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Images of Organizations and Consequences of Regulation

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Government can control conflicts of interest in business firms by either issuing obligatory commands to behave in a specified way or by creating incentives to alter private behavior. In order to choose between these two approaches, we also need to know something about the nature of the subject firms and the way that they are likely to respond to particular stimuli. Legislators and legal scholars often rely on intuition to predict the behavior of firms, but this will not suffice for such a complex situation. Fortunately, there is a well-developed body of scholarship that addresses organizational behavior; unfortunately, like many bodies of scholarship, it contains rival and conflicting approaches. This article discusses four of these approaches to organizational behavior: the nexus of contracts theory, an application of rational choice theory to corporations; decision theory; general systems theory and its recent autopoetic variants; and new institutionalism. It then uses each of these approaches to predict the way that firms will respond to obligatory commands and behavior incentives. The specific cases it discusses are the U.S. Sentencing Commission's Organizational Sentencing Guidelines, the Sarbanes-Oxley Act, and contemporary compliance theory's idea of reasonable, responsive, or cooperative enforcement.

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INTRODUCTION

There are generally two modes of governmental action to resolve conflicts of interest within organizations such as business firms: obligatory commands to behave in a specified way and the creation of incentives to alter private behavior. In order to choose between these alternative approaches, we need to know something about the nature of the two alternatives and about the government's capacity to design and implement them effectively. But we also need to know something about the other side of the equation: the nature of the subject firms and the way that they are likely to respond to particular stimuli.

Of the two alternatives, the creation of incentives would appear to be more dependent on knowing something about the behavior of the subject firm. In this article, I will argue that both alternatives are heavily dependent on such knowledge. More generally, I will argue that no strategy for resolving conflicts of interest in firms can proceed without extensive knowledge of the firm's organizational structure and behavior. I will also argue that we need to rely on explicit economic or sociological theory to obtain the knowledge that we need. When we discuss legislation involving individual behavior — a law against assault, for example, or assigning tort liability to drivers — we predict the effects of the legal rules we are creating by making assumptions about the way individuals will respond to those rules. These assumptions will not always be reliable, but they are often pretty good. After all, we — the legislators, administrators, and scholarly observers — are all individuals ourselves. Firms, however, are not individuals but complex institutions; thus, when we discuss legislation involving firms, our intuition will be of much less help. These institutions come in many different forms, and most of them are complex organizations that are often barely understood, even by those who spend their entire lives in them. To determine how these organizations are likely to respond to different stimuli, we need some systematic knowledge that goes beyond mere intuition.

Scholars who study organizational behavior generally distinguish between external forces that act on the organization and the internal features of the organization. Some argue that the first is the crucial determinant of organizational behavior, while others argue that the second one is crucial, but most would acknowledge that the organization's behavior is determined by a combination of these factors. This conclusion seems hard to resist, and it will be the one that I will adopt in this article. Because the external force — the governmental action to reduce conflicts of interest — is the variable being considered, I will focus on the second factor, that is, the internal structure of the firm. The only organizations that I will discuss are for-profit corporations of at least moderate size. What I will say about them will apply, with modifications, to many other organizations as well, but this type of firm represents an important enough category, with respect to conflict of interest legislation, to be considered on its own.

I will begin by presenting four models of organizational behavior: the nexus of contracts theory, an application of rational choice theory to corporations; decision theory; general systems theory and its recent autopoetic variants; and new institutionalism, as that term is used in sociology.[1] The second section will then apply these models to an analysis of the U.S. Sentencing Commission's Organizational Sentencing Guidelines.[2] In the third and final section, I will provide much briefer applications of the models to the Sarbanes-Oxley Act of 2002[3] and to contemporary compliance theory's idea of reasonable, responsive, or cooperative enforcement. Note that these three examples refer to regulatory strategies adopted and enforced through three different mechanisms of governance: the Organizational Sentencing Guidelines were created by a seven-member commission located within the federal judiciary and are implemented through the federal courts; Sarbanes-Oxley is a legislative enactment implemented by a regulatory agency, the Securities Exchange Commission, that is required to follow its provisions; while cooperative enforcement is a regulatory strategy that is typically adopted at the agency level, without legislative guidance. The multiple modalities of the examples suggest that the choice between command-and-control and incentive manipulation and the impact of organizational behavior on this choice will occur at virtually all levels of modern government.

I. IMAGES OF ORGANIZATIONS

A. The Corporation as a Nexus of Contracts

The dominant image of the corporation, in modern economics and law and economics scholarship, is that it represents a nexus of contracts. This

1 The use of this term in economics is more closely related to decision theory.

2 U.S. Sentencing Commission, An Overview of the United States Sentencing Commission and the Organizational Guidelines, *at* www.ussc.gov./TRAINING/corpover04.pdf (visited Sept. 1, 2003).

3 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. §§ 7201-66 (2002)).

approach has been developed by economists such as Armen Alchian, Harold Demsetz, Michael Jensen, and William Meckling,[4] based on the earlier work of Ronald Coase,[5] and by legal scholars such as Frank Easterbrook and Daniel Fischel.[6] It treats the corporation as a set of contracts and, more specifically, as a legal mechanism through which contractual relationships can be efficiently organized. Initial investors contract with each other to create a firm and divide the profits among themselves and others in a particular way. Subsequent investors contract with the firm to provide it with capital in exchange for a share of its profits or contract with other investors to pay money in exchange for their contractual entitlement to a share of the firm's profits. Lenders also contract to provide the firm with money, in this case, in exchange for repayment with interest. Employees contract with the firm to provide services in exchange for salary and benefits or, at high levels, for salary, benefits, perquisites, and profit shares. Suppliers and distributors contract with the firm to provide money in exchange for goods or services or goods or services in exchange for money. The firm may also enter into a variety of other, more specialized contracts — with consultants, franchisees, joint venturers, guarantors, and so forth. In short, the firm is simply a locus of these various contractual arrangements, a legally created mechanism that contracts with a variety of other natural and legal persons.

This image of the firm is very familiar, but I want to offer a few observations about it, most of them equally familiar. First, the image is grounded on a rational actor model of human behavior. No one would deny that all the contracts specified above actually exist. What makes the nexus of contracts approach a theory of the firm, as opposed to a trivial observation of an incontestable reality, is the underlying idea that contracts enable people to maximize their preferences through rational action. Thus, the nexus of contracts approach asserts that the firm is a legal setting — a nexus — where people maximize their preferences by entering various voluntary agreements with each other. Because preference maximization is efficient, the further point is that these agreements lead to an economically efficient outcome.

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4 Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

5 Ronald Coase, *The Nature of the Firm*, 4 Economica N.S. 386 (1937), *reprinted in* The Nature of the Firm: Origins, Evolution, and Development 18 (Oliver Williamson & Sidney Winter eds., 1991).

6 Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law (1991).

But the main point is simply that analyzing the way individuals contract with each other in the setting of a corporation is a good way to understand that corporation's overall behavior.

A second point about the nexus of contracts approach is that it tends to dissolve the boundary between the corporation and the surrounding world, most notably the market. The corporation is no longer an entity, as the traditional legal picture would suggest, but simply a collection of bilateral or multilateral arms-length relationships mediated by a legal definition. The rational actor model contributes to this tendency, because it portrays the individual as motivated exclusively by personal self-interest and not by any emotional commitment to the corporation as an entity or by any psychological commitment to a collective decision-making process. Central to the nexus of contracts theory is the observation that agency problems will be rampant in the firm; that is, each subordinate will attempt to maximize her own self-interest, rather than following the instructions promulgated by her superior or the role expectations created by the corporation's rules. Since corporations appear, at least intuitively, to function as more substantial entities, there is a certain instability to the nexus of contracts perspective. One effort to account for the apparent corporeality of corporations, while arguably remaining within the nexus of contracts framework, is Oliver Hart's idea that the firm is defined by its property rights, that is, its residual right to control tangible and intangible assets.[7]

Thirdly, the nexus of contracts approach represents what can be generally described as a thin theory of the firm as an organization, as opposed to a thick theory. The terms thin and thick were developed by John Ferejohn and others to refer to theories of individual behavior;[8] the theory that individuals are rational actors is described as a thin theory, while theories of behavior that incorporate other motivations are described as thicker. The application of these

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7 Oliver Hart, Firms, Contracts and Financial Structure (1995); Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757 (1989), *reprinted in* Organization Theory: From Chester Barnard to the Present and Beyond 154 (Oliver Williamson ed., 1995) [hereinafter Organization Theory].

8 John Ferejohn, *Rationality and Interpretation: Parliamentary Elections in Early Stuart England, in* The Economic Approach to Politics 279 (Kristen Monroe ed., 1991); Clifford Geertz, *Thick Description: Toward an Interpretive Theory of Culture, in* The Interpretation of Cultures 3 (1973); Donald Green & Ian Shapiro, Pathologies of Rational Choice Theory 17-19 (1994); Russell Korobkin & Thomas Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 Cal. L. Rev. 1051 (2000). The concept of thick description originally comes from 2 Gilbert Ryle, *Thinking and Reflecting; The Thinking of Thoughts, in* Collected Papers 465 (1971).

terms to an organization is obviously related to this usage and may seem to reiterate the point I just made about the nexus of contracts resting on a rational actor model of behavior. But it has some additional implications when applied to organizations. Even if one rejects a rational actor model of human behavior, one can still maintain the nexus of contracts approach to corporations. One can either abandon the claim that the corporation is an efficient means of organizing economic relations or one can conclude that there are mechanisms, both contractual and market-based, by which individual irrationalities are controlled and suppressed. Even without making either claim, one can still argue that a corporation is best described as a nexus of contracts because contracting behavior, rational or irrational, is the only thing involved. Once one has described the contracts, and perhaps the property rights of the firm as a legal entity, one has described the wellsprings of the corporation's behavior.

B. The Corporation as a Decision-Making Hierarchy

Decision theory is a modification of rational actor theory that focuses on the nature of decision-making in an organization and recognizes at least two factors that modify or limit the rationality of those decisions. These factors are the organization's structure and the personal limitations of the decision-makers. Most of the organizations under consideration here, that is, large or moderate-sized corporations, are structured as hierarchies.[9] This observation is, on its face, as incontestable as the observation that firms enter into contractual relations with their investors, lenders, employees, suppliers, distributors, and others. Despite extensive discussion of flexible specialization and post-Fordist organization as a coming trend, or at least a viable option, most large firms continue to be organized along hierarchical lines.[10] The question is whether the hierarchical nature of the firm is an important factor in determining its behavior and its response to external stimuli. When we say that

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9 On the connection between hierarchy and general bureaucratic structure, see Henry Jacoby, The Bureaucratization of the World (Eveline Kanes trans., 1973) (1969); Max Weber, Economy and Society 217-26, 956-1003 (Guenther Roth & Claus Wittach eds., Ephraim Fischoff et al. trans., 1978) (1914); Gerald Frug, *The Ideology of Bureaucracy in American Law*, 97 Harv. L. Rev. 1276 (1984).

10 *See* The Search for Labour Market Flexibility: The European Economies in Transition (Robert Boyer ed., 1988); Alain Lipietz, Towards a New Economic Order: Postfordism, Ecology and Democracy (Malcolm Slater trans., 1992) (1989); Michael Piore & Charles Sabel, The Second Industrial Divide (1984); Paul Hirst & Jonathan Zeitlin, *Flexible Specialisation versus Post-Fordism: Theory, Evidence and Policy Implications*, 20 Econ. & Soc. 1 (1991); Charles Sabel, Work and Politics: The Division of Labour in Industry (1982).

a corporation is a hierarchy, we are generally referring to the organization of its employees.[11] There is nothing necessarily hierarchical about the organization of the other participants, such as investors, lenders, suppliers, or distributors, and it is not even clear that the term, as we generally use it, has much meaning in those contexts. The notion of the corporation as a hierarchy rests on the proposition that the hierarchical organization of its employees is a decisive determinant of its behavior.

This hypothesis about corporate behavior is not necessarily a separate hypothesis from the nexus of contracts theory, with its rational actor model of human behavior. Hierarchy, after all, is fixed by contract; employees are hired for a particular position, and their relationships to superiors and subordinates are explicit or implicit consequences of their positions. The complexity that leads to decision theory models is that the contracts that constitute the firm, and, most specifically, the contracts that determine the roles of the firm's employees, are incomplete.[12] As a result, many of the employees' actions, including the way that they enact their contractual relationships, will not be specified by contract, but rather by the governance structure of the corporation, that is, by the corporate hierarchy. In particular, they will be governed by what Edward Rock and Michael Wachter describe as non-legally enforceable rules and standards, that is, norms of behavior that cannot be captured in a contract or described in contractual terms.[13]

The view that the hierarchical nature of the firm is a crucial factor in describing and predicting the firm's behavior can be traced to the scientific management theory developed by Frederick Taylor and others.[14] Taylor, an engineer, aspired to describe the hierarchical firm in mechanistic terms, and his approach has been widely criticized on that ground, particularly since the advent of human relations theory.[15] Modern discussions of firms as hierarchies, which have been developed by organization theorists such as Herbert Simon,

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11 The reason is that hierarchy requires a structured chain of command. The term originally referred to the organization of priests (hierarchs) and angels in orderly ranks. Dionysius, The Pseudo-Aeropagite: The Ecclesiastical Hierarchy (Thomas Campbell trans., 1981).

12 Edward Rock & Michael Wachter, *Islands of Conscious Power: Law, Norms and the Self-Governing Corporation*, 149 U. Penn. L. Rev. 1619 (2001).

13 *Id. See also* M.P. Baumgartner, *The Myth of Discretion, in* The Uses of Discretion 129 (Keith Hawkins ed., 1994).

14 Henri Fayol, General and Industrial Management (1949); Frederick W. Taylor, Principles of Scientific Management (1911).

15 George Homans, The Human Group (1950); Elton Mayo, The Human Problems of Industrial Civilization (1933).

James March, and Richard Scott[16] and by economists such as Douglass North and Oliver Williamson,[17] incorporate human motivations and reactions into their accounts.

While these theories accept the contractual nature of the employee relationship and, with some qualifications, the rational actor model of behavior, they go well beyond the nexus of contracts model and present a much thicker picture of the firm's behavior. The basic reason is that they recognize emergent characteristics at the micro level. An emergent characteristic is one that is generated by combining separate elements into a larger whole. In natural science, this is a trivial point, of course; no one doubts that chemical compounds display characteristics different from their constituent elements or that an amoeba displays characteristics that go beyond the organic molecules that comprise it. In sociology, however, the point is more controversial. Do groups of individuals — communities, organizations, social movements, or nations — behave in ways that cannot be explained by looking at the behavior of the individuals who comprise them?[18] Rational actor theory answers this question with a definitive "No"; that is, it adopts the epistemological posture of methodological individualism.[19] The theory of organizational hierarchy, although it accepts the rational actor model to a considerable extent, gives an opposite answer and thereby paints a thicker picture of the corporation.

The second factor that decision theory recognizes as modifying the rational actor model is the set of limitations on the decision-making capacities of the

16 James March, Decisions and Organizations (1988); James March & Herbert Simon, Organizations (2d ed. 1958); W. Richard Scott, Organizations (2d ed. 1987); Herbert Simon, Administrative Behavior (1957).

17 Douglass North, Institutions, Institutional Change, and Economic Performance (1990); Oliver Williamson, The Mechanisms of Governance (1996).

18 On emergent characteristics generally, see Alfred Kroeber, *The Concept of Culture in Science, in* The Nature of Culture 118 (1952); Allan Hanson, Meaning in Culture (1975); David Kaplan, *The Superorganic: Science or Metaphysics?*, 67 Am. Anthropologist 958 (1965); Leslie White, *The Concept of Culture*, 61 Am. Anthropologist 227 (1959). The idea of emergent characteristics still recognizes the central role of individuals, but asserts that not all social or cultural phenomena can be analyzed in individual terms. It thus stops short of post-modernist claims that the individual is a fanciful or outmoded construct, *see, e.g.*, Gregory Bateson, Steps to an Ecology of Mind (1972); Michel Foucault, The Order of Things: An Archaeology of the Human Sciences (1970).

19 *See* James Coleman, Foundations of Social Theory (1990); Anthony Flew, Thinking About Social Thinking (2d ed. 1995); Dennis Mueller, Public Choice II (1989). For a reconsideration, see Richard Jones, Reductionism: Analysis and the Fullness of Reality (2000).

individuals who inhabit it. This set of limitations is described in the theory as bounded rationality, which can mean two different things. First, it can mean that people's capacity for optimal action is bounded by the information available to them and by their own information-processing capacities. When used in this manner, bounded rationality is not inconsistent with a strict rational actor model. The model only predicts that people will choose the optimal means to achieve their goals given the information available to them. There is nothing irrational about buying stock in a publicly-traded company at the market price, even if it subsequently turns out that the company was hiding information indicating that it was bankrupt at the time the stock was purchased. But bounded rationality can also mean that people's capacity to engage in rational action of any kind is bounded, that they will sometimes engage in suboptimal behavior because they are emotional, lazy, fatigued, or confused. Williamson favors the first kind of bounded rationality,[20] while Simon favors the second and describes people as displaying satisficing behavior, that is, suboptimal behavior to simplify the decision-making process.[21] Although this difference is easy enough to state,[22] the two approaches to bounded rationality tend to merge when applied in complex situations because both note the frequent occurrence of suboptimal behavior. This creates an operational difference from a theory, such as nexus of contracts, that treats the firm as an efficient, profit-maximizing entity.

It is decision theory that provides an organizational locus for the recent work on cognitive illusions.[23] According to this work, people are over-responsive to risks that are salient to them (availability bias), over-optimistic about projects they initiate (optimism bias), and strongly affected by factors that are in fact irrelevant to their decision-making goals (framing and anchoring). To have a cognitive bias, one first of all needs to be a human

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20 Oliver Williamson, Markets and Hierarchies: Analysis and Antitrust Implications 4-7, 21-26 (1975).

21 Simon, *supra* note 16, at 38-41, 80-84, 240-44.

22 For Williamson's discussion of the two approaches, see Oliver Williamson, *Chester Barnard and the Incipient Science of Organization, in* Organization Theory, *supra* note 7, at 29.

23 *See, e.g.*, Behavioral Law and Economics (Cass Sunstein ed., 2000); Daniel Kahneman & Amos Tversky, *On the Reality of Cognitive Illusions*, 103 Psych. Rev. 582 (1996); Russel Korobkin, *Inertia and Preference in Contract Negotiations: The Psychological Power of Default Rules and Form Terms*, 51 Vand. L. Rev. 1583 (1998); Jeffrey Rachlinski, *The "New" Law and Psychology: A Response to Critics, Skeptics and Cautious Supporters*, 85 Cornell L. Rev. 739 (2000); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. Bus. 251 (1986).

being; virtually all the research in this field involves actual individuals and seems to rest on the qualities and limitations of real people. In addition, one must be trying to be rational, in some sense, that is, one must be trying to choose a course of action by weighing its pragmatic consequences. If a manager is ineffective because he flies into a purple rage whenever someone contradicts him, we would not say that he is suffering from a cognitive illusion and the remedy would not be to provide additional information, or to reframe the problem, or any of the other remedies that cognitive psychologists propose, but, rather, some sort of psychotherapy. Thus, cognitive illusions become relevant in a decision theory model of the corporation; they will be largely rejected by a rational actor model and will be regarded as less relevant if the corporation is viewed as an organism or an arena of ritualized enactments.

To this model of human behavior as boundedly rational, the hierarchy model of the corporation adds an analysis of particular modes, and particular pathologies, of organizational decision-making. Simon, for example, notes that subordinates in many organizations exhibit goal displacement. The superior's goal corresponds to the goals of the corporation — maximizing profits — and she instructs her subordinates to carry out certain tasks that are necessary to achieve that goal — accelerating inventory flow, for example. But for the subordinate, the task becomes the goal, so that he will not only implement strategies that contribute to the general goal, but will also do things that are counterproductive, such as distributing inventory before it is needed or adjusting the inventory records to make the flow appear more rapid.[24] Another phenomenon that Simon discusses is uncertainty absorption, where each subordinate simplifies a situation that she is reporting to her superior, in order to make a more coherent presentation or a better impression.[25] The result is that information that may be crucial, and that the superior wants to know, is lost. Diane Vaughan describes the related process of deviance normalization, where small deviations from a standard become established as a decisional norm and then provide a basis for further deviations until the practices that have become institutionalized differ widely from the original standard.[26] Williamson discusses the make-or-buy decision in similar terms. A firm may pay market prices for an input, instead of producing the input for itself, because the transaction costs of organizing

24 Simon, *supra* note 16, at 62-66.

25 *Id.* at 154-71.

26 Diane Vaughan, The Challenger Launch Decision: Risky Technology, Culture and Deviance at NASA (1996); Diane Vaughan, *The Dark Side of Organizational Mistake, Misconduct and Disaster*, 25 Ann. Rev. Soc. 297 (1999).

production and controlling subordinates often make internal production more expensive.[27]

The decision theory model and the nexus of contracts model may not appear to be dramatically different. After all, phenomena such as goal displacement, uncertainty absorption, and transaction costs of internal production can be explained as rational responses to contractually structured situations. But the intuitive feel of the two approaches, and thus the type of conclusions that they tend to reach about corporate behavior, are quite different. By combining bounded rationality of either variety with an analysis of organizational structure, the decision theory model observes various behaviors that can be regarded as emergent phenomena. If one were to fully analyze these behaviors, they might be explicable by means of the methodological individualism and thus merge into the nexus of contracts approach. But the pragmatics of scholarship preclude the easy translation of one approach into another. While the nexus of contracts approach will tend to perceive individual, rationally-motivated behavior, decision theory will tend to perceive a variety of organizational behaviors that are explained most readily, and perhaps exclusively, by the structure of the organization and its effects on individual decision-making.

C. The Corporation as Organism

General systems theory offers a distinctly different approach to corporate behavior. According to this approach, all organisms and organizations share certain basic characteristics. They have a boundary that separates them from their environment, and within that boundary they have an internal structure with defined, although not necessarily constant, features. Information or physical objects come through the boundary as inputs, are processed by the system's internal structure, and then altered information or objects pass through the boundary as outputs. In complex systems, part of the output is sampled by the system and fed back as a new input. This feedback loop enables the system to adjust its internal processes on the basis of its output.[28]

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27 Williamson, *supra* note 20, at 117-54 (Markets & Hierarchies).

28 *See generally* Ludwig von Bertalanffy, General System Theory (1968); Walter Buckley, Sociology and Modern Systems Theory (1967); Jay Galbraith, Organization Design (1977); Toward a Unified Theory of Human Behavior: An Introduction to General Systems Theory (Roy Grinker ed., 1956) [hereinafter Toward a Unified Theory of Human Behavior]; George Klir, An Approach to General Systems Theory (1969); Alfred Kuhn, The Logic of Social Systems: A Unified, Deductive, System-Based Approach to Social Science (1974); Talcott Parsons, The Social System (1957).

Like other forms of organization theory, systems theory attempts to describe and predict the behavior of the organization. A central claim about such behavior is that functioning systems attempt to maintain their equilibrium, or steady state, that is, their boundary, their internal structure, and their level of output, at least to the extent that the output is fed back into the system. Their ability to do so is described as homeostasis.[29] Thus, if there is a change in the system's environment, the system will attempt to restore its previous condition by changing its internal processes or its external environment.[30] In addition, a system can have a goal or purpose, which simply means that the system is programmed to produce a particular output; in fact, equilibrium can be regarded as a specific type of system goal. While this is unproblematic for humanly designed systems, it raises questions with respect to naturally occurring ones. One solution was to explore the process of self-organization, by which a system progressively differentiates through interaction with its environment.[31] In either case, there is generally a necessary balance between equilibrium and other goals, because a system that cannot maintain its equilibrium may not survive long enough to achieve some other goal. Thus, animals usually need to maintain their metabolic processes in order to live long enough to reproduce; a firm, in most labor markets, must keep its employees from leaving if it wants to make a profit. An important point about systems, however, is that they can often achieve a specified goal, whether equilibrium or something else, in a variety of different ways, a feature known as equifinality.[32]

Designed and self-organized systems are capable of learning, that is, of making changes in their internal processes in order to produce desired results more reliably. Such learning can either be supervised or unsupervised. Unsupervised learning, identified by Donald Hebb, occurs when the system is programmed to repeat a decision pathway that has previously been triggered, but has no standard for assessing the results it is producing.[33] To take a very

29 See Walter Cannon, The Wisdom of the Body (rev. ed. 1963), for the origin of this concept.

30 Thus, as Luhmann points out, a major feature of systems theory is "to replace the traditional difference between *part* and *whole* with that between *system* and *environment*." Niklas Luhmann, Social Systems 6 (John Bednarz, Jr. trans., 1995) (1984).

31 *See, e.g.*, Self-Organizing Systems (Marshall Yovits & Scott Cameron eds., 1960); Self-organizing Systems (Marshall Yovits et al. eds., 1962); Principles of Self-Organization (Heinz von Foerster & George Zopf eds., 1962).

32 *See* von Bertalanffy, *supra* note 28, at 131-38.

33 Donald Hebb, Organization of Behavior (1949).

simple example, consider an electrical circuit that turns on a light for one hour at a time, but is also programmed to leave the light on in a given hour if the light has been turned on during that hour ten times in a row. The system will quickly learn to leave the light on during certain hours. Memory may work this way, to a certain extent. Supervised learning, which requires the system to respond to some specified condition in the environment, is more common. An electrical circuit that begins by turning a light on or off at random once an hour can learn to turn the light on only during the night if it is programmed to reiterate its previous decision whenever switching on the light produces a measurable increase in illumination.[34] In recent years, cybernetics and the study of neural networks have focused heavily on the question of systemic learning.[35]

Classical systems theory, as developed by Talcott Parsons, Ludwig van Bertalanffy, and others,[36] treats complex systems as open, that is, as being in direct contact with their environment through the inputs they receive. A new version of this theory, developed by Nicholas Luhmann and Gunther Teubner, reflects the linguistic turn in modern philosophy and social science.[37] According to this approach, which is partially derived from the theory of self-organizing systems, complex systems are closed, that is, they are not in direct contact with their environment. The only information or objects they can process are those that are internal to the system. Such systems, described by the term autopoetic, interact with their environment by translating external stimuli into inputs that are phrased or structured in the terms that the system itself uses. By doing so, the system reproduces itself, and it is this process of self-reproduction that gives it the character of an ongoing system. A mammal must digest food before using it to produce energy; the stock market must

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34 Bernard Widrow & M.E. Hoff, *Adaptive Switching Circuits*, 1960 IRE Western Electric Show & Convention Record, pt. 4, Aug. 23, 1960, at 96-104, *reprinted in* James Anderson & Edward Rosenfeld, Neurocomputing: Foundations of Research 123 (1988).

35 William Bechtel & Adele Abrahamsen, Connectionism and the Mind 66-106 (1991); Patricia Churchland & Terence Sejnowski, The Computational Brain 96-105, 229-328 (1992).

36 *See* sources cited *supra* note 28.

37 Luhmann, *supra* note 30; Niklas Luhmann, The Differentiation of Society (Stephen Holmes & Charles Larmore trans., 1982) (1970); Autopoetic Law: A New Approach to Law and Society (Gunther Teubner ed., 1988); Gunther Teubner, *How the Law Thinks: Toward a Constructivist Epistemology of Law*, 23 Law & Soc. Rev. 727 (1989); Gunther Teubner, *Breaking Frames: The Global Interplay of Legal and Social Systems*, 45 Am. J. Comp. L. 149 (1997); Gunther Teubner, Law as an Autopoetic System (Anne Bankowska & Ruth Adler trans., 1993).

turn news into predictions of economic performance before processing the information into changes in the price of stock.

Either form of systems theory, when applied to corporations, can be regarded as nexus of contracts theory's diametric opposite. According to systems theory, all corporate behavior is emergent, that is, it is a new behavior generated by the interaction of the organization's components. Moreover, the emergent behavior occurs at the macro level, that is, the level of the corporation as a whole. Thus, systems theory can be reasonably described as the thickest possible approach to organizational structure. In this theory, individual motivation and behavior count for relatively little; the behavior of the organization is determined by its environment, its internal structure, the feedback loops it establishes, and similar organizational features. Consider, for example, a corporation's response to an increase in the price of a crucial ingredient of its production process, such as steel for a company that makes washing machines. Nexus of contracts theory would look at the way the corporation's contracts with its steel suppliers changed and the way this change affected the decisions of individual employees and investors. Decision theory would take a similar approach, but would focus on the way these decisions were affected by the structure of the corporation. Systems theory, in contrast, would approach the issue by focusing exclusively on structure. A system that is subjected to an environmental stress will respond by modifying its internal process, modifying its output, or moving away from the stress into a different environment. Thus, the corporation would try to manufacture washing machines that use less steel, or raise the price of its product, or try to find a substitute for steel.

All images of an organization are metaphorical, of course, but systems theory may seem metaphorical in an important sense that nexus of contracts theory or decision theory is not; that is, it relies on its metaphor to explain the source of action. The other theories rest on the motivation of individual human beings, whether these human beings are conceived as rational, partially rational, or not rational at all. Systems theory essentially eliminates human beings from its account and ascribes motivations to collective entities — the system uses homeostasis, it wants to achieve a particular goal, and so forth. For some, this sort of account smacks of mysticism and lacks verifiability. One possible response is that the individual is an equally metaphorical creation.[38] A second is that we make this assumption that

38 Bateson, *supra* note 18; Jacques Derrida, Writing and Difference (1978); Foucault, *supra* note 18; Gianni Vattimo, The End of Modernity: Nihilism and Hermeneutics in Post-modern Culture (1988).

organizations exhibit emergent behaviors as a matter of everyday discourse. We commonly say that General Motors decided to close a factory or that France responded to the news from the Middle East. I do not think such statements can be readily dismissed as verbal shorthand, because they refer to actions that are so apparent for us and they could only serve as shorthand for sets of individual actions that are much less readily understood. The question that remains, however, is whether our common experience of organizational action is best explained by treating the organization as a self-motivated organism.

D. The Corporation as a Culture

The relationship of a corporation to its surrounding culture has been a matter of much discussion in recent years, with Japan, the most heavily industrialized and economically successful non-Western nation, as a dramatic test case. According to one view, which may be described as culture independent, all people are motivated by rational self-interest and differences in behavior are simply rational responses to differences in the circumstances they confront.[39] According to the opposing view, which can be called cultural dependence, people from different cultures, such as the U.S. and Japan, possess distinctly different values and motivations that strongly affect their actions.[40] While the former view rests on the same ground as the nexus of contracts theory of the corporation, it is not quite the same theory, because it allows for the possibility that different cultures could have structured the corporation itself in a culturally-specific form, thereby creating differences in the organizational environment, even if these cultures do not determine individual behavior. In fact, since behavior clearly does differ from one culture to another, the rational actor view is required to acknowledge some sort of organizational differences, presumably resulting from phenomena such as external stress and path dependency.[41] Decision theory, as described, might treat people as rational actors, but generally allows for suboptimal behavior.

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39 Chalmers Johnson, MITI and the Japanese Miracle (1982); Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. Rev. 1 (1987); Mark Ramseyer, *The Costs of the Consensual Myth: Antitrust Enforcement and Institutional Barriers to Litigation in Japan*, 94 Yale L.J. 604 (1985).

40 Richard Pascale & Anthony Athos, The Art of Japanese Management: Applications for American Executives (1981); Peter Tasker, A Major Exploration of Modern Japan (1987); David Litt et al., *Politics, Bureaucracies and Financial Markets: Bank Entry into Commercial Paper Underwriting in Japan and the United States*, 139 U. Pa. L. Rev. 369 (1990).

41 Path dependency should be resolved, according to rational action theory, by a

This, plus its greater emphasis on the particular structures of organization, tend to align it with the cultural dependence perspective. Systems theory, ironically, is more similar to nexus of contracts theory, since it asserts that the same behavioral regularities exist in every culture and, indeed, in settings without culture and without human beings. But its insistence on the impact of a variable surrounding environment will lead to predictions that behavior will differ markedly in different situations, and the theory does not make any assertions about the regularity of the environment that would correspond to rational actor theory's claims about the market.

This discussion of the impact of surrounding culture on an organization, however, is not really a separate theory of organizational behavior. As my account in the preceding paragraph suggests, the surrounding culture is a matter that each theory must take into account. Or, to put the matter another way, we need a theory of the organization in order to explain the effects of culture, and different organizational theories will lead us to offer different explanations. But there is also a separate theory of organizations that is based on the notion of culture: rather than treating culture as an influence on the organization, it asserts that the organization itself constitutes a culture and that its behavior can be described in terms of that culture.

The idea that organizations constitute a culture can actually mean two different things. The first is that modern culture has become a culture of organizations. Instead of looking at traditional components of culture, such as language, religion, music, art, social rituals, and customs, we need to look to the corporations, government agencies, labor unions, non-governmental organizations, and other organizations that constitute the framework of our daily existence in the modern world.[42] Whatever the validity of this account — and it seems quite convincing — it goes to the nature of society in general and thus cannot provide much help in choosing between different modes of governmental intervention in the organization. The second version of the idea is that each organization constitutes its own distinctive culture and that the way to understand the organization is to understand that culture. When culture is used in this way, of course, it cannot mean such things as language, religion, music, or art, for these will be determined by the surrounding general culture. Rather, it means something that is simultaneously more general and more

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functioning market, but the theory is not committed to the existence of such a market in all circumstances.

42 Anthony Giddens, Modernity and Self-Identity (1991); James March & Johan Olsen, Rediscovering Institutions: The Organizational Basis of Politics (1989); Robert Presthus, The Organizational Society (1978); William Whyte, The Organization Man (1956).

specific. Culture consists of any set of social enactments that are reflexively understood by an interacting group of people and that distinguish that group from all others.[43] Rock & Wachter's concept of the corporation's internal norms would be included in this idea of culture.[44] Thus, every moderate or large organization has a culture of some sort, with the strength and distinctiveness of that culture varying from one organization to another.

While discussions of corporate cultures have become a staple of pop management theory,[45] this assertion typically refers to leadership style, motivational techniques, and related features that are derived from the human relations school of organization theory. Such features are undoubtedly important, but discussions of them often take the form of advice to individuals and do not provide any particular image of the organization as such. In recent years, a rather different approach, typically described as the "new institutionalism," has given greater depth to the idea of organizational culture.[46] New institutionalism does not contest the relevance of seemingly universal features of modern organizations, such as their commitment to defined goals, their formal bureaucratic structure, and other aspects of rational actor or decision theories. But it does observe that these features are not simply taken at face value, but become particularized rituals of the organizations as they are performed by the individuals within those organizations.

The structure of an organization, for example, may be established by the members to be rational, efficient, or fair, but it will often mimic other organizations in its field. This can arise from regulatory coercion, but it is more commonly a response to uncertainty or professional norms.[47] Different

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43 *See* Clifford Geertz, The Interpretation of Cultures (1973); Clyde Kluckhohn, Mirror for Man 24-46, 170-95 (1963); Harold Garfinkel, Studies in Ethnomethodology (1967); Claude Levi-Strauss, The Raw and the Cooked (John Weightman & Doreen Weightman trans., 1969) (1964); Karl Weick, The Social Psychology of Organizing (1979); Robert LeVine, *Properties of Culture: An Ethnographic View*, *in* Culture Theory: Essays on Mind, Self and Emotion 67 (Richard Shweder & Robert LeVine eds., 1984). According to Geertz, culture is "the fabric of meaning in terms of which human beings interpret their experience and guide their action," Geertz, *supra*, at 145; according to LeVine, it is "a shared organization of ideas that includes the intellectual, moral and aesthetic standards prevalent in a community and the meanings of communicative actions," LeVine, *supra*, at 67.

44 Rock & Wachter, *supra* note 12.

45 *See, e.g.*, Tom Peters & Robert Waterman, In Search of Excellence (1982).

46 Organizational Environments: Ritual and Rationality (John Meyer & W. Richard Scott eds., 1983) [hereinafter Organizational Environments]; The New Institutionalism in Organizational Analysis (Walter Powell & Paul Dimaggio eds., 1991) [hereinafter New Institutionalism].

47 John Meyer, *Institutionalization and the Rationality of Formal Organizational*

parts of the organization that are supposed to be coordinated will often be decoupled from each other, so that conflicts are reduced and responsibility is defused; inspections and evaluations become ceremonial occasions, rather than efforts to discipline dysfunctional units or increase efficiency.[48] Units established to monitor compliance with a legal rule, such as non-discrimination or environmental protection, often over-dramatize the legal risk.[49] Structures established at the time the organization was created may become "imprinted" on the organization so that they are retained without being reevaluated for their effectiveness, which is essentially a form of path dependence.[50]

Such behaviors are, of course, open to a variety of interpretations. They could be viewed as rational behaviors by self-interested actors or as decisions taken by actors in a hierarchy under various conditions of uncertainty. What is interesting and distinctive about new institutionalism is that it grounds its observations on more psychological and phenomenological models of human behavior. People want to do a good job, and they want to derive meaning and a sense of achievement from their work. It is these very desires, not cynical self-interest, that generate ritualized and symbolic behavior. New institutionalism can thus incorporate both functionalist and interpretivist understandings of culture. Just as societies develop ceremonies to confront the unknown, respond to risk, and reduce uncertainty,[51] so members of organizations, in a conscientious effort to act effectively in uncertain situations, mimic other organizations, decouple organizational components, engage in ritual compliance, and imprint initial structures. Just as societies develop ceremonies to express meaning and confer a sense of significance on individuals,[52] so members of organizations engage in symbolic performances of these same kinds.

One strength of new institutionalism, in contrast to nexus of contracts theory, systems theory, and, to a lesser extent, decision theory, is that it explains divergences among organizations. This explanation is based on

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Structure, in Organizational Environments, *supra* note 46, at 261; John Meyer & Brian Rowan, *Institutionalized Organizations: Formal Structure as Myth and Ceremony, in* New Institutionalism, *supra* note 46, at 41.

48 Meyer, *supra* note 47.

49 Lauren Edelman, *Professional Construction of the Law: The Inflated Theory of Wrongful Discharge*, 26 Law & Soc. Rev. 47 (1992).

50 Arthur Stinchcombe, *Social Structure and Organizations, in* James March, Handbook of Organizations 142 (1965).

51 *See, e.g.*, Edward Evans-Pritchard, Social Anthropology (1951); Bronislaw Malinowski, Magic, Science and Religion (1954).

52 Geertz, *supra* note 43; Victor Turner, Dramas, Fields and Metaphors: Symbolic Action in Human Society (1974).

the contention that each organization develops a distinctive culture. One corporation will develop a cultural style that is aggressive, contentious, adversarial toward government, and ruthless toward competitors (e.g., ITT under Harold Geneen).[53] Another will be ethical, humane, cooperative toward government, and scrupulous toward competitors. These styles can pervade different corporations that have the same incentives, the same hierarchical structure, and the same systemic features and, to add human relations theory, that recruit the same types of people. The autopoetic version of systems theory provides some explanation for this phenomenon, since it recognizes the self-reproducing nature of the closed systems, and decision theory can supply the idea of path dependence. But these accounts do not really explain the origins of the widely-perceived differences in corporate style or the meaning that the individuals within the corporation appear to derive from them. The idea that organizations generate a culture seems to possess more explanatory force in this regard.

I will now offer some brief comparisons among these four perspectives by way of summary. It can be plausibly argued that the central problem in contemporary social theory is the micro-macro problem, that is, the effort to link theories of individual behavior and theories of collective or organizational behavior.[54] The nexus of contracts and general systems approaches to corporations attempt to solve this problem by reducing one level to the other. According to nexus of contracts theory, the corporation's actions are merely the sum of individual behaviors. According to general systems theory, the corporation's actions are independently determined and determine the behavior of its individual members. The decision theory and new institutional models try to mediate between the two levels, although each tends in a particular direction. Decision theory recognizes the organization's effect on individuals, but, like nexus of contracts, tends to focus on individual behavior; new institutionalism recognizes the role of individual behavior, but tends to focus on organizational structures. Another ground of comparison involves emergent characteristics. Here, general systems theory is more closely allied with new institutionalism, in that both argue for emergent characteristics at the macro level: inputs and feedback or isomorphism and decoupling. Decision theory also recognizes emergent behaviors, but tends to locate them at the micro level of individual action. Nexus of contracts

53 Rand Araskog, The ITT Wars (1989).

54 The Micro-Macro Link (Jeffrey Alexander et al. eds., 1987); Thomas Schelling, Micromotives and Macrobehavior (1978); Randall Collins, *The Microfoundations of Macrosociology*, 86 Am. J. Soc. 984 (1981).

theory rejects the possibility of emergent characteristics and seeks to explain organizational actions in terms of individual behavior. The result of these differences is that nexus of contracts is the thinnest possible theory of the corporation, decision theory is somewhat thicker, new institutionalism is much thicker, and systems theory is the thickest possible theory, in that all explanation occurs at the organizational level.

II. THE IMAGES OF ORGANIZATIONS AND THE ORGANIZATIONAL SENTENCING GUIDELINES

As should be apparent from the foregoing discussion, there is no consensus about the proper way to view an organization such as a corporation. Rather, there are competing schools of thought, with distinct and often mutually incompatible theories. Given this disarray in the study of organizations, it might seem that the best course is to dispense with the entire inquiry. But reflection suggests that this is not an option. Any effort to regulate corporations must be based on some hypothesis about the way that the organization is likely to respond. To take an extreme example, if the corporation's response to a particular legal rule were entirely adverse — if punishing the corporation for worker injuries could be shown to increase those injuries — enacting the legal rule would make no more sense than giving a medicine to a patient who is intensely allergic to it. In short, we cannot escape the need to predict corporate behavior in regulating corporations. We can rely on intuitive, rather than theoretical, methods of prediction, but, for reasons I mentioned earlier, the accuracy of our intuitions is open to serious doubt.

In this section, I want to apply the models of the corporation discussed above to the U.S. Sentencing Commission's Organizational Sentencing Guidelines.[55] The Organizational Sentencing Guidelines establish financial penalties for corporations, as well as other organizations, found guilty of crimes such as fraud, environmental waste discharge, tax violations, and antitrust violations. They set the penalty according to the gain from the illegal conduct and the loss to the victim, but no less than rather modest base levels. These penalties, as computed, can then be increased or reduced on the basis of various factors such as the corporation's prior history of violations and its willingness to cooperate with the investigation.[56] Their overall impact, as Cindy Alexander, Jennifer Arlen, and Mark Cohen have

55 U.S. Sentencing Commission, *supra* note 2.

56 *See generally* Ilene Nagel & Winthrop Swenson, *The Federal Sentencing Guidelines*

concluded, has been to produce significant increases in the criminal fines imposed on corporations.[57]

Another factor in adjusting the penalty is the corporation's creation of internal compliance structures prior to the time of the violation. Internal compliance systems, based on codes of ethics, have been a familiar feature of American business practice since the 1970s. These codes typically refer to the corporation's legal responsibilities, but they rarely establish any serious independent sanctions for violation of the stated code.[58] The Organizational Sentencing Guidelines now give these compliance systems legal significance by reducing criminal penalties for corporations that have instituted such systems. Interestingly, the Sentencing Commission offers a justice-based explanation, rather than a deterrence-based justification, for consideration of this factor. Because the actions of a single employee can cause an entire corporation to be held criminally liable, it declares, it is attempting "to alleviate the harshest aspects of this institutional liability by incorporating into the sentencing structure the preventive and deterrent aspects of systematic compliance programs."[59] But embedded in this explanation is the idea that a compliance program will simultaneously prevent and deter corporations from violating the criminal law.[60]

In pursuing this inquiry, the first point worth mentioning is that there are no easy generalizations. It might appear, at first, that command-and-control regulation would be linked with a thin theory of the corporation, because such regulation operates as an external influence, while incentive manipulation would be linked with a thick theory, because it attempts to readjust the corporation's internal processes. But command-and-control might turn out to be the preferred strategy according to a thick theory such as the general systems approach, while incentive manipulation could very readily be preferred when the corporation is viewed as a collection of rational individuals. Neither regulatory approach necessarily implies a particular model of the corporation nor does any model necessarily suggest a particular

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for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future, 71 Wash. U. L.Q. 219 (1993).

57 Cindy Alexander et al., *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J.L. & Econ. 393 (1999).

58 M. Cash Mathews, Strategic Intervention in Organizations: Resolving Ethical Dilemmas 51-61 (1988).

59 United States Sentencing Commission, *supra* note 2.

60 Another explanation for the appearance of various factors in the Guidelines is, of course, political pressure. *See* William S. Lofquist, *Legislating Organizational Probation: State Capacity, Business Power, and Corporate Crime Control*, 27 Law & Soc'y Rev. 741 (1993).

type of regulation. The apparent link between command-and-control and thin theories of the corporation is primarily historical; command-and-control is the traditional approach to regulation, and thin theories — not nexus of contracts, but the more primitive idea that a corporation is controlled by the individuals who own or manage it — are the traditional approach to corporate behavior.

A second generalization that should be rejected is that incentive manipulation places greater information demands on the government regulator. It is true that one needs to know a good deal about corporate behavior before the incentives of the various actors can be altered to produce a desired result. But one needs to know just as much in order to determine whether command-and-control will have such effects.[61] Even when individuals are involved, the effects of simple prohibitions are difficult to predict. There is a raging debate, for example, about the deterrent effects of criminal sanctions.[62] When the target of a prohibition is a corporation, the deterrent effect of the prohibition and its attendant sanction is likely to be still more uncertain. Determining the kinds of prohibitions and sanctions that will produce the desired effect is likely to demand as much information about the corporation as manipulating its incentive structure.

A final caution is that the effort to predict an organization's response to a particular legal initiative, whether by using organization theory or by any other means, is necessarily speculative without extensive empirical research. Organization theory, in my view, guides our speculations and reveals possibilities that intuition would tend to ignore, but it will not provide definitive answers.

A. Nexus of Contracts Theory

From the nexus of contracts perspective, reduced penalties for establishing a compliance program would initially appear to be a bad idea. Individual

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61 *See* Robert Jackall, Moral Mazes: The World of Corporate Managers (1988). Sally Simpson, Corporate Crime, Law and Social Control 22-44 (2002), summarizes studies indicating that criminal penalties do not deter corporate crime.

62 *E.g.*, Johannes Andenaes, Punishment and Deterrence (1974); Deterrence and Incapacitation: Estimating the Effects of Criminal Sanctions on Crime Rates (Alfred Blumstein et al. eds., 1978); Philip Cook, *Research in Criminal Deterrence: Laying the Groundwork for the Second Decade*, *in* 2 Annual Review of Research 213 (Norval Morris & Michael Tonrey eds., 1980); Jack Gibbs, Crime, Punishment and Deterrence (1975); Franklin Zimring & Gordon Hawkins, Deterrence: The Legal Threat in Crime Control (1973).

members of the firm would decide whether to violate the criminal law on the basis of a rational computation of costs versus benefits. The benefits would be the benefits of the crime itself — reduced costs from non-compliance with environmental rules, the increased profits from committing fraud or violating the antitrust laws, and so forth — plus the reduced costs of monitoring subordinates to ensure that they do not commit offenses. The costs would be financial penalties that result from a criminal conviction, the reputational costs of the investigation and conviction,[63] the legal costs of defending against a criminal prosecution, and the disruption caused by the investigation.[64] Imposing criminal liability on the firm would increase these costs and thus induce corporate managers to avoid the proscribed activity and increase their efforts to prevent such activity by their employees.[65] Reduced penalties would reduce the costs to the corporation, thus altering the cost-benefit calculation in favor of committing the crime. Thus, the opportunity to create a compliance program, and obtain reduced penalties, could lead to increased corporate crime.

The justice rationale offered by the U.S. Sentencing Commission appears to concede that the reductions will operate in this manner. According to this rationale, it is harsh (unfair?) to hold the corporation criminally accountable for the actions of a single employee, so the corporation that establishes a compliance program, thus showing good faith, will be granted a reduced sanction. But controlling employees is presumably a matter of money: the more resources the managers invest in monitoring behavior that they find undesirable, the less such behavior will occur. The managers will decide on the level of risk that they are willing to take by balancing the costs of an offense against the benefits of the offense, one of those benefits being the

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63 *See generally* Cindy Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J.L. & Econ. 489 (1999); Jonathan Karpoff & John Lott, *The Reputational Penalty Firms Bear from Committing Fraud*, 36 J.L. & Econ. 757 (1993).

64 I omit the complex but relevant issue of what the managers can do to reduce the possibility of an investigation that does not lead to a conviction. For a discussion of this regulatory technique, see John Scholz, *Cooperation, Deterrence and the Ecology of Regulatory Enforcement*, 18 Law & Soc. Rev. 179 (1984).

65 *See* Francis Cullen et al., Corporate Crime Under Attack (1987); Christopher Stone, Where the Law Ends: The Social Control of Corporate Behavior (1975); Michael Block et al., *The Deterrent Effects of Antitrust Enforcement*, 89 J. Pol. Econ. 429 (1981); Jonathan Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. Rev. 315 (1991); A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 Int'l Rev. L. & Econ. 239 (1993).

reduced cost of monitoring employees. If the managers decide that the costs of an offense would be disastrous, then they will invest very large amounts in monitoring employees. A compliance program that meets the Sentencing Commission's requirements will necessarily be cheaper than such very high levels of monitoring. Presumably, however, it will also be less effective. But the managers can opt for this cheaper, less effective program and accept the increased likelihood that employees will offend. Again, the Sentencing Guidelines appear to offer managers who conclude that an offense will have very high costs an opportunity to reduce those costs, because the Guidelines simultaneously lower both the legal penalty and the cost of monitoring subordinates.

Despite the language of the U.S. Sentencing Commission, the underlying expectation for the Guidelines, of course, is that the compliance program will reduce corporate crime. This approach has been given a theoretical grounding by Jennifer Arlen and Reinier Kraakman.[66] Implicitly adopting the principal-agent, or network of contracts, model of the corporation, they argue that, prior to the enactment of the Guidelines, the gains that a corporation achieved from monitoring its agents, and trying to prevent them from committing crimes, will be more than counterbalanced by the increased number of penalties that will be imposed, because the monitoring reveals crimes that would otherwise go undetected.[67] Thus, they argue, rational agents will decide not to monitor illegal activity. They endorse the approach of the Organizational Sentencing Guidelines on the ground that the reduced penalty will induce monitoring that firm managers will be otherwise motivated to avoid. Thus, more crimes will be discovered, and this will more than counterbalance the loss of deterrent effect from the reduced sentences provided by the Guidelines when monitoring occurs.[68]

This conclusion, however, assumes that the managers are profit-maximizers, that is, that they are motivated by the desire to maximize

66 Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. Rev. 687 (1997); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. Legal Stud. 833 (1994).

67 Arlen & Kraakman, *supra* note 66, at 707-09. That is, fewer crimes will be committed, but a larger proportion of this smaller number will be revealed, and this latter number exceeds the number that will be reported without monitoring. Arlen & Kraakman's study also applies to tort liability, and the image of the corporation that they employ is equally relevant to this aspect of their study. Since I am discussing criminal sentencing guidelines in this section, however, I will ignore the tort issue.

68 *Id.* at 745-52. They have numerous criticisms of the Guidelines' specific provisions, however.

the net benefits to the corporation. Nexus of contracts theory does not accept this traditional assumption, however; rather, the theory recognizes the agency problems that arise from rational behavior on the part of managers, particularly when their compensation is not directly tied to corporate profits. By contractual arrangement, the manager is in control of the compliance program and can presumably decide whether her own crimes are reported or suppressed. That is, the agent in charge of the compliance program may dutifully report crimes committed by other agents, but may be persuaded to suppress crimes committed by her direct superiors. In this situation, the reduced sentences provided by the Guidelines may once again lead to increased corporate crime because they allow the manager to institute a monitoring program and reduce the consequences of criminality without increasing the risk that her own crimes will be detected.

Agency problems of this sort, however, are well known to others, particularly to the risk-takers, or residual claimants, in the corporation, such as stockholders. Of course, the managers take risks as well, since they commit their human capital to the corporation and the corporation's success is likely to affect the subsequent value of this human capital in the market for managerial talent. In addition, they are often compensated with stock options and similar devices whose value is tied to the corporation's profitability. But the success that increases the value of the managers' human capital, and their stock options, is likely to be shorter-term success than the general profitability of the firm. An individual shareholder can always sell her shares, to be sure, but the class of shareholders, as represented by the directors, cannot escape long-term risk, and a controlling shareholder may find it difficult to do so. In addition, fines assessed against the corporation will be paid out of profits, that is, by the risk-takers, and the reduced fines that result from instituting the compliance programs will certainly benefit them.

Thus, the risk-holders in the corporation may value visible compliance programs as a means of disciplining managers and aligning the incentives of these managers with their own. The compliance program can be used by the risk-takers, or, more often, their representatives, to discover and prevent behavior that will impose more costs on them than on the managers. To begin with, a legally-structured compliance program may provide directors, who do not necessarily have the information-gathering resources of managers, with a means of monitoring corporate employees. In addition, the creation of such a program may represent a credible commitment by the directors to punish managers who violate the law or, more precisely, whose cost-benefit function differs from their own. From this perspective, legislation that rewards the creation of such a program with lower penalties may well be effective in reducing corporate crime because it will provide directors with a real incentive to create a mechanism that makes managers' assessment of the costs and benefits of offending more congruent with the directors' own, more offense-sensitive assessment.

B. Decision Theory

Decision theory yields a somewhat different result. The rational calculation of costs and benefits that characterizes nexus of contracts theory is here replaced with bounded rationality, satisficing, and cognitive illusions. This suggests that the criminal sanction will no longer be viewed as a pure matter of costs and benefits, but rather as an event of uncertain probability and uncertain consequences for each actor. How employees assess the cost of breaking the law will be determined by the salience that the law possesses for them. An employee who is unaware of the law or who does not expect it to be applied will undervalue its potential costs in his decision-making calculus, while an employee who is intensely aware of the law may take excessive precaution. In comparing this cost assessment, whether undervalued or overvalued, against the benefits of violating the law, the employee will not conduct a systematic analysis, but instead will satisfice, that is, make a rough estimate in the time allowed, with the information that is readily available. This estimate, moreover, will be further distorted by cognitive illusions such as the optimism bias.

Because the decision-making process is strongly affected by the many subjective and idiosyncratic factors that decision theory recognizes, the particular place in the hierarchy where the decision is made will influence, and often determine, the content of the decision. In nexus of contracts theory, everyone is presumed to be a rational actor and to thus make the same assessment of costs and benefits. The location of the decision in the corporate hierarchy matters only to the extent that it affects the costs or benefits of the decision to that person, and any variations are thus predictable on the basis of purely individual behavior. But in decision theory, the location of the decision has a profound effect on each step, and on the ultimate result. The theory agrees with nexus of contracts theory that the decision is being made by individuals and that these individuals are trying to be rational, but it differs because the individuals in decision theory are not succeeding, and their lapses are heavily determined by their position in the hierarchy.

Turning to the Organizational Sentencing Guidelines, the principle of salience suggests that the employees with the greatest knowledge of the Guidelines would be most concerned about their violation. Typically, this would be corporate counsel and outside counsel.[69] The employees who would be least concerned about violations would be operational employees, that is, the ones who are most likely to be committing fraud, antitrust, or environmental violations. Legal rules would not possess much salience for these employees, and they may very well ignore such rules in order to facilitate a particular project in which they are engaged. Moreover, criminal sanctions, already undervalued by their low salience to the operational employees, may be further undervalued by an optimism bias. Indeed, Sally Simpson, using a vignette analysis of corporate attitudes, found that the idea of violating the law might have a positive appeal as an indication of aggressive business practice.[70]

In this situation, the compliance program and reduced sanctions of the Organizational Sentencing Guidelines may be reasonably effective. In deciding whether to create a compliance program and how much resources to devote to it, managers are not likely to engage in the dispassionate, comprehensive assessment of costs and benefits that nexus of contracts theory suggests. Rather, they will be uncertain whether the benefits exceed the costs and may conclude that they are better off obtaining the reduced sanctions than refusing to do so and then being unable to justify this refusal to their superiors if things go wrong.[71] To establish the program, the corporation will either create a new department or expand the size and authority of corporate counsel. The greater resources devoted to compliance and the emphasis placed on the subject if a new department is created will tend to increase the salience of the criminal law for operational employees. Their uncertainty about the consequences of their actions may convince them that it is better to follow the instructions of the compliance personnel.

Whether the internal unit that manages the compliance program is effective will depend on a variety of factors. Serge Taylor, in a study of environmental regulation, found that the effectiveness of such a unit depends on its own commitment to the program, its autonomy, the outside support for its

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69 For simplicity, I will not address the complexity of defining the boundaries of the organization and the location of actors such as outside counsel with respect to it. *See generally* Toward a Unified Theory of Human Behavior, *supra* note 28, at 278-314; Phillip Gunther Herbst, *A Theory of Simple Behavior Systems*, 14 Hum. Rel. 71 (1961).

70 Simpson, *supra* note 61, at 116-51.

71 Boards may be risk averse as well — not because they have superiors, but because they may be more sensitive to scandal than to less than optimal profits. *See* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 Geo. L.J. 797, 819-20 (2001).

efforts, and the clarity of its goals.[72] Another factor in the compliance unit's effectiveness may be its ability to reduce uncertainty absorption by circumventing the existing hierarchy. To the extent that the compliance personnel deal with lower-level employees and are able to report back to higher levels of the firm more directly than these employees, the uncertainties of the benefits that flow from non-compliance and the uncertainties about whether offending behavior will be discovered are likely to be absorbed to a lesser extent. In the absence of a compliance program, an employee who decides to engage in legally risky behavior, like instituting a cheaper production process that creates more waste, may have nagging doubts about the wisdom of doing so, but will suppress some of those doubts in reporting to his superior, who will, in turn, suppress some of the doubts that were expressed to her in reporting to her superior. Compliance staff may short circuit some of these bureaucratic levels by reporting the employee's doubts directly to top management.

But decision theory also suggests some problems with the Organizational Sentencing Guidelines. Inducing firms to establish a compliance program by offering reduced penalties creates an obvious danger of goal displacement — the firm may focus more on creating the program than on actually obeying the statute. Kimberly Krawiec has aptly described this as cosmetic compliance.[73] Moreover, once the compliance program is created, the optimism bias may convince managers, to an unrealistic extent, that they will only receive the proverbial slap on the wrist if they actually violate the law, thus possibly encouraging violations. This is virtually encouraged by the justice rationale that the Commission offers for the reduced sanctions; we know you cannot control your staff, so just make a cosmetic effort and we will let you off the hook. Finally, the precision to which the Guidelines aspire, in the interest of fairness, may remove that very uncertainty that creates the greatest inducement for a satisficing manager to avoid offending, that is, the uncertainty about the consequences that will result from being caught.

C. Systems Theory

According to systems theory, the enactment of criminal sanctions for corporate action of some sort constitutes a stimulus, that is, a change in the corporation's external environment. Confronted with this change, the theory

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72 Serge Taylor, Making Bureaucracies Think: The Environmental Impact Statement Strategy of Administrative Reform (1984).

73 Kimberly Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 Wash. U. L.Q. 487 (2003).

predicts that the system will attempt to maintain its equilibrium, or steady state, through a process of homeostasis. This steady state includes both profits and sales: profits because they determine the corporation's long-term survival and sales because they determine the corporation's current size, range of operations, and internal resources. Systems theory suggests that both are equally important. This is not in direct conflict with nexus of contracts theory; the two can be aligned if one is willing to conclude that the corporation is subject to irremediable agency problems stemming from the benefits the managers derive from running a larger organization.

Thus, an initial prediction of systems theory is that the corporation, in striving to maintain a steady state, will avoid the sanctioned behavior if such avoidance has no effect on sales or profits or if it only affects the corporation's ability to increase them, but will not avoid the sanctioned behavior if the avoidance will lead to a decrease. The corporation will determine the effect of avoiding the sanctioned behavior by learning; it will make incremental adjustments in response to the stimulus, that is, the sanction, and then compare its output, profits, and sales after the adjustment to its profits and sales prior to the adjustment. This is supervised, or Widrow-Hoff,[74] learning, because the system has a defined outcome — prior sales and profits — against which to measure its new output. If the corporation learns that avoiding the prohibited behavior will decrease sales or profits, it will respond to the stimulus by trying to avoid detection or punishment, not by avoiding the behavior. The way to prevent such behavior is to increase the strength of the stimulus to the point where the sanction for the prohibited behavior, discounted by the probability of detection, will decrease sales and profits by a larger amount than the continuation of that behavior will increase them.

The Organizational Sentencing Guidelines move in the opposite direction, since they reduce the sanction for legal violations. The rationale given by the Commission, which goes to managers' inability to control their subordinates, is irrelevant in systems theory, primarily because it is phrased in terms of individual motivations, which is not a determinant of organizational action according to the theory. Rather, the theory asserts that any stable organization will learn ways of avoiding the prohibited behavior if the sanction is large enough to produce this response. If the sanction is reduced, this learning process will not take place. The requirement that the corporation establish a compliance program in order to qualify for the reduced sanction will not compensate for this loss of effect, because the corporation will strive to

74 Widrow & Hoff, *supra* note 34.

maintain a steady state, or equilibrium. This tendency will overcome any influence exercised by the compelled introduction of a new unit or program. According to the *principle of equifinality*, a stable system can reach the same result, that is, its steady state, in a number of different ways. Consequently, introduction of a compliance program will simply induce the corporation to develop other internal mechanisms to counteract the effect of the program and thereby maintain the same level of sales and profits.

As this brief discussion suggests, the systems theory model of the corporation differs from the nexus of contracts model and the decision theory model by being considerably more pessimistic about the ability of a compulsory compliance program to produce any significant effect. The reason for this difference is that nexus of contracts theory and, to a lesser but still considerable extent, decision theory dissolve the corporation into a collection of individual actors. There are virtually no emergent characteristics of the collective entity in nexus of contracts theory and only a limited number of these characteristics in decision theory. Systems theory, in contrast, portrays the corporation as being composed entirely of emergent characteristics. It is a collective entity with a definitive boundary that is difficult to penetrate, instead of a collection of individuals who are as reactive to influences from outside the corporation as to those from within. An anecdotal version of this same idea is that a compliance unit located within a firm becomes "co-opted" by those whom it is intended to discipline. But this notion could just as easily refer to the way that the incentives of individual employees responsible for compliance are affected by rational or decision theory considerations, which means that the extent of co-optation would be variable. Systems theory suggests that the process is an inevitable aspect of the corporation itself as a collective, emergent entity that strives to achieve its equilibrium through homeostasis.

What I have said thus far is phrased in terms of open systems. As described above, one contemporary approach to systems theory treats systems as closed, or autopoetic, rather than open. This means that, strictly speaking, nothing crosses the boundary between the outside world and the system; the corporation does not react directly to the sanction itself, nor to the incentives regarding the creation of a compliance program. Rather, the environmental stimuli produced by legal regulations or guidelines can only function within the organization if they are translated into terms the organization can understand or absorb. The system reproduces itself, and maintains its structural integrity, by this process of translation.

According to Teubner, legal regulation of the corporation cannot rely on the imposition of specific stimuli; rather, it will be effective only if it can induce an internal process that integrates the corporation with other social systems.[75] This may suggest a more positive assessment of the Organizational Sentencing Guidelines than other forms of general systems theory, since the Guidelines are specifically designed to generate an internal process. The problem, however, is that the powerful internal process that autopoetic theory postulates will render the effort to generate an internal process ineffective and, in fact, counterproductive. Consider a corporation that regularly dumps waste into a river as part of its manufacturing process. Standard systems theory predicts that the corporation would attempt to maintain its equilibrium by avoiding detection, but would abate the problem if the threat of criminal sanctions becomes too severe. The autopoetic version of the theory predicts that the corporation will translate this statute into a pure cost, rather than the moral judgment that was originally intended by the legislature. When the corporation is offered an opportunity to reduce the potential sanctions by establishing a compliance program, it is likely to translate the program into a means of reducing sanctions rather than as a means of avoiding violations. Not only will the corporation try to maintain its equilibrium, but its members will perceive the compliance unit as properly created to achieve this goal. Reducing the sanction will become the perceived purpose of the compliance unit, not as a matter of goal displacement but as a genuinely felt purpose of the entire organization. An internal process that truly integrates corporate norms with the norms of other social systems would demand more comprehensive legal efforts.

D. New Institutionalism

New institutionalism suggests a strong upside, but an even stronger downside, to the Organizational Sentencing Guidelines' strategy of trading reduced criminal sanctions for the organization's creation of a compliance program. According to this view of organizations, no one really knows how to structure an organization in the most effective manner; rationality is not only bounded but lacerated, and satisficing reigns supreme. In this situation, managers often rely on institutional isomorphism, reiterating

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75 Gunther Teubner, *Corporate Fiduciary Duties and Their Beneficiaries: A Functional Approach to the Legal Institutionalization of Corporate Responsbility*, *in* Corporate Governance and Director Liabilities: Legal, Economic and Sociological Analyses of Corporate Social Responsibility 149 (Klaus Hopt & Gunther Teubner eds., 1985); Gunther Teubner, *Juridification: Concepts, Aspects, Limits, Solutions*, *in* Juridification of the Social Spheres: A Comparative Analysis of the Areas of Labor, Corporate, Antitrust and Social Welfare Law 3 (1987). Teubner refers to this internal process as "reflexion."

socially-available patterns within their own organization. Thus, it is quite possible that the creation of compliance programs will reach the tipping point where it becomes the norm; in that case, corporations will institute such programs even when they have only weak incentives to do so. Compliance programs will become one of the things that every fashionable, up-to-date corporation needs to have.

But the compliance that the program achieves is very likely to be largely ceremonial in nature. The investigation, monitoring, reporting, training, and correcting that the compliance unit carries out will be a cultural enactment where everyone in the corporation participates in the satisfying rituals of corporate morality, but where very little changes in response to the criminal statute. From this perspective, the cosmetics that Krawiec has noted in cooperative governance schemes become unappetizingly thick.[76] To the highly ritualized and ceremonial atmosphere that prevails in the corporation, the Sentencing Guidelines add public approbation and the charm of public service. What could be more enticing, more likely to generate genial self-congratulation within the firm, than a governmental declaration that violations of the law will not really count if the firm has instituted a compliance program? When the government declares that the corporation cannot really be responsible for its employees' behavior and that all it is expected to do is establish a program that declares an intention to implement this impossible task, it is virtually insisting on ritual and not results.

The decoupling of the organization's components that Meyer and Rowan discuss will lead to similar results.[77] Because attempts to exercise real control produce conflicts and institutional stress, different units within the firm tend to become detached from one another, performing their separate, ritualized functions without interacting in the prescribed or programmed manner. The interactions between these semi-isolated units that do occur are mediated by informal contacts between individuals within each unit, rather than by the firm's hierarchical structure. Thus, the activities that the general counsel's office or the specialized compliance unit performs are not only rituals, but rituals enacted largely for their own benefit and within their own sub-institutional boundaries. Reports are written, training programs documented, research conducted, and resources expended, while the managers of the compliance unit reassure their colleagues in the units they are monitoring that they are not trying to disrupt their efforts or get them in trouble with higher management.

76 Krawiec, *supra* note 73.
77 Meyer & Rowan, *supra* note 46.

A corporation that has instituted an acceptable compliance program and is then accused of violating a criminal law is likely to settle with the enforcement agency rather than go to trial. Agencies tend to reserve the scarce resource of litigator time for those regulated parties they perceive as recalcitrant.[78] If the case does go to trial, however, one can readily imagine that the trial, far from representing the imposition of a public stigma that is supposedly the criminal law's most characteristic sanction, would become a validation of the corporation's ceremonial efforts. After all, one does not even need to be a new institutionalist to perceive criminal trials as a form of public ritual. In the prosecution of a firm with a compliance program, this familiar ritual would reinforce and amplify the rituals within the firm, as various executives testify to their assiduous efforts to establish and implement a compliance program in accordance with the government's directives and the judge, in sentencing the firm, reduces the sentence and commends the firm for its compliance with the Guidelines.

But organizations are complex entities, and the picture painted by new institutionalism is not as uniformly bleak as the foregoing description seems to suggest. The compliance program installed in response to the promise of reduced sanctions for criminal offenses may be largely ceremonial, but it is not cynical. In contrast to nexus of contracts theory, new institutionalism does not assert that managers are merely trying to reduce costs and increase benefits; in contrast to systems theory, it does not assert that the corporation is merely trying to maintain its former equilibrium. The ceremonial aspect of the compliance program stems from the process by which the members of the organization create meaning for themselves. They are sincere, not cynical, about their efforts, and thus the members of the compliance unit, whose entire work lives are centered on this effort, will pursue it conscientiously. The effort remains ceremonial, to be sure, but ceremonies sometimes produce the very effects they represent if continued for a sufficient period of time. Moreover, the decoupling of the corporation's components means that the top managers, who are more concerned with economic performance than compliance, will not be in control of the compliance unit. Like other units, it will operate in a semi-autonomous manner and will thus be free to infuse its ceremonies with substance.

Overall, the most common outcome is probably that the ceremonial aspect of compliance will prevail, but the precise balance between ceremony and substance will vary from one corporation to another. As I noted above, new

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78 *See* John Scholz, *Cooperative Regulatory Enforcement and the Politics of Administrative Effectiveness*, 85 Am. Pol. Sci. Rev. 115 (1991).

institutionalism's concept of corporate culture provides a useful framework for explaining variations in corporate style. Its implication is that the balance between ceremony and pragmatism, between intransigence and compliance, will vary among corporations as it does among societies. In a corporation that sees itself as ethical and cooperative, the ceremonies of compliance will produce a real impact on the behavior of their intended audience. This will occur even though the compliance program remains ceremonial and the component units of the corporation are decoupled. Ceremonies do not produce their impact by controlling people, by giving them orders or imposing formal sanctions, but by creating a pervasive ethos that induces imitation and aspirational effort. These are much more diaphanous causal linkages than those intended by the Organizational Sentencing Guidelines. How effective they will be, in the current business atmosphere of increased productivity, "winner-takes-all" competition, and the disparagement of regulatory governance, remains a matter of some doubt.

III. Two More Examples and Some Tentative Conclusions

In this final section, I will provide much briefer discussions of two other regulatory programs and then offer some tentative conclusions. The programs that I will discuss are the disclosure provisions of the 2002 Sarbanes-Oxley Act and the administrative strategy that is generally described as reasonable, responsive, or cooperative regulation.

A. The Sarbanes-Oxley Act

The Sarbanes-Oxley Act[79] was passed in response to revelations of fraudulent activities by public corporations and the failure of the accounting firms retained by these corporations to detect or report such activities. Title I and, secondarily, Title II turn accounting services for publicly-traded companies into a regulated industry, with a few oddities to assuage the conscience of the Republican Congress that enacted it, such as making the regulatory authority a nonprofit corporation rather than a federal agency.[80] The Act increases command-and-control regulation of corporations themselves to some extent, but its major provisions regarding corporations are incentive-driven. In

79 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. §§ 7201-66 (2002)).

80 § 7211.

essence, they require the corporation to establish its own internal monitoring systems. One of these is an audit committee, consisting of members of the corporation's board of directors who have no relationship with the corporation other than being board members. This committee is then charged with the supervision of any accounting firm that audits the corporation and is further required to establish a system for receiving complaints from employees and outsiders about accounting and auditing matters. A second monitoring requirement is that the Chief Executive Officer and Chief Financial Officer of the corporation certify, in each annual or quarterly report filed under the Securities Exchange Act, that they have established internal controls for the detection of fraud.[81] The corporation is also required to disclose, as part of its regular reports under the Securities Exchange Act, whether it has adopted a code of ethics for senior financial officers and, if not, state the reason for its refusal to do so.[82] Failure to establish an audit committee is punished by prohibiting the corporation from listing its securities on national securities exchanges, which is generally equivalent to a death sentence. Failure to disclose information regarding internal controls or the code of ethics constitutes a violation of the Securities Exchange Act and can involve severe monetary penalties. Knowing inaccuracies in the reports filed by the Chief Executive Officer and Chief Financial Officer carry penalties of up to five million dollars, twenty years imprisonment, and forfeiture of incentive-based compensation and profits from sale of securities to the corporation.[83]

We can safely predict that Sarbanes-Oxley will lead to the creation of audit committees, internal controls, and ethics codes. The question, of course, is whether these mechanisms will decrease fraudulent behavior in corporations. Again, an answer to this question requires an understanding of how an organization, specifically the middle-to-large-sized corporations at issue in this article,[84] will behave. Sarbanes-Oxley is similar to the Organizational Sentencing Guidelines in that it attempts to regulate corporate behavior by altering the incentives of the participants rather than by imposing government-drafted rules and enforcing those rules through government agents. Much of what I said above in connection with the Guidelines applies to Sarbanes-Oxley as well. But this statute differs from the Guidelines in that it imposes additional, and quite severe, sanctions for violations of its

81 § 7241.

82 § 7264.

83 18 U.S.C.A. § 1350 (2004).

84 Technically, Sarbanes-Oxley applies only to publicly-traded companies. Most publicly-traded companies are middle to large-sized corporations, and, conversely, most firms that fall into this category are publicly-traded.

requirements, rather than reducing existing sanctions for compliance with these requirements. Punishments resulting from convictions for fraud are governed by the Guidelines, but Sarbanes-Oxley contains a provision to ensure that the punishments are sufficiently severe[85] and also imposes specified penalties for certain violations.[86]

The use of sticks, rather than carrots, to induce corporate compliance makes more of a difference according to nexus of contracts theory and decision theory than according to systems theory or new institutionalism. This is not surprising, because Sarbanes-Oxley seems to be premised on a model of the corporation that is drawn from the first two theories. Viewing the corporation as a nexus of contracts suggests that each of those contracts is subject to efficient breach; there will be some circumstances in which the contracting party can derive more benefit from breaching the contract than from performing it. Sarbanes-Oxley is designed to increase the cost of one particular breach, thereby rendering it inefficient for the potential breaching party. Costs are increased by increasing the amount of monitoring, altering by law the contracts of various persons who are assigned as monitors, and providing increased penalties in certain circumstances.

Sarbanes-Oxley employs these cost increases to create specific motivations for rational corporate agents and principals. To begin with, corporate directors, who are responsible for the quality of the audit but do not derive any financial benefit from their positions other than a fixed payment, are motivated by Sarbanes-Oxley's requirements to ensure that the audit is accurate. Second, corporate officers, who are responsible for the accuracy of internal control provisions in reports required by the Securities Exchange Act, are motivated to monitor those internal controls assiduously. Third, the corporation's risk-takers, acting through the directors, are motivated to compel the corporation to enact a code of ethics that protects their own contractual rights. The underlying idea, which is consistent with Arlen & Kraakman's analysis,[87] is to overcome the rational actor's inclination to decrease monitoring in order to reduce the number of crimes detected, even if the sanction for those crimes is more severe. In contrast to the Guidelines, and to Arlen & Kraakman's recommendation, Sarbanes-Oxley attempts to achieve this goal by imposing specified monitoring obligations. Whether these agents comply with their obligations or try to circumvent them will depend on their

85 18 U.S.C.A. §§ 1348, 1514A (2004).

86 18 U.S.C.A. § 1350.

87 *Supra* note 66.

particular cost-benefit function, but the severity of the sanctions suggests a reasonable likelihood of success.

Decision theory produces modifications of the rational actor, or nexus of contracts, model that move in opposite directions. The audit committees demanded by the statute will have the clarity of purpose, autonomy, and outside support that Taylor regards as the hallmarks of effectiveness.[88] The directors and officers responsible for monitoring fraudulent activity are likely to be overcautious, that is, to respond to uncertainty by taking more precaution than a rational actor model would predict. Sarbanes-Oxley's use of sanctions, rather than sanction reductions, is likely to amplify this tendency toward cautious behavior. This is partially a result of the sanction's greater absolute magnitude, but also a result of a cognitive illusion. A reduced sanction, even if it ends up being the same size as one that is directly imposed, will seem less severe because of anchoring or the status quo bias, that is, people's tendency to take a given situation as a standard and then judge other situations by their relation to that standard.

The countervailing tendency is that the severe sanctions of Sarbanes-Oxley, combined with its emphasis on filing reports and making disclosures, may increase goal displacement, thereby leading to the cosmetic compliance Krawiec describes.[89] Creating an audit committee, a set of internal controls, and an ethics code is a fairly elaborate undertaking that creates an impression of sedulous activity, but the codes and committees may become the end in themselves, without any significant gains in compliance. By attaching its sanctions to the failure to create these committees, controls, and codes, Sarbanes-Oxley may exacerbate this tendency. Its emphasis on knowing violations, moreover, as opposed to the strict liability offenses that the Guidelines govern, may lead corporate officers to encourage uncertainty absorption at the lower levels of the hierarchy.

From the perspective of systems theory and new institutional analysis, the provisions of Sarbanes-Oxley are less likely to produce a significant impact. These theories, in portraying the organization as a system or a culture, treat it as possessing a definitive boundary. Sarbanes-Oxley, like the Organizational Sentencing Guidelines, employs an external stimulus to produce changes inside that boundary. But systems theory predicts that a system subject to an external stress is more likely to respond with an effort to maintain its equilibrium than it is to undergo real change. The Guidelines seem to encourage such behavior by offering a positive inducement — a reduction of

88 Taylor, *supra* note 14.
89 Krawiec, *supra* note 73.

external stress — for adoption of a compliance program, without necessarily altering the rate of violation. Sarbanes-Oxley imposes more severe sanctions and offers no such inducement. The essential predictions of systems theory, however, do not depend on the existence of an inducement but on the existence of the system boundary and the tendency of the system within the boundary to maintain its equilibrium through homeostasis. Thus, Sarbanes-Oxley seems likely to generate more elaborate compliance programs and ethics codes, but this might not necessarily translate into significant change in the direction desired by the Act. The autopoetic version of the theory only strengthens this prediction, because it suggests that the idea of an ethics code will be translated from what the authors of the Act envisioned into what the members of the corporation understand, which is a means of maintaining the existing system.

New institutionalism suggests a similar outcome. The increased sanctions will lend a greater gravity to the required rituals, and institutional isomorphism is likely to propagate these rituals throughout corporate America.[90] But these rituals are likely to be enacted by specialized, decoupled units and have largely ceremonial effects; the severity of the sanction may affect the nature of the rituals rather than their impact on the behavior of the firm at large. The high profile of Sarbanes-Oxley may produce an effect, however; corporations that have a culture of compliance may respond by instituting real operational changes in response to the Act. This effect can be seen as allied to what some commentators have described as the expressive function of law.[91] In this case, the sanctions function as an expression of public concern, rather than as an actual threat. New institutionalism suggests that the effect of this expression will be highly dependent on the particular culture of the corporation. A pessimistic view is that it will impose additional costs on those firms that society does not want to discipline, i.e., those that are already ethical and compliant, while producing little impact on the immoral and recalcitrant ones.

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90 A specific prediction of new institutionalism is that firms that are not subject to Sarbanes-Oxley will respond in a similar manner to covered firms.

91 *See* Elizabeth Anderson & Richard Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. Penn. L. Rev. 1503 (2000); Deborah Hellman, *The Expressive Dimension of Equal Protection*, 85 Minn. L. Rev. 1 (2000); Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. Penn. L. Rev. 2181 (1996); Richard Pildes, *Why Rights Are Not Trumps: Social Meanings, Expressive Harms, and Constitutionalism*, 27 J. Legal Stud. 725 (1998); Cass Sunstein, *On the Expressive Function of Law*, 144 U. Penn. L. Rev. 2021 (1996); Cass Sunstein, *Social Norms and Social Roles*, 96 Colum. L. Rev. 903 (1996).

B. Responsive Regulation

Another, and rather different, way to make use of incentives to change corporate behavior is responsive regulation. This approach, sometimes referred to as New Public Governance, has been developed by scholars in law and political science concerned with compliance issues and has been applied in certain regulatory situations, as these scholars report.[92] Ayres & Braithwaite, in developing a general theory of implementation, give it the name I am using; Braithwaite also describes it as enforced self-regulation; Scholz offers a theoretical explanation; and Bardach & Kagan provide a detailed example involving monitoring factories under the Occupational Health and Safety (OSH) Act. Responsive regulation, as Bardach & Kagan's example makes clear, recognizes that the implementing agency does not have enough resources to enforce a complex, comprehensive regulatory program in a stringent manner. Scholz, using game theory, suggests that the agency treat the effort to induce compliance as a repeated prisoners' dilemma game and adopt the optimal strategy for such a game. Computer simulations suggest that this strategy is "tit-for-tat";[93] confronted with an opportunity to cooperate or defect, the player using a tit-for-tat strategy will cooperate until the opposing player defects, then defect once, and then return to a cooperative approach until the next defection. This means that the regulators will overlook minor violations and try to help the firm correct major ones in a non-punitive manner. They will continue this approach as long as the firm makes a genuine effort to eliminate serious violations. If the firm defects, that is, if it stops trying to prevent serious violations or tries to mislead the agency, the agency would respond by imposing sanctions for every violation, however minor, that is, it would "go by the book."[94] As soon as the firm mends its ways, the agency would return to its previous policy.

Responsive regulation resembles the Organizational Sentencing Guidelines

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92 Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (1992); Eugene Bardach & Robert Kagan, Going By the Book: The Problem of Regulatory Unreasonableness (1982); John Braithwaite, *Enforced Self-Regulation: A New Strategy for Corporate Crime Control*, 80 Mich. L. Rev. 1466 (1982); John Braithwaite, To Punish or Persuade: Enforcement of Coal Mine Safety (1985); Michael Dorf, *Legal Indeterminacy and Institutional Design*, 78 N.Y.U. L. Rev. 875 (2002); Jody Freeman, *Collaborative Governance in the Administrative State,* 45 UCLA L. Rev. 1 (1997); Scholz, *supra* note 64; Scholz, *supra* note 78; Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 Colum. L. Rev. 458 (2001).

93 Robert Axelrod, The Evolution of Cooperation (1984).

94 *See* Bardach & Kagan, *supra* note 92.

and the Sarbanes-Oxley Act in that it attempts to use incentives to induce compliance with the law. It differs in being implemented by a regulatory agency with rule-making, inspection, and enforcement authority.[95] The instinct behind other incentive-based approaches is to avoid such regulation on the grounds that it is burdensome and inefficient, specifically that the regulators do not know enough about the internal operation of the firm to avoid ineffective or, indeed, counterproductive measures. Responsive regulation is an effort to decrease these difficulties by inducing the regulated entity to adopt a cooperative, rather than an adversarial, role with the regulating agency.[96] The hope is that firms will be more willing to provide the regulators with accurate information about their internal operations and that regulators, in turn, will be more receptive to acting on this information.

Nexus of contracts theory would predict that responsive regulation would not be much more effective than ordinary, command-and-control regulation, although it might avoid the more extreme inefficiencies of the latter method. Decision-makers in the corporation would cooperate to the extent that it is in their own their self-interests, and no more. Thus, a manager would welcome responsive regulation to the extent that it reduces the costs of complying with complex regulations and might well be willing to spend money preventing major violations to avoid the costs of complying with those regulations that have no effect. (This assumes, of course, that the regulator can distinguish between genuine dangers and mere violations of the statute, which is obviously a big assumption.) But there is no reason to think that the officer, whose contract presumably includes rewards of some sort for minimizing the cost of precautions, will cooperate when she has an opportunity to defect. In other words, the value of responsive regulation, from the nexus of contracts perspective, resides entirely in the value of the strategy that the regulator adopts. Tit-for-tat may not be as effective in real life as it is in computer simulations, particularly when the agency does not have the resources to detect or respond to defections.

Decision theory makes responsive regulation seem somewhat more promising. It suggests that compliant behavior is not only a rational *quid pro quo* for lenient enforcement, but also an emergent feature of corporate behavior at the micro level. Faced with conditions of uncertainty, people will satisfice, that is, they will rely on heuristics to simplify the decision-making

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95 Parts of Sarbanes-Oxley are enforced by the Securities Exchange Commission, and all criminal law is enforced by police and prosecutors, but responsive regulation, as in the case of the OSH Act, is a strategy adopted by a comprehensive regulator.

96 Robert Kagan, Adversarial Legalism: The American Way of Law (2001).

process and remove some of the tension inherent in a potentially risky situation. If the agency acts cooperatively, corporate decision-makers may satisfice by meeting its demands and thus avoid dealing with the complex set of strategic moves involved in a tit-for-tat strategy. Moreover, the status quo bias will lead them to value an existing status of cooperation more highly than the potential gains of a defection. Maintaining this status, that is, getting along with the regulator, may then, through goal displacement, become an end in itself. Of course some of these same factors, most notably the status quo bias and goal displacement, could lead to an emergent behavior of recalcitrance as well.

Systems theory and new institutionalism offer a stronger argument for responsive regulation because such regulation provides a means of penetrating the organizational boundary that seems so impervious to other incentive-based approaches. The reason for this lies in the interactive nature of responsive regulation. To begin with system theory, a set of fixed rules, however severe, functions as a single stimulus, and the system will tend to adjust to it through homeostatic processes. Responsive regulation enables the government to create a continuously varying stimulus that is more likely to produce real changes in corporate behavior. If — and this is, of course, a big "if" — the agency can sanction the corporation for genuine violations after it has responded with cosmetic changes, the corporation will learn over time, through a Widrow-Hoff process of supervised learning, to reduce these violations. This behavior, moreover, may then become institutionalized through a Hebbian learning process.[97] If the system is viewed as autopoetic, then responsive regulation requires it to translate a continuous stimulus into an internal practice. Rather than perceiving the government demand as a single cost, the corporation's process of self-understanding may lead it to perceive this demand as a need to get along with the agency, to develop a relationship based on genuine compliance.

From the new institutional perspective, responsive regulation may be able to overcome the ceremonial nature of compliance programs. As already discussed, this perspective provides a framework for understanding the widely-perceived variations in corporate culture. Compliance programs in corporations with a culture of compliance are likely to be more effective, not because they are less ritualized, but because their rituals produce behaviors that correspond to the patterns of compliant behavior.[98] Responsive regulation will tend to produce a more compliant corporate culture because the

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97 Hebb, *supra* note 33.

98 This is related to Weber's theory that Calvinists became successful capitalists because their religious beliefs happened to correspond to an effective economic

cooperative interaction between the regulator and the corporation's officers tends to penetrate the organizational boundary of the firm and create a new culture that includes the regulator.[99] From an adversarial perspective, this may look like regulatory capture, and in some sense it is, but the sociological (and philosophic) understanding of a capture is that it alters the dominant party as well as the dominated one.[100] In pragmatic terms, it means that many firms may value their ability to live with the regulator and may view their cooperative relationship with the regulator as a basic feature — almost an asset — of their organization. This attitude can potentially, although not necessarily, become pervasive in an industry. It may be imposed by a very powerful and knowledgeable regulator, such as the Federal Reserve Board,[101] or it may be generated by institutional isomorphism.

The caveat to this entire section is that the regulatory agency is itself an organization, subject to the same complexities as the corporation.[102] Its members may act in their own self-interest; their decision-making process may be affected by their hierarchical position and their personal limitations; the agency may function as a homeostatic system or its practices may be highly ritualized and its component parts decoupled. This must be taken into account in order to make a complete assessment of responsive regulation. Public policy may be legitimately designed from the perspective of an idealized decision-maker (normative discourse would be difficult without adopting

strategy. Max Weber, The Protestant Ethic and the Spirit of Capitalism (Talcott Parsons trans., 1992) (1904).

99 *See* Christine Parker, The Open Corporation: Effective Self-Regulation and Democracy (2002); Simpson, *supra* note 61.

100 G.W.F. Hegel, The Phenomenology of Mind 229-40 (J.B. Baillie trans., 1967) (1807).

101 Ayres & Braithwaite, *supra* note 92, at 40-44.

102 This is a basic insight of public choice theory. *See, e.g.*, R. Douglas Arnold, Congress and the Bureaucracy: A Theory of Influence (1979); Jean-Luc Migue & Gerard Belanger, *Toward a General Theory of Managerial Discretion*, 17 Pub. Choice 27 (1974); Jonathan Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange*, 74 Cornell L. Rev. 43 (1988); William Niskanen, Bureaucracy and Representative Government (1971); Samuel Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & Econ. 211 (1976); Barry Weingast, Regulation, *Reregulation and Deregulation: The Political Foundations of Agency Clientele Relationships*, 44 Law & Contemp. Probs. 147 (1981). While I find public choice accounts of government seriously flawed, *see* Edward Rubin, *Public Choice, Phenomenology and the Meaning of the Modern State: Keep the Bathwater, But Throw Out That Baby*, 87 Cornell L. Rev. 309 (2002), the basic insight that government organizations are subject to the same organizational and motivational forces as any other organization seems incontestable.

this perspective), but any realistic design must recognize the limitations of governmental actors as well as private ones. I have not attempted to factor this additional complexity into the analysis. The only point I would make, in this particular article, is that the need to do so, in order to carry out a complete analysis, only emphasizes the importance of understanding organizational behavior.

C. Tentative Conclusions

The multiplicity of theories regarding organizational behavior may appear to preclude any usable conclusions about the optimal means for controlling corporations. This is not an uncommon situation in social science, however. Explanatory theories are generally contested, and we lack a consensus method of validating one or the other, as we have in natural science. An appealing solution that must be resisted is to ignore organization theory in its entirety and rely on intuition. The multiplicity of theories does not suggest that there are really no organizational effects, but, rather, that there are so many that they cannot be contained within a single conceptual framework. To ignore these effects is to ensure inaccuracy.

One tentative conclusion that can be drawn from the multiplicity of theories is that public policy should not rely on a single model of the corporation, but should hedge its bets. This suggests that parallel approaches are preferable to tightly unified ones. The Organizational Sentencing Guidelines seem to rely heavily on a simplified rational actor model: if one offers sentence reductions for compliance programs, the corporation will be incentivized to develop such programs, which will, in turn, incentivize the employees to avoid criminal activity. If this is wrong, and all the theories canvassed here suggest it is, then the Sentencing Commission has simply undermined enacted law.

Sarbanes-Oxley represents a preferable version of the same idea. It retains the advantage of allowing corporations to develop their own compliance programs, making use of the superior information available to them and of their own incentive structure to develop the most efficient solution to a problem, but it treats this as a separate requirement, with separate sanctions attached to the violation of that requirement, rather than as a means of reducing other sanctions. Thus, even if Sarbanes-Oxley is ineffective, and several of the theories canvassed here suggest it is, sanctions established under other theories, other models of the corporation, will remain in place.

Ongoing regulation can be treated as another parallel approach. That is, it need not be seen as a substitute for incentive-based compliance programs, but as a separate means of ensuring compliance. There is no particular reason, for example, why the effort to compel corporations to adopt codes of ethics need be restricted to disclosure requirements. These codes could also be enforced by a regulatory agency, such as the SEC. The agency could inspect corporations, for example, to determine whether they are following their own code.

To be sure, regulation of this sort is in somewhat bad repute at present, particularly with many members of the present Congress (although this did not stop them from imposing it on accounting firms in Sarbanes-Oxley). Responsive regulation is an effort to avoid the most widely-noted problem with such regulation — its inflexible, adversarial character — while preserving its advantages. In fact, it is extremely difficult to dispense with ongoing regulation under the conditions of modern, industrial culture, precisely because of the organizational phenomena I have described. To a large extent, public policy is designed to change the behavior of organizations. Whether the organization is viewed as a group of strategic actors, a system, or a culture, it will generally possess the financial and intellectual resources to adjust to any fixed rule promulgated by the government, that is, to follow whatever behavior it chooses regardless of the rule. The government can combat this tendency only by maintaining an ongoing interaction with the corporation, which, of course, is the whole point of administrative governance and the essential lesson of the last two centuries.

But regulation is still in its early stages and can obviously be much improved. The idea that responsive regulation can occur in parallel to fixed, incentive-based rules, or in support of such rules, is a promising one. Precisely how this should be arranged is a crucial question for contemporary governance. The basic point that I have argued in this article is that answers to this question must be based on a sophisticated understanding of organizational behavior.