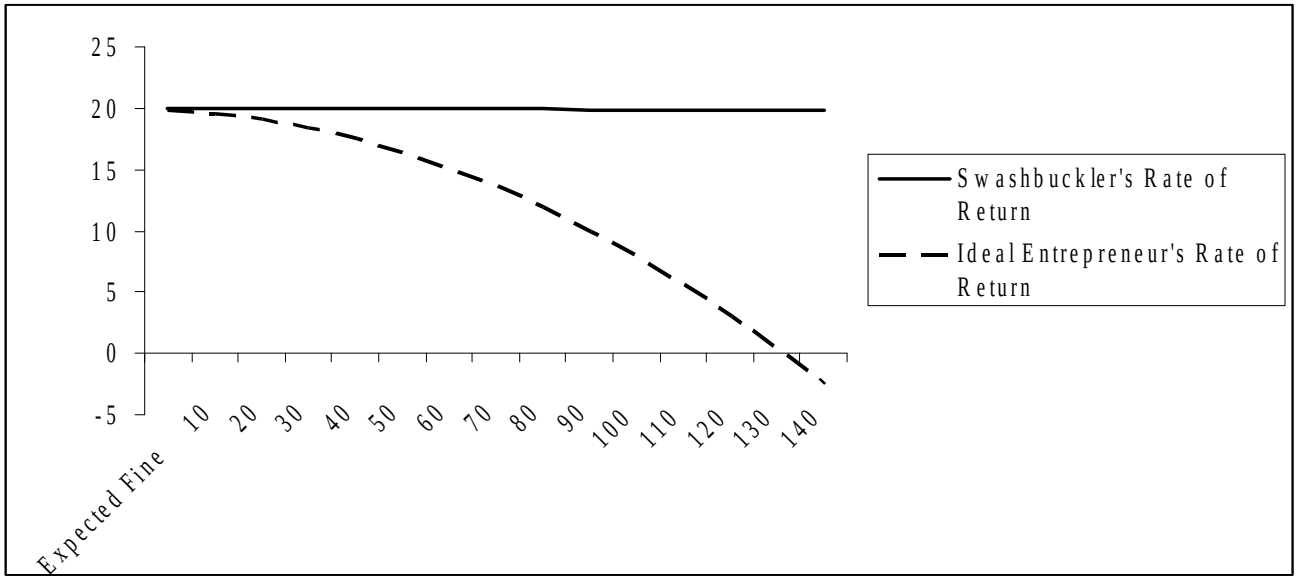
Furthermore, the process of adverse selection continues. Because the imposed fine of $5,000 has done nothing to deter the swashbuckler, there are still numerous violations.[114] Legislatures and regulators will be tempted then, especially after high-profile corporate scandals, to prove their determination to eliminate crime by both re-writing the law, making it more indeterminate and thus easier to convict, and by ratcheting up penalties. So suppose that the imposed fine is doubled to $10,000, or an *f* of $100. Then for the swashbuckler, the return is 19.90%,[115] while for the ideal entrepreneur the return drops to 9.90%.[116] Significantly, the doubling of the fine has reduced the swashbuckler's rate of return hardly at all, from 19.95% to 19.9%, but it has seriously dented the ideal entrepreneur's rate of return, from 17.4% to 9.9%.

More crimes, more clamor: Now increase the nominal fine yet again to 15,000, so the expected fine, or *f*, is $150. The swashbuckler's return is still very healthy 19.85% rate of return,[117] but the situation is dramatically different for the ideal entrepreneur. Remember that he is choosing between two projects, A with a safe 5 % rate of return, and the riskier but potentially more profitable project B. When assessing the merits of Project B, his expected return is now -2.6%.[118] At this point, then, the ideal entrepreneur, if forced to choose, will

[114] The total number of "violations" may even increase, due to the fact that the ideal entrepreneur will now be subject to criminal prosecution.
[115] Using formula (1), $r = I + P - f - pc$, we arrive at this figure as follows: $100,000 + ($100,000 * 0.2) - $100 - $0 = $119,900.
[116] Using the formula (2) , $r = I + P - f^2 - pc$, we arrive at this figure as follows: $100,000 + ($100,000 * 0.2) - $(100)$^2$ - $100 = $109,900. Note that for the ideal entrepreneur we have squared *f*, reflecting his risk-aversion to criminal fines.
[117] Using formula (1), $r = I + P - f - pc$, the calculation is $100,000 + ($100,000 * 0.2) - $150 - $0 = $119,850.
[118] Using the formula (2) , $r = I + P - f^2 - pc$, we arrive at this figure as follows: $100,000 + ($100,000 * 0.2) - $(150)$^2$ - $100 = $97,400. In other words, the expected return is a loss of $2,640.

invest in the perfectly safe Project A, which yields a return of 5%, rather than Project B, with a negative rate of return.

The graph and table below show how the steady increase in the actual imposed fine has a negligible impact on the swashbuckler's rate of return: A fifteen fold increase in the actual fine, from $1000 to $15,000, and corresponding increase in the expected fine from $10 to $150, scarcely dents his expected return. Note, moreover, that the swashbuckler will continue investing in Project B even as penalties skyrocket, and it not until the actual fine is $1.5 million that he will forego the riskier Project B for the safer Project A (with a guaranteed return of 5%). The ideal entrepreneur's calculation is dramatically different. When the actual fine is set at around $12,500, project B's expected rate of return dips below 5%, at which point project A becomes preferable.



| Expected Fine | Swashbuckler's Rate of Return | Ideal Entrepreneur's Rate of Return |
|---|---|---|
| 10 | 19.99 | 19.9 |
| 20 | 19.98 | 19.6 |
| 30 | 19.97 | 19.1 |
| 40 | 19.96 | 18.4 |
| 50 | 19.95 | 17.5 |
| 60 | 19.94 | 16.4 |
| 70 | 19.93 | 15.1 |
| 80 | 19.92 | 13.6 |
| 90 | 19.91 | 11.9 |
| 100 | 19.9 | 10 |
| 110 | 19.89 | 7.9 |
| 120 | 19.88 | 5.6 |
| 130 | 19.87 | 3.1 |
| 140 | 19.86 | 0.4 |
| 150 | 19.85 | -2.5 |
| 15000 | 5 | |

In the face of steadily increasing criminal penalties, and ambiguously drafted laws, collectively raising the specter of de facto strict liability crimes, some ideal entrepreneurs will

have their animal spirits drained away. They will behave like bean counters, parking capital in safe investments like Project A and foregoing the riskier and more profitable ventures that may give rise to criminal exposure. Other ideal entrepreneurs, however, will retain their animal spirits but flee the scene entirely, leaving behind the swashbucklers and a smattering of bean counters. Grisham's law, an example of adverse selection, applies itself to the world of regulatory crimes. Much as high insurance premiums drive out the good drivers and leave the bad behind, so do harsh regulatory penalties scare the good and attract the bad.

## VI. Conclusion

Laws against corporate corruption can be beneficial to the extent that they promote public safety and increase trust in publicly traded corporations (thus allowing for more widespread investment). Such rationales have inspired lawmakers and regulators to amend such laws in a variety of ways over the past century. In this paper, we have focused on the dilution of the *mens rea* requirement and the escalation of penalties. We have suggested an ironic consequence of this legislative trend: precisely as the laws against criminal corruption become more inchoate and the penalties more draconian we predict that there will be *more* corporate corruption, not less, as the most law-abiding businessmen simply exit the arena. The reason is adverse selection: When insurance companies first raise liability rates, the best drivers opt out of the group, causing other good drivers out of the group, causing rates to increase further, and so on, until only the worst drivers remain. Likewise, in the face of laws that make compliance with the criminal law excessively costly, and even then at best uncertain, those truly determined to comply with the law (the ideal entrepreneurs) might simply opt out, leaving relatively more swashbucklers in the midst. When, predictably, those

swashbucklers commit crimes, the consequence is a further dilution in the mens rea requirement, which may only further drive away the most law-abiding entrepreneurs.

Where to go from here? Ideally, we would call for a return to an era when the prosecution had to prove a "guilty mind" on the defendant's part. Indictments that did not aver that the defendant knew that he was violating a clearly defined statute or regulation should be dismissed; and trials in which the state does not prove that the defendant was unreasonable in his steps to comply with the rules or ascertain their meaning should result in an acquittal. More modestly, and realistically, we propose that the defendant be allowed to introduce, as a defense, that he took the necessary steps to comply with the law or to ascertain its meaning; and if this is established, the jury (or trier of fact) should be instructed to take this into account when ascertaining the guilt of the accused.

This is, in fact, the Canadian approach. The Canadian Supreme Court faced the question of strict liability crimes in two different eras of its constitution's history (once before Canada had the equivalent of the U.S. Bill of Rights and once after), and in both instances it reaffirmed that defendants have the right to rebut the state's evidence with evidence of due diligence.[119] Although the state could enact laws that presumed the guilt of anyone caught in violation (e.g., strict liability for "spillages"), the defense had the right to introduce into evidence the various steps it took to comply with the law. This evidence could then establish that the defendant was simply an unfortunate victim of circumstances.[120]

If embraced, this approach would allow defendants who did take adequate levels of care to signal that they are law-abiding entrepreneurs. The ideal entrepreneurs could then

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[119] *R. v. Sault Ste. Marie (City)*, [1978] 2 S.C.R. 1299; *Reference re: Section 94(2) of the Motor Vehicle Act*, [1985] 2 S.C.R. 486. *See* James Stribopulos, *The Canadian Constitutionalization of "Fault" in Canada: A Normative Critique*, 42 CRIM. L. Q. 227 (1999).
[120] *Id*. at 239.

compete with the swashbucklers, who have not incurred adequate precaution costs and who would therefore face criminal liability. Unless the law credits the efforts of ideal entrepreneurs to abide by the criminal law, that law will not simply deter them; it will drive them away altogether. Society may not be pleased to discover who is left behind.