

האוניברסיטה העברית בירושלים

THE HEBREW UNIVERSITY OF JERUSALEM

CORPORATE CRIME AND PLEA BARGAINS

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Discussion Paper # 697 (March 2016)

מרכז פדרמן לחקר הרציונליות

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Abstract

Corporate entities enjoy legal subjectivity in a variety of forms, but they are not human beings, and hence their legal capacity to bear rights and obligations of their own is not universal. This paper explores, from a normative point of view, one of the limits that ought to be set on the capacity of corporations to act "as if" they had a human nature, their capacity to commit crime. Accepted wisdom has it that corporate criminal liability is justified as a measure to deter criminal behavior. Our analysis supports this intuition in one subset of cases, but also reveals that deterrence might in fact be undermined in another subset of cases, especially in an environment saturated with plea bargains involving serious violations of the law.

The Framework

The separate legal person of corporate entities is a staple of every developed legal system. It is commonly interpreted as a device to allocate risk among corporate constituencies, and especially between owners and creditors⁴. It is equally clear, however, that corporations are distinct from natural persons and hence their legal subjectivity, i.e. their capacity to bear rights and obligations of their own, is limited. For example, they cannot be elected to public office. What corporations "can" or "cannot" do is a perennial subject of discussion which permeates numerous fields

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³ Thanks are due to Ronen Avraham, Sharon Hannes, Alon Harel, Omer Kimhi and Ariel Porat for helpful comments on former drafts. Yonatan Horan provided excellent research assistance.

⁴ This assertion is based on the premise that as long as a corporation is solvent the "veil" that separates it from its owners need not be "pierced" and hence there is no meaning to the separateness of corporate rights and obligations. Once the corporation becomes insolvent, however, the veil protects owners from the reach of the corporate creditors; hence the existence of a "veil" is a mode of allocating the risk of insolvency to the creditors, rather than to the owners of the firm. The efficiency reasons behind opting for such an allocation of risk, especially in the case of publicly held firms, is articulated, *inter alia*, in Frank Easterbrook and Daniel Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985).

of law⁵. This paper is crafted to explore one of these borderline cases, the issue of corporate crime. It was famously stated that corporations do not have a body to be kicked or a soul to be saved⁶. Can a soul-less, body-less entity commit a crime? As a matter of positive law, jurisdictions vary on this question. Whereas in Common Law systems corporations are frequent defendants in criminal proceedings⁷, some important Civil Law jurisdictions (e.g. Germany) adhere to the view that companies are "incapable" of forming criminal intent (*mens rea*) and hence ought to be immune to criminal charges^{8,9}. Although this purist view is waning in a number of European jurisdictions in recent years, we will refer to it, for convenience, as the "European approach", in contrast to the traditional Common Law approach which feels at ease with corporate criminal liability. In what sense does the European approach doubt the capacity of corporations to engage in criminal behavior? Clearly, corporations are not less "capable" of forming *mens rea* than they are competent to form contractual resolve or delictual intent, and yet they are universally recognized as bearers of contractual or delictual rights and obligations. In fact, companies cannot *do* things to a greater extent than they can *intend* to do them; hence, even corporate *actus reus*, which is routinely worked into European criminal jurisprudence, let alone liability for deeds in the contractual or tortious spheres, raise exactly the same "capacity" questions as the psychological intention to commit a felony. Since as a matter of empirical observation corporations cannot either *do* or *intend* to

⁵ Discussions about the nature and scope of the so-called "artificial" legal person have a long and respectable pedigree. For a general survey see Martin Wolff, *The Nature of Legal Persons*, 54 Law Q. Rev. 494 (1938).

⁶To the best of my knowledge the first to have used a similar metaphor was Lord Edward Thurlow, who served for a number of years as Lord Chancellor of England in the 18th Century.

⁷In actual fact, of course, the crime is committed by a natural person; and traditional English law was loath to ascribe to anyone, including a corporation, vicarious criminal liability for the crime committed by someone else. In response, traditional English law developed the so-called "organic theory" which holds that certain key officers are not mere agents of the corporate entity, but are actually its "organs", and consequently the corporation's liability for their crimes is "direct", or "personal", rather than vicarious. For a line of case embracing this view and their analysis see L.C.B. Gower, *Principles of Modern Company Law* 206 ff (4th ed., 1979).

⁸An excellent comprehensive summary of the current state of corporate criminal liability in a variety of important European jurisdictions was prepared by the law firm of Clifford Chance and is available at

http://www.cliffordchance.com/content/dam/cliffordchance/PDFs/Corporate_Liability_in_Europe.pdf (2012).

⁹ The notion that corporate entities are not "capable" of committing crimes is probably fed by the kind of narrative one imagines when one thinks about criminals, which does not sit well with non-human offenders. On the psychology of thinking about criminals in this context see Tom Tyler and Avital Mentovich, *Punishing Collective Entities*, 19 J. Law and Policy 203 (2015).

do anything, the question must be removed from the realm of the *is* unto the realm of the *ought*; namely should corporations, as a normative matter, be treated *as if* they could form a criminal intent and be charged with crimes in spite of the fact that they are obviously nothing but a figment of the human imagination.

Clearly, corporate criminal liability entails some externalities that mutilate against the concept. The corporate entity, as such, does not mind the severity of the sanction, simply because it does not possess the potential of suffering. The sufferers are often innocent agents, like stockholders and other stakeholders whose personal fortunes are tapped to foot the bill. But externalities of this nature are perennial both in the non- corporate world and in corporate law. Outside of corporate law, if a suspect is found guilty and sanctioned, a multitude of innocents, like family members, creditors or business associates might be unintentionally but unavoidably penalized. In corporate law proper, stakeholders pay the consequences of corporate contract breaches, tort malfeasance or other violations of the law, not less than say, when a company pays a criminal fine. The added element of criminal sanctions, the stigma resulting from conviction, normally does not attach to innocent corporate agents, because stigma is a moral response to turpitude, and innocent stakeholders are often as clean as a whistle. In an imperfect world, these necessary externalities are treated as collateral damage and dismissed with a nod.

Even if we put to one side the negative spillovers affecting innocent agents, we still have to answer the normative question- Why impose criminal responsibility on the corporate form? Accepted wisdom is straightforward in this respect: it is speculated that corporate criminal liability enhances the goal of deterrence, and ought to be supported for this reason¹⁰. The argument goes like this: corporate incumbents, like directors and officers of the company, are personally loath to have their corporation convicted in criminal proceedings. This is not necessarily because they are such great sentinels of unblemished behavior, but rather because their personal fortunes depend, for greater or lesser extent, on the corporate record of lawfulness and trustworthiness. A director or officer

¹⁰ See, for instance, Henry Edgerton, *Corporate Criminal Responsibility*, 36 Yale L. J. 827, 833 (1927); Bruce Coleman, *Is Corporate Criminal Liability Really Necessary?* 29 SW L. J. 908, 919 ff; Celia Wells, *Corporations and Criminal Responsibility* 31 (1993).

whose firm was publicly exposed as having engaged in crime on her watch may be severely disciplined by the forces of the market for managerial talent¹¹, and arguably, to a lesser extent, by those of the capital market¹² and the market for corporate control¹³. To avoid being in that spot, directors and officers (except the perpetrator of the crime himself) have a strong incentive to monitor each other's potentially criminal behavior and to otherwise guard not against corruption *per se*, but rather against the resulting personal embarrassment. With an army of spies, crime gets to become more costly, and at an equilibrium, more scarce¹⁴.

To make the story even more convincing, a plethora of laws are passed in many jurisdictions, which impute the criminal responsibility of the corporation to its senior directors and officers as well, unless they can exculpate themselves by proving that the commission of the crime was consummated behind their backs and they were not negligent in not preventing it¹⁵. This practice in itself has some unsavory aspects to it, because it imposes vicarious criminal liability on these senior officers, for crimes of *mens rea*, in spite of the fact that their state of mind was mere negligence; the silver lining is that the fear of personal criminal liability augments the innocent agents' incentive to monitor potential perpetrators and further reduces the incidence of crime. Let us assume *arguendo* that if that were the end of the story we would have been content to interpret

¹¹ This is either because she might be sued by the corporation for breach of a fiduciary obligation, or because the demand for her services is anticipated to decline.

¹² Firms with a criminal record might find it costlier to raise funds and hence to compete against other firms whose cost of capital is lower.

¹³ If the firm is hit with a severe criminal sanction it might depress the value of its stock and make it easier prey for hostile takeover bids, in which incumbent officers might lose their grip on their position of stewardship.

¹⁴ See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. Leg. Stud. 833 (1994). In this thoughtful piece Professor Arlen both documents this common contention and criticizes it.

¹⁵ For instance, see the Statute Law Amendment (Directors' Liability) Act which was passed in Victoria, Australia, which amended a variety of laws so as to include a clause that imputes corporate criminal liability to corporate officers, unless they can prove that they used diligence to prevent the crime. Israel has scores of statutes to exactly the same effect, e.g. Section 53 (e) of the Securities Law, 1968, as amended; in the United States an evolving doctrine imputes personal liability to senior officers under certain statutes, such as the Food, Drug and Cosmetic Act, the Resource Conservation and Recovery Act, the Clean Air Act and the Clean Water Act. See Brenda Hustis and John Gotanda, *The Responsible Corporate Officer: Designated Felon or Legal Fiction?* 25 Loy. U. Chi. L. J. 169 (1994); Cynthia Finn, *The Responsible Corporate Officer, Criminal Liability and Mens Rea: Limitations on the RCO Doctrine*, 46 Am. U. L. Rev. 543 (1996).

this "massacre of the innocents" as if it were just another necessary form of collateral damage.

Unfortunately, there is another angle to this story, which has to do with the political economy of prosecutors and courts, and the game they play with corporate incumbents. Prosecutors are commonly rewarded, by promotion and otherwise, on the basis of their "success rate" in prosecutorial activities. Since it is hard to gauge what "success" precisely means, the common practice is to interpret the concept as a forensic effort resulting in a conviction. Less attention is being focused on the number of convicted suspects in any given charge or on the severity of the sentence. It is well known that most criminal proceedings involve a plea bargain which judges are normally happy to embrace, because the alternative, a lengthy and cumbersome trial, is a burden on their congested dockets as well as on their leisure activities. Now it works for the advantage of everyone (except the corporation and its innocent stakeholders) to strike a deal, in which directors and officers plead guilty on behalf of the corporation, in exchange for dropping the personal charges against them. The officers get an easy way out of a looming conviction, the prosecutors improve their conviction rates¹⁶, the judges can manage their dockets more easily and spend some time with their grandkids, and only the corporation, which does not possess a mind of its own to reject the plea bargain, is probably convicted of some crimes that have never been committed, to the detriment of its stockholders and other innocent stakeholders. We are perfectly aware that in spite of this incentive-structure some cases involving corporate crime go to trial, i.e. do not end in plea bargains. Similarly, some prosecutors decline to be swayed by the

¹⁶See generally, John Coffee, *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 Mich. L. Rev. 836 (1981); Nuno Garoupa, *The Economics of Prosecutors*, in Alon Harel and Keith Hylton (eds.) *Research Handbook on the Economics of Criminal Law* 231 (2012); Stephanos Bibas, *Plea Bargains Outside the Shadow of Trial*, 117 Harv. L. Rev. 2463 (2004); Albert Alschuler, *The Prosecutor's Role in Plea Bargaining*, 36 U. Chi. L. Rev. 50 (1968); Stephen Schulhofer, *Plea Bargaining as Disaster*, 101 Yale L. J. 1799 (1992). Another explanation for prosecutorial enthusiasm to plea-bargain has to do with consideration of budget constraints. Litigation is costly and litigation in the area of white collar crime is particularly so, given the vast resources that are usually marshalled on the defense side. Plea bargains are cheap and generate more convictions, given the budget constraints, than any kind of adversary proceedings. See Jed Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted?* New York Review of Books, January 9, 2014. See also Reinier Kraakman, *Corporate Liability Strategies and the Cost of Legal Control*, 93 Yale L. J. 857 (1984). It ought to be noted that some commentators emphasize the average length of prison sentences, rather than the rate of convictions, that motivate prosecutors as a means of advancing their careers. See Richard Boylan, *What do Prosecutors Maximize? Evidence from the Careers of U.S. Attorneys*, 7 Am. L. and Econ. Rev. 379 (2005).

personal lure embedded in plea bargains. Our purpose is not to argue that *all* cases are settled out of court, but to compare the impact of corporate criminal liability, with and without plea bargains, on the incentives to monitor corporate criminality and to deter crime.

Discussion

We formalize, in a rather stylized manner, three possible regimes: no corporate criminal liability ("the European approach"), corporate criminal liability without plea bargains and corporate criminal liability where plea bargains abound. This paper concludes that the second case, corporate criminal liability without plea bargains has, at least in the case of serious crimes, the greatest effect on deterrence and consequently on the reduction of crime. The comparison between the two remaining cases, the European approach and corporate criminal liability *cum* plea bargains is more nuanced. Whereas the European approach seems to be the least effective measure in terms of reducing crime, it has some attractive deontological features that are lacking in the other two legal regimes.

A corporation has a number of senior officers, all of whom are assumed to be expected utility maximizers. One of these officers, whose identity is not known, is a potential offender. If the crime is detected and sanctioned, the same sanction extends to the corporation. In addition, we assume that it also extends to all of its innocent senior officers, unless they can exculpate themselves on proof of diligent behavior. One method of exculpation is to report the crime as soon as it comes to the attention of a senior officer, and before it is independently detected by the law enforcement authorities. The criminal sanction imposed upon conviction is C . The probability of detection is p . If the crime is not detected, the perpetrator derives a benefit of β , which is also the cost for society resulting from the commission of the crime¹⁷. If the crime is detected, every officer, except officers who diligently reported the crime to law enforcement authorities suffers a disutility of α ($\alpha < \beta < C$)¹⁸ occasioned by

¹⁷ For example, if the crime involves embezzlement of funds, the offender's payoff equals the loss of the crime victims.

¹⁸ One could reasonably argue that C is not uniform across the board. Clearly, some methods of punishment, such as incarceration, cannot be administered in the case of convicted companies. Likewise, the punishment meted out to the perpetrator is likely to be more severe than that of the innocent officers, because the perpetrator's guilt is direct, and the innocent officers' liability is vicarious. However, in the following analysis these distinctions are without a difference, because if we stick to the assumption that $\alpha < \beta < C$ for all players, the results of the following analysis remain intact.

loss of reputation and the resulting market discipline. This loss of reputation is spared to the reporting officers because they prevented the commission of the crime, and proved in their conduct both their diligence and their commitment to lawful corporate behavior. The payoff to the innocent officers in the case of non-detection is zero. We further assume that in a world without plea bargains if the crime is detected the case goes to trial and a clairvoyant court convicts the offender. Thus, risk neutral perpetrators are expected to commit the crime if-

$$(1) \beta > p(C + \alpha).$$

If C is set at the socially optimal level, i.e. β/p ¹⁹, no crime is ever committed, because its expected benefit to the perpetrator is negative. In that ideal case, corporate criminal liability is redundant, because there are no crimes to be deterred. Under these conditions, crimes are only committed by over-optimistic offenders who irrationally under-estimate the magnitude of C or over-estimate β . The way to combat this situation is to devise ways to correct the myopic estimation of the offenders, such that C and β attain, in their eyes, realistic proportions. This role is assigned, in the current system, to the innocent officers. Assume that if an innocent officer is charged with the crime committed by the perpetrator, the probability of exculpation based on exemplary behavior is q . Hence, if a crime is committed by the perpetrator, innocent officers face an expected cost of $Cp(1-q) + \alpha p$. Note that if the crime is detected and sanctioned α is suffered by the innocent officers even if they took diligent efforts to forestall it. Each innocent officer can engage in monitoring efforts at the cost of K and she is incentivized to do so if K is small enough, compared to the risk that a perpetrator should commit a crime and inflict the resulting damage on her peers. The rhetoric is that these monitoring efforts scare away offenders and hence actually reduce crime. This is, roughly speaking, the rationale of imposing criminal liability on corporate entities and on their senior officers.

Thus far we assumed that the perpetrator actually committed the crime, and hence, due to the court's assumed clairvoyance, if the crime is detected (at the probability of p) conviction is certain. In other words, the probabilities of detection and that of conviction are identical. But in a

¹⁹This is the optimal fine, because it re-internalizes to offenders all the external costs of their crimes, not only those that have been detected and then vindicated.

world with plea bargains this assumption may not necessarily hold, because the prosecution may err in its decision to indict and hence the probability of conviction by a clairvoyant court, hereby denoted γ , is less than unity. Of course, if a plea bargain is signed conviction follows as a matter of certainty. If the accused decline to accept the offer they still retain a chance of $(1-\gamma)$ to be acquitted. Since all cases are assumed to be concluded with plea bargains, the only defendants, the corporate entities, are sometimes penalized without guilt, and when all these cases are aggregated (call their number n) corporations (and their innocent constituencies) suffer an unwarranted penalty of $nC(1-\gamma)$. Innocent constituencies foot the bill even if the crime had in fact been committed; this "collateral damage" is exacerbated in the case of actual innocence. Let us now examine if this collateral damage is justified in terms of deterrence.

The suspected (risk neutral) perpetrator is motivated to accept the bargain in the pre-conviction stage, if-

$$(2) \alpha < C\gamma + \alpha\gamma, \text{ or } \alpha(1-\gamma) < C\gamma.$$

Since $C > \alpha$ and if we assume the reasonable assumption that $\gamma > 0.5$, the conclusion seems certain that the suspected perpetrator will accept the bargain whether she is in fact guilty or not.

We now turn our attention to the innocent officers. Risk neutral innocent officers will be incentivized to accept the bargain if-

$$(3) \alpha < C\gamma(1-q) + \alpha\gamma, \text{ or } \alpha(1-\gamma) < C\gamma(1-q).$$

Unlike the perpetrator, the set of cases in which the innocent officers might decline to accept the offer is conceivably non-empty; for instance, if $q = 1$ the inequality will not hold and the bargain will not be struck. Nonetheless it is very reasonable to assume that given the smallness of the left hand side of the inequality and the empirical evidence that γ is quite substantial (the prosecution wins in the vast majority of litigated cases), the bargain will be struck save, again, in the exceptional cases where the innocent officers are quite certain that they can establish their innocence in open court. This conclusion is further buttressed if the innocent officers are risk averse and if the cost of establishing innocence in open court is non-trivial. Finally, we trust that the remaining two

players, the prosecutor and the sitting judge, are set to support the bargain as a dominant strategy from their respective points of view.

It now becomes common knowledge that with the exception of the remote possibility that innocent officers will decline to accept the bargain, it will indeed be struck. The question is how the realization of this fact affects the ex-ante incentives of the innocent officers to monitor potential perpetrators.

There are three relevant states of the world. First, a state of affairs mimicking the European approach, where only flesh and blood offenders face criminal liability ("Case 1"). Second, a state of affairs mimicking the Common Law model, where corporations may be charged with crimes committed by its senior officers, augmented by some sort of vicarious criminal liability which is imputed to innocent officers unless they can prove some version of good behavior, but no plea bargains are permissible ("Case 2"). Finally, Case 3 is identical to Case 2 but plea bargains abound.

We start by comparing Case 1 to Case 2. In Case 1, monitoring efforts are expected to occur if $K < \alpha p$. In Case 2, on the other hand, more monitoring efforts will be invested, since they are expected to materialize if $K < C_p(1-q) + \alpha p$; Clearly, then, Case 2 dominates Case 1 in terms of the objective of reducing crime²⁰.

We proceed now to compare Case 2 to Case 3. As we just observed, senior officers will have an incentive to monitor perpetrators in case 2 if $K < C_p(1-q) + \alpha p$; In case 3 the senior officers are already aware that if a suspicion of a crime should be detected they will be offered a plea bargain, and hence their monitoring efforts will be conditioned on $K < \alpha \gamma$. It follows that more monitoring efforts are expected to be undertaken in Case 2 if-

$$(4) C_p(1-q) + \alpha p > \alpha \gamma.$$

Now suppose that the sentencing policy approximates its optimum, namely $C = \beta/p$. If this is the case we can substitute β for C_p in the left hand side of the inequality, such that the inequality can be restated as-

²⁰We leave unresolved, here and elsewhere, whether more monitoring is superior to less monitoring, given the duplication of effort by all innocent officers to engage in diligent mutual supervision.

$$(5) \beta(1-q) + \alpha p > \alpha \gamma.$$

We may safely assume that $\gamma > p$, because the rate of convictions is considerably higher than the rate of detection. It follows that although $\beta > \alpha$, inequality (5) may be violated in cases of insignificant crimes where β is sufficiently small (say, in cases of petty larceny). But in cases of severe criminality, where β is large enough, Case 3 emerges as inferior to Case 2 in terms of crime reduction. For instance, if $\beta = 10$, $\alpha = 5$, $p = 0.2$, $\gamma = 0.8$, and $q = 0.5$, more attempts to commit crime will be monitored and prevented in a world without plea bargains. The normative implications of this result are quite significant. Plea bargains are not struck because of their "truth value" (defined as a state of the world where the guilty are punished and the innocent are exonerated). Quite the contrary, plea bargains are never aligned with this ideal state of the world, because the negotiated sentence is too slight if the offenders are guilty and too severe in cases of innocence. Plea bargains are struck because they clear congested dockets and make it possible for the administration of criminal justice to move forward. But the resulting injustice is more striking where the bargain is negotiated in cases of serious felonies than it is in instances of minor infractions of the law. Inequality (5) suggests that the time saving obtained by plea bargains ought to be reserved for the lesser crimes (where β is relatively small), but ought to be discarded in cases of severe violations of the law. Inequality (5) accomplishes two goals: it formalizes this result in terms of crime prevention, and it conforms to the intuition that the truth value of sentences ought to be particularly important in cases of severe criminality.

It remains to be considered how one compares Cases 1 and 3. In this case it seems that the European approach is the least effective measure to reduce crime, since it is clear that $\alpha p < \alpha \gamma$. This clear finding does not, of course, disparage the rationale of the European approach altogether, because that approach has the advantage of eliminating all unsavory externalities; it simply implies that any kind of a personal threat to individual officers incentivizes them to take some preventive measures that reduce crime.

One possible objection which is noted in the literature need be addressed before conclusion. It has been suggested that once the innocent senior officers are alerted to the commission of the crime they might have an

incentive to stonewall it as a means of fending off their personal disutility resulting from its exposure. Clearly, if they engage in this behavior they forfeit their chances of exculpation, which are only reserved for players displaying exemplary behavior. But in a world where everything ends with plea bargains it could be contended that the risk of detection is reduced, from the senior officers' point of view, even without chances of exculpation, to just α , and this reduction of risk enhances their *ex ante* motivation to hide their damaging information if they become aware of the commission of the crime. This analysis does not hold according to the tenets of the present model. Stonewalling officers still face an expected cost of αp (recall that in the relevant situation $q = 0$ and $\alpha = \gamma$), whereas early reporting of the crime exposes them to the expected cost of zero. Even if we relax our assumption that exposing the crime obliterates the loss of reputation in its entirety, it is reasonable to assume that it is sufficiently mitigated to be eclipsed by the expected cost of a plea bargain.

In summary, Case 2, corporate criminal responsibility without plea bargains tops both of its alternatives in terms of deterrence and reduction of serious crime; In the case of minor offenses plea bargains do not reduce the incentive to monitor violations of the law; The European approach is the least effective regime in terms of the incentives to reduce crime, but it has some saving features of the deontological type.