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Visions of the Republic Symposium: Facts and Fictions of Corporate Executive Accountability

Masaki Iwasaki

Harvard Law School, nstewart14@law.fordham.edu

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FACTS AND FICTIONS OF CORPORATE EXECUTIVE ACCOUNTABILITY

*Masaki Iwasaki**

U.S. Senator and former Democratic presidential contender Elizabeth Warren recently proposed the Corporate Executive Accountability Act, a bill that lowers the level of mental state required to prosecute executives for any corporate crime. A nationwide debate has been raging over this Act, but most arguments have focused on the appropriateness of the relaxed requirement, and the whole picture of executive accountability is vague. This Essay reveals what the facts and fictions of corporate executive accountability are, focusing on the degree of punishment of criminal executives. The author presents the estimates of expected direct and indirect punishments of executives and considers other options to deter corporate crimes, options that could be used with or without the proposed Act.

INTRODUCTION

On April 3, 2019, U.S. Senator and former Democratic presidential contender Elizabeth Warren proposed a bill titled the Corporate Executive Accountability Act¹ (the “Act”), which would dramatically change the enforcement of corporate criminal law if the bill is enacted. In many corporate crimes, an intent to commit a crime is required for criminal liability and mere negligence is not sufficient. However, the Act relaxes this standard to negligence for any corporate crime;² under the Act, it will be unlawful for an executive of a corporation with more than \$1 billion in revenue to negligently permit or fail to prevent a corporate offense.³

* Terence M. Considine Fellow in Law and Economics at Harvard Law School; Associate at Nishimura & Asahi; J.S.M., Stanford Law School. The author is grateful to Bala Dharan, Reinier Kraakman, J. Mark Ramseyer, Steven Shavell, Holger Spamann, Kathryn E. Spier, and Wataru Tanaka for their helpful comments. He is also grateful to Lena Bruce, Salvatore Cocchiario, Rebecca Guthrie, Leili Saber, and Nora Stewart for their excellent editorial work. For financial support, the author thanks Harvard Law School’s Summer Academic Fellowship and Terence M. Considine Fellowship through the John M. Olin Center for Law, Economics, and Business.

1. S. 1010, 116th Cong. (2019).

2. *Id.* § 2.

3. *Id.*

While the Act has been endorsed by several influential organizations such as Public Citizen and Americans for Financial Reform,⁴ some have fiercely questioned the desirability of the Act.⁵ Most arguments over the Act have focused on the appropriateness of the relaxed requirement, and it is unclear to what extent this type of reform is necessary and whether other options exist. Different views seem to implicitly assume that the punishment of executives is currently either sufficient or insufficient, but those views rarely show empirical support for their assumptions.

This Essay reveals the facts and fictions of corporate executive accountability, focusing on the punishment of criminal executives. The aim of this short piece is not to discuss the desirability of the Act, which would require a substantial number of pages. Rather, this Essay presents estimates of the expected punishment of executives to show that the current deterrence of corporate crime is probably insufficient. Then the author explores other options we may have in order to improve deterrence. The options featured here are whistleblower reward programs and corporate self-reporting schemes. These options could be used with or without the Act. Readers' judgment on the Act would be facilitated if other options are presented at the same time.

Part I presents the rough estimates of expected direct and indirect punishments of criminal executives. Part II shows how whistleblower reward programs can improve the enforcement of corporate criminal law. Part III considers whether and how corporate self-reporting schemes can enhance deterrence. Part IV concludes.

I. DIRECT AND INDIRECT PUNISHMENTS OF CRIMINAL EXECUTIVES

If an executive commits a corporate crime, this individual is exposed to two expected punishments: direct and indirect punishments. If the executive is prosecuted and convicted, this person will suffer direct punishment, such as fines and imprisonment. Moreover, the executive may suffer indirect punishment through a reduction in his or her wealth if a company suffers a corporate sanction. In U.S. public companies, executives such as chief executive officers (CEOs), receive significant stocks and options as their compensation.⁶ If a company is sanctioned, its value will decrease, and its

4. See Press Release, Elizabeth Warren, Senator Warren Unveils Bill to Expand Criminal Liability to Negligent Executives of Giant Corporations (Apr. 3, 2019), <https://www.warren.senate.gov/newsroom/press-releases/senator-warren-unveils-bill-to-expand-criminal-liability-to-negligent-executives-of-giant-corporations> [https://perma.cc/P4G3-59G2].

5. See, e.g., Carissa Byrne Hessick & Benjamin Levin, *Elizabeth Warren's Proposal to Imprison More Corporate Executives Is a Bad Idea*, SLATE (Apr. 4, 2019, 1:39 PM), <https://slate.com/news-and-politics/2019/04/elizabeth-warren-corporate-fraud-prison-negligence-mass-incarceration.html> [https://perma.cc/ADP7-JBJ5].

6. See, e.g., David F. Larcker & Brian Tayan, *CEO Compensation: Data Spotlight*, STAN. GRADUATE SCH. BUS.: CORP. GOVERNANCE RES. INITIATIVE,

executives' compensation may decrease as well. If corporate crimes are detected, companies may need to disgorge illicit profits, pay fines, and suffer reputational loss, all of which reduce their stock prices and thus reduce the wealth of their executives.

Given this background, this Essay attempts to roughly estimate the expected direct and indirect punishments of CEOs of U.S. public companies, based on data from prior literature.⁷ The results are presented in Table 1. We first calculate the probabilities of detecting a corporate crime and prosecuting a CEO. For fraud cases of large U.S. public companies, I. J. Alexander Dyck et al. estimated that the probability of detecting a crime is approximately 33 percent.⁸ We can also calculate the conditional probability of prosecuting a CEO given a crime detection, based on the study of Brandon L. Garrett.⁹ His sample includes 306 deferred and non-prosecution agreements with U.S. public and private companies, with the sample period ranging from 2001 to 2014.¹⁰ In these cases, 26 CEOs were prosecuted,¹¹ and thus the conditional probability of CEO prosecution can be estimated as 8.5 percent.

Executives, including CEOs, do not necessarily engage in corporate crimes even if their company commits crimes. If so, the true conditional probability of CEO prosecution would be higher than 8.5 percent. However, the estimated number would not be significantly different from the actual number. Executives often play a leadership role in large-scale corporate crimes, but they are rarely prosecuted.¹² Prosecuting individuals is practically more difficult than prosecuting corporations.¹³

Next, we calculate the direct punishment. According to Garrett's study, the mean fine is \$381,000 for individuals prosecuted and fined, and the mean jail time is 18 months for individuals sentenced.¹⁴ Hence, by multiplying (1) these numbers by (2) the probability of crime detection by (3) the conditional probability of CEO prosecution, the expected direct punishment can be roughly estimated at a fine of \$10,687 and a jail time of 0.5 months. One

<https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-quick-guide-17-ceo-compensation-data.pdf> [<https://perma.cc/4TFF-HXYJ>] (last visited Apr. 28, 2020).

7. The explanation of Table 1 draws on the analysis in Masaki Iwasaki, *A Model of Corporate Self-Policing and Self-Reporting* (Harvard John M. Olin Fellow's Discussion Paper Series No. 88, 2019), http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Iwasaki_88.pdf [<https://perma.cc/9672-4JWJ>].

8. I. J. Alexander Dyck et al., *How Pervasive is Corporate Fraud?* 2 (2017) (unpublished manuscript). An earlier version of the paper is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2222608 [<https://perma.cc/RU7R-BLSQ>].

9. Brandon L. Garrett, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789 (2015).

10. *Id.* at 1791. Data including only public companies is not available.

11. *Id.* at 1802.

12. *See, e.g.*, RENA STEINZOR, *WHY NOT JAIL?: INDUSTRIAL CATASTROPHES, CORPORATE MALFEASANCE, AND GOVERNMENT INACTION* 5 (2014).

13. *See, e.g.*, BRENT FISSE & JOHN BRAITHWAITE, *CORPORATIONS, CRIME AND ACCOUNTABILITY* 57 (1993).

14. Garrett, *supra* note 9, at 1813, 1833.

caveat is that the true direct punishment of CEOs is likely to be higher than the estimated value because the data of the mean fines and jail time includes both senior executives and lower-level employees. But even if the fine amount is adjusted upward, because of the low probabilities of crime detection and CEO prosecution, the expected direct punishment would still be low. Another caveat is that CEOs may suffer reputational loss and face the risk of dismissal, which are not calculated here because it is difficult to obtain data for that calculation.

Lastly, regarding the indirect punishment, according to David Larcker and Brian Tayan, a 1 percent change in stock price leads to a median change of \$193,000 in CEO wealth for U.S. public companies.¹⁵ Furthermore, according to a study by Jason Pierce, corporate prosecution decreases the stock price of a U.S. public company by approximately 11 percent.¹⁶ Therefore, by multiplying (1) the probability of crime detection by (2) the change in CEO wealth with a 1 percent stock price change by (3) the impact of corporate prosecution on stock price, the expected indirect punishment can be estimated at \$700,590.

These data suggest that the total expected punishment of executives is unlikely to be sufficiently large relative to the expected illicit profits to these individuals from committing crimes. Indeed, illicit profits from corporate crimes are known to be huge in many cases when compared to the amounts of fines.¹⁷ The data also imply that the expected direct punishment may not significantly increase even if the probability of crime detection is increased because the conditional probability of CEO prosecution, the expected amount of fines, and the expected length of imprisonment remain at low levels. Although CEOs may be exposed to additional punishments, such as reputational loss and dismissal, these costs are unlikely to be high because of the low probability of executive prosecution.

The gist of the Act is to raise the conditional probability of CEO prosecution by easing the existing difficulties of proof. While the Act would have social benefits from enhancing deterrence, it may also have social costs. Thus, the social benefits and costs from introducing the Act should be carefully evaluated. The desirability of this particular solution is beyond the scope of this paper, but the estimates above at least demonstrate that some changes would be necessary to improve deterrence. In order to enhance deterrence, there are three options: (1) increasing the probability of crime detection, (2) raising the conditional probability of executive prosecution, and (3) imposing greater fines and longer prison sentences. Increasing fines and the length of sentences may be difficult because their maximum values are constrained by factors such as considerations of fairness and the wealth

15. Larcker & Tayan, *supra* note 6.

16. Jason R. Pierce, *Reexamining the Cost of Corporate Criminal Prosecution*, 44 J. MGMT. 892, 911 (2018).

17. *See, e.g.*, John M. Connor & Robert H. Lande, *Does Crime Pay?: Cartel Penalties and Profits*, ANTITRUST, Spring 2019, at 29, 33.

of wrongdoers,¹⁸ and thus this Essay focuses on the first two measures in the next two parts.

Table 1: Direct and Indirect Punishments of CEOs

1. Probabilities	
Probability of crime detection	33%
Conditional probability of CEO prosecution	8.5%
2. Direct punishment	
Individual fine	\$381,000
Jail time	18 months
Expected direct punishment	\$10,687
	0.5 months
3. Indirect punishment	
Change in CEO wealth with 1% stock change	\$193,000
Impact of corporate prosecution on stock price	11%
Expected indirect punishment	\$700,590

II. WHISTLEBLOWER REWARD PROGRAMS

Corporate crimes are extremely difficult to detect because the harms caused by these crimes are often invisible. While unlawful business activities, such as false financial disclosure and illegal marketing, cause harm to society, the victims often do not realize that they are victims. Furthermore, because of information asymmetry between corporate insiders and outsiders about corporate activities, collecting evidence is difficult for enforcement agencies.¹⁹ Moreover, in corporate crimes, executives often order illegal strategies but are not engaged in day-to-day conduct.²⁰ Thus, obtaining evidence of executives' criminal involvement is difficult.

Whistleblowers can solve these difficulties by providing inside information to enforcement agencies. They often have access to critical evidence as corporate insiders and can increase the probabilities of both crime detection and executive prosecution. In the case of the defective airbags of Takata, a Japanese automotive parts company, employees'

18. Thomas J. Miceli, *Optimal Criminal Procedure: Fairness and Deterrence*, 11 INT'L REV. L. & ECON. 3, 4 (1991); see also Louis Kaplow & Steven Shavell, *Optimal Law Enforcement with Self-Reporting of Behavior*, 102 J. POL. ECON. 583, 586 (1994).

19. Masaki Iwasaki, *Effects of External Whistleblower Rewards on Internal Reporting* 6 (Harvard John M. Olin Fellow's Discussion Paper Series, No. 76, 2018), http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Iwasaki_76.pdf [https://perma.cc/K73U-SJUX].

20. Iwasaki, *supra* note 7, at 2.

whistleblowing led to the indictment of the company's executives as well as the largest automotive recall in U.S. history.²¹ Proof of corporate crime requires knowledge of companies' business and technology, and potential whistleblowers, such as employees, are in the best position to help enforcement agencies.

In fact, many jurisdictions have increasingly relied on whistleblowers to detect corporate crimes. Over the past three decades, a large number of countries have established whistleblower legislation to protect whistleblowers from wrongdoers' retaliation.²² In addition, some countries, such as the United States, Canada, and South Korea, have provided monetary rewards to incentivize whistleblowers.²³ Whistleblowers need time and effort to collect evidence; furthermore, they are exposed to the risk of retaliation, such as dismissal, all of which can be significant costs to them. Therefore, whistleblower protection laws and reward programs can improve the balance of the personal benefits and costs of whistleblowing and encourage corporate insiders to blow the whistle.

The United States has whistleblower reward programs for several categories of crime, such as securities and tax fraud, and the Securities and Exchange Commission (SEC) program under the Dodd-Frank Wall Street Reform and Consumer Protection Act²⁴ has recently expanded. In this program, whistleblowers can receive a reward when they provide original information that leads to an enforcement action in which more than \$1,000,000 in sanctions is ordered.²⁵ Whistleblower rewards range from 10 percent to 30 percent of the monetary sanctions imposed on corporations.²⁶ Since the establishment of the program in 2011, the SEC has paid approximately \$326 million to fifty-nine whistleblowers.²⁷

Figure 1 shows the number of whistleblower tips received by the SEC (the left vertical axis) and the reward amounts from the Investor Protection Fund (the "Fund"), from which whistleblowers are paid (the right vertical axis), in recent fiscal years.²⁸ Both whistleblower tips and reward amounts show a

21. David Shepardson, *Takata Whistleblowers to Share \$1.7 Million Award, Lawyers Say*, REUTERS (Mar. 28, 2018, 11:48 AM), <https://www.reuters.com/article/us-takata-whistleblowers/takata-whistleblowers-to-share-1-7-million-award-lawyers-say-idUSKBN1H32A2> [<https://perma.cc/NUN5-5R5A>].

22. Iwasaki, *supra* note 19, at 7.

23. CAITLIN MASLEN, TRANSPARENCY INT'L, WHISTLEBLOWER REWARD PROGRAMMES 3 (2018), <https://knowledgehub.transparency.org/assets/uploads/helpdesk/Whistleblower-Reward-Programmes-2018.pdf> [<https://perma.cc/JT6S-6KF3>].

24. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

25. 15 U.S.C. § 78u-6 (2018).

26. *Id.*

27. U.S. SEC. & EXCH. COMM'N, 2018 ANNUAL REPORT TO CONGRESS: WHISTLEBLOWER PROGRAM 1 (2018), <https://www.sec.gov/sec-2018-annual-report-whistleblower-program.pdf> [<https://perma.cc/P7DG-2CTC>].

28. The data were taken from the SEC's annual reports to Congress for the years 2011 through 2018. See *Reports and Publications*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/reports?aId=edit-tid&year=All&field_article_sub_type_secart_value=

rapidly increasing trend in the past eight years, and the most recent numbers are 5,282 tips and \$94 million, respectively. While our interest lies in whether the SEC's whistleblower program can improve the deterrence of corporate crime, empirical studies have shown that the introduction of the SEC's whistleblower program reduced accounting fraud significantly.²⁹

Although whistleblower reward programs have already been utilized in the United States to detect certain types of violations such as securities and tax fraud, there is room for the expansion and reform of these programs. For example, expanding the types of violations covered by whistleblower reward programs may be worth consideration. In fact, Congress passed the Motor Vehicle Safety Whistleblower Act in 2015 to grant rewards for whistleblowing on automotive safety violations.³⁰ Furthermore, the waiting period for whistleblowers to receive awards seems long and should probably be shortened. In the case of the whistleblower reward program of the Internal Revenue Service (IRS), it generally takes at least eight years to receive a reward after filing a claim.³¹ This would discourage potential whistleblowers to take action.

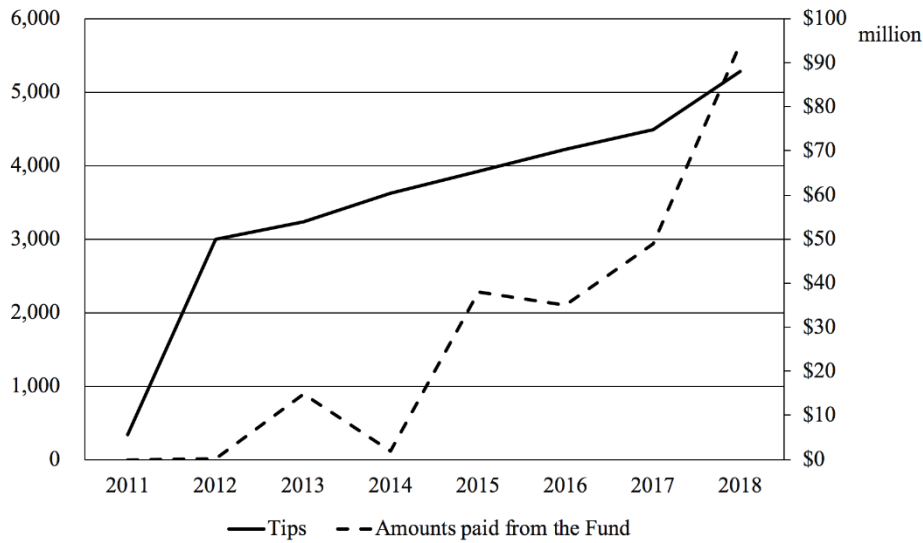
Reports+and+Publications-AnnualReports&tid=59 [https://perma.cc/F57X-ZY4E] (last visited Apr. 28, 2020).

29. *See, e.g.*, Philip G. Berger & Heemin Lee, Do Corporate Whistleblower Laws Deter Accounting Fraud? 7 (Mar. 22, 2019) (unpublished manuscript), <https://ssrn.com/abstract=3059231> [https://perma.cc/TV9W-R35R].

30. 49 U.S.C. § 30172 (2018).

31. INTERNAL REVENUE SERV., WHISTLEBLOWER PROGRAM: FISCAL YEAR 2018 ANNUAL REPORT TO CONGRESS 9 (2018), https://www.irs.gov/pub/whistleblower/fy18_wo_annual_report_final.pdf [https://perma.cc/JC2M-LRW7].

Figure 1: Whistleblowing Tips and Amounts Paid from the Fund



III. CORPORATE SELF-REPORTING SCHEMES

Another option to improve the deterrence of corporate crime is to make corporations themselves report their crimes. Jennifer Arlen and Reinier Kraakman suggested that, by granting self-reporting companies rewards in the form of reduced corporate sanctions, corporate self-reporting schemes can incentivize companies to self-police and disclose their organizational members' crimes.³² If firms have incentive to detect and self-report their corporate crimes, individual criminals such as executives and employees are more likely to be prosecuted and suffer the direct punishment, such as fines and imprisonment. Corporate self-reporting schemes may therefore increase the expected direct punishment of criminal executives by increasing the probability of crime detection.

In order for corporate self-reporting schemes to work effectively, several conditions must be satisfied. First, companies must have effective compliance systems, and their boards and compliance officers must be incorruptible enough to self-police and self-report the companies' offenses. Second, the expected direct punishment must be severe to a certain extent even when there are no corporate self-reporting schemes. These schemes essentially sacrifice the indirect punishment of executives for the direct punishment of them.³³ Reducing corporate sanctions means that the impact of corporate sanctions on executives' wealth, such as stocks and options, is

32. See Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 753 (1997).

33. Iwasaki, *supra* note 7, at 6.

also reduced, which decreases the expected indirect punishment of executives. Even if the probability of crime detection increases by companies' self-policing and self-reporting, if the expected direct punishment is originally too low, the increase in the expected direct punishment of executives is offset by the decrease in the expected indirect punishment.

As explained with Table 1, the conditional probability of executive prosecution, given the detection of a crime, is likely to be low, and thus the expected direct punishment would not be high relative to the expected indirect punishment. In this circumstance, the strategy to sacrifice the indirect punishment for the direct punishment may not be useful, and hence corporate self-reporting schemes may not work effectively. Although enforcement agencies such as the SEC and the Department of Justice have already used corporate self-reporting schemes as an enforcement tool, deterrence may not have significantly improved.

One way to overcome this impasse is increasing the probabilities of crime detection and executive prosecution by extensive use of whistleblower tips. As explained above, whistleblower rewards have potential to increase the probabilities of executive prosecution as well as crime detection. Moreover, if employees' whistleblowing is more likely to occur, companies' board members and compliance officers may be more incentivized to self-police and self-report in an incorruptible manner.

CONCLUSION

The estimate of expected punishment of corporate executives implies that the level of deterrence may be insufficient in the current enforcement regime. To improve deterrence, there are two ways: increasing the probability of crime detection and increasing the conditional probability of executive prosecution given the crime detection. The proposed Accountability Act would ease the difficulty of proof in executive prosecution by lowering the level of mental state required for criminal liability, but the social costs and benefits of introducing this solution must be carefully evaluated. This Essay explored other solutions, which can be used to improve deterrence regardless of the introduction of the Act. The most promising option seems to be the expansion and reform of whistleblower reward programs. This should also help corporate self-reporting schemes work more effectively. The combined use of such whistleblower reward programs and corporate self-reporting schemes would improve deterrence by increasing the probabilities of crime detection and executive prosecution.