MARKET-DRIVEN MISCONDUCT

by

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About a century ago, Max Weber, the pioneer analyst of modern bureaucracy, commented on the operation of norms of regularity within bureaucratic organizations, such as modern business corporations. He characterized bureaucracy as the most efficient, rational form of administration, as providing stable, strict, intensive, and calculable administration, and as imposing on individual employees dominant norms of straightforward duty.[1]

How does it happen, then, that, despite bureaucratic systems of regularity, from time to time criminal or otherwise socially undesirable conduct occurs not merely in one or two or a few firms in an industrial sector, but in many, most, or even all firms in a sector? How does it happen that, seemingly all of a sudden, many savings-and-loan associations make improper loans, many crude-oil resellers misclassify oil, many generic drug manufacturers submit fraudulent applications to FDA? Why are so many

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1 Max Weber, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 333-40 (A.M. Henderson & Talcott Parsons trans. 1947).

medical-products companies the targets of federal investigations and lawsuits by state attorneys general?

When misconduct is discovered, government lawyers, editorial writers, commentators on television, and politicians denounce supposed greed and disregard of the legitimate interests of the public. But did executives in the savings-and-loan industry, the oil industry, and the generic drug industry suddenly in the 1980s become more greedy than they had been before? Was there a sudden influx of sociopaths into those executive ranks? Is that what happened in other industries tainted by industry-wide scandal? Are the people who work in medical-products companies less law-abiding than those who work in other regulated industries or than people generally? If you believe that, I may want to sell you a bridge.

Richard Posner's recent book, *A Failure of Capitalism*,[2] offers an explanation of the causes of the recent financial crisis, which he calls a depression. He attributes the crisis to the effects of deregulation of financial services, through policies made by Congress and the Executive Branch, and low interest rates, resulting from policy set by the Federal Reserve. These policies operated directly on banks and other financial intermediaries operating under intense competition.

Freed from much regulation and facing a low-interest economy, commercial banks, investment banks, and other financial institutions

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[2] Richard A. Posner, A FAILURE OF CAPITALISM (2009).

developed capital structures, mortgage-loan portfolios, and investments in exotic financial instruments that materially increased their profits but also their risk of insolvency if prices of residential and commercial properties declined. When property prices did decline, the banks became insolvent – with the results we have been experiencing.

During the property-value bubble of the 1990s and into the current decade, were the bankers greedy, stupid, and uncaring about their institutions? More so than they or their predecessors had been in previous decades? Judge Posner comments: "Because risk and return are positively correlated, a firm that plays it too safe is, paradoxically, courting failure because investors will turn elsewhere."[3] "You may doubt that the price of some tradable asset will continue to rise, but the fact that it is rising means that other people disagree with you. They may know something you don't. Often they do. It is risky but not irrational to follow the herd. (It is also risky to abandon the herd—ask any wildebeest.)"[4] "As Citigroup's then CEO put it in 2007, 'When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.' (He didn't know it, but the music had stopped.)"[5]

Judge Posner further comments:

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[3] *Id.* at 79.

[4] *Id.* at 84.

[5] *Id.* at 88-89.

> As for the difficulty of climbing down off a bubble even if you recognize it as such, suppose a bank's management tells its investors, "We're afraid we're riding a housing bubble by being heavily invested in mortgage-backed securities, and because we fear that the bubble may burst soon we are going to reduce our leverage or place more of our capital in less risky assets and this means that your short-run return will be less. But we think that in the long run you'll be better off, although we cannot be certain of that and we do not know how long you'll have to wait." As long as the other banks are continuing to ride the bubble, this will be a hard sell. Your investors, observing that the investors in your competitors are continuing to make a lot of money, are apt to think you're simply offering an excuse for failure.[6]

"Notice," he says, "that I have listed no psychological factors among the underlying causes of the depression. My narrative has been of intelligent businessmen rationally responding to their environment yet by doing so creating the preconditions for a terrible crash."[7] He notes that "competition force[s] businessmen to be profit maximizers," and also "is what drives economic progress."[8] Finally:

> Risky behavior of the sort I have been describing was individually rational during the bubble. But it was collectively irrational. In deciding to reduce his savings, a person will not consider the negligible effect of his decision on the economy as a whole, any more than a banker will in deciding how high to crank up the leverage in his bank's capital structure. Rational indifference to the indirect consequences of one's business and consumption behavior is the reason the government has a duty, in regulating financial behavior, to do more than prevent fraud, theft, and other infringements of property and contract rights . . . . Without stronger financial regulation than that, the rational

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6 *Id.* at 90-91.

7 *Id.* at 100.

8 *Id.* at 107.

> behavior of law-abiding financiers and consumers can precipitate an economic disaster."[9]

Thus, Judge Posner ends with a need for effective government regulation. That is where I want to begin.

Market competition drives firms and the people who run them to respond to market incentives. Firms and executives who don't are driven out. The criminal law, of course, creates its own powerful incentive or deterrent; and it is intended to be a counterforce to contrary market incentives that would lead firms to decrease costs or increase revenues by cheating in any of the ways prohibited by the criminal law.

The criminal law is an effective incentive and deterrent, however, only when certain conditions are satisfied – (i) that it is reasonably clear what the law prohibits, (ii) that it is reasonably likely that violations will come to the attention of the relevant enforcement agency, and (iii) that it is reasonably likely that the agency will take enforcement action adequate to deter future violations. Failure of the government to satisfy all three of these conditions leads to a weakening of the criminal-law incentive in two ways. First, each particular firm will be less deterred if the conditions are not satisfied. Second, each firm will calculate that its competitors are less deterred, and particular firms may learn that their undeterred competitors are engaging in conduct of questionable lawfulness. Market forces will then

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[9] *Id.* at 106-07.

further weaken the already weakened deterrent effect of the law on each particular firm.

A further word on the first condition: if the law's prohibition is unclear, then even Weberian bureaucratic regularity cannot perform its usual norm-implementing function. If the law is unclear, company lawyers can't write for the operating units opinion memos that clearly distinguish permitted from prohibited conduct. Commonly, the lawyers can define a probably safe harbor – but the safety of a harbor may be obtained only at the cost of losing some lawful profits obtainable at some risk of later being held to have violated the law. A particular company's willingness to take such a risk may depend on the size of the foregone profits, on the company's need for them, and on the overall strength of the pressure of market forces on the company. A ship that stays in a safe harbor doesn't bring home the treasure that might be found by sailing into the open sea.

My thesis is that the sudden appearance of industry-wide socially undesirable conduct usually results from some significant change in marketplace incentives in circumstances where one or more of the three conditions for effective legal deterrence is not satisfied. Often, the change in incentives is an unintended and unforeseen result of a change in a statute or other government policy.

Thus, the savings-and-loan scandal resulted from an inflation-driven increase in government insurance of accounts in S&Ls, decreased

regulation, and increased opportunities and incentives for self-dealing by industry executives that was risky for the S&Ls.

The crude-oil reseller scandal resulted from vast new opportunities for profit from fraudulently re-classifying so-called "old" oil as so-called "new" oil in circumstances where it was thought that detection was unlikely. The distinction between "old" and "new" oil was a part of federal efforts to create incentives for discovery of new domestic sources of oil. Those efforts were a governmental response to the oil embargoes of the 1970s.

The generic drug scandal resulted from an incentive structure for generic manufacturers that was created by the Hatch-Waxman Amendments of 1984. The amendments offered to the first submitter of an apparently adequate ANDA that challenged a patent on a pioneer drug a reward worth possibly tens or even hundreds of millions of dollars. Thereby, the amendments created an enormous incentive for fraudulent efforts to be first, in circumstances where, again, it was thought that the fraud was unlikely to be detected.

These are examples of poor-quality law-making and or poor-quality administration of the law by the federal government. Sub-par governmental performance does not excuse out-and-out fraud. Successful prosecutions, however, are not a sufficient remedy, and are not always an appropriate remedy, for poor-quality law-making or law-administration. Crime, even when detected and punished, is socially harmful and

undesirable; and a major part of the responsibility for sudden outbreaks of industry-wide crime or otherwise socially undesirable behavior rests with those who make and those who administer the law. They should learn from their mistakes.

For example, the law governing speech by FDA-regulated companies about their products is, in some important respects, unclear. It is unclear because FDA has never adequately taken account of the First Amendment, and because neither the Federal Food, Drug, and Cosmetic Act, nor FDA's regulations, nor its guidance documents and other issuances define with adequate precision the types of speech intended to be prohibited. Of course, some prohibitions are clear, and therefore fairly enforceable; but, in part to maintain its enforcement discretion, FDA has been unwilling, or perhaps it is simply unable, to delineate other speech-related prohibitions with precision.

The result is that, in the generally highly competitive food, drug, and medical device industries FDA regulates, market forces drive companies to venture out of safe harbors in order to maintain their competitiveness; and the investigations follow. Where a supposed violation is not outright fraud, but, rather, a violation of an unclear regulatory standard, an enforcement action is fundamentally unfair.

In regulated markets, such as those for foods, drugs, and medical devices, only the government can provide the three conditions

necessary for effective deterrence. Therefore, it is the government's responsibility to make sure that those conditions are in fact present. If they are not, competition is distorted, as questionable conduct by some companies forces others to face the choice between engaging in such conduct and losing market share.

Our legal system entrusts prosecutors with broad discretion as to the cases they bring. Where the three conditions are present, enforcement should be vigorous. Where they are not, however, the exercise of prosecutorial discretion should reflect that circumstance. Beyond the constitutional constraint against criminal enforcement of vague legal standards, especially where speech is involved, law-enforcement officials should also be sensitive to the unfairness of bringing cases where some deficiency in the governing legal regime has allowed market forces to penalize companies that don't respond to questionable conduct by their competitors.

Where the conditions are not satisfied, the government, in selecting cases for enforcement, should apply a more rigorous standard than the one it applies where the conditions are satisfied. It should bring an enforcement action only where the conduct is *malum in se* – inherently wrongful, inherently harmful to a value that any reasonable elaboration of the law would protect against such harm.

And, of course, in regulated markets where the three conditions are not present, it is the responsibility of the regulatory agency to make them present. Regulated markets can function properly and provide the full benefits that society expects from them only when the set of incentives that firms in the market face drive them to lawful, rather than unlawful, activity. Just as economic crises are caused not only by financial firms but also by governments, so, too, crimes are caused not only by criminals, but also by governments.