One of the chief defining characteristics of large businesses is the separation of ownership and control. In the public corporation, for example, the firm’s nominal owners, the shareholders, exercise virtually no control over either day-to-day operations or long-term policy. Instead, control is vested in the hands of professional managers, who typically own only a small portion of the firm’s shares.

This “separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, as Professors Berle and Means observed in The Modern Corporation and Private Property (1932).

Economists Michael Jensen and William Meckling coined the term agency costs to refer to the consequences of Berle and Means’ divergences. Jensen and Meckling defined these costs as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. In turn, shirking includes any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.

A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor’s optimal trade-off between labor and leisure is, by definition, the same as the firm’s optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: The principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. Corporate governance traditionally addressed this problem through a mixture of carrots and sticks, such as stock options to align manager and shareholder interests and fiduciary duty law to punish managers who shirk.

Economic theory tells us that actors are deterred when the expected punishment exceeds the expected benefits of committing the crime. In turn, the expected punishment is determined by multiplying the nominal sanction (the penalty imposed if convicted) times the probability of being caught.

The problem is that business decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly. If prosecutors, judges, and juries are unable to distinguish between competent risk taking and criminal mismanagement, however, high nominal sanctions may do more than just deter wrongdoing—they may discourage honest managers from taking risks.

Yet, risk-taking is precisely what shareholders want managers to do. As the corporation’s residual claimants, shareholders do not get paid until all other claims on the corporation are satisfied. Because risk and return are positively correlated, the high returns on corporate investment necessary to leave something for the shareholders require high risks.
In *Trapped*, John Hasnas contributes to the growing understanding of this problem with a carefully documented analysis of how the federal government has increasingly criminalized agency costs. Hasnas identifies three broad categories of legal changes that make corporate governance a matter of concern for white collar criminal prosecutions rather than the civil law.

First, an emerging class of crimes for which liability can be imposed on the enterprise itself rather than individuals. As Hasnas demonstrates, such crimes are significantly easier to prosecute than charges against individuals because firms lack many of the constitutional safeguards that protect individual rights.

Second, Congress adopted new criminal laws designed to make it easier for prosecutors to bring white collar cases. Some of these laws created offenses whose elements were easier to prove than their traditional equivalents. For example, criminal fraud is much easier to establish under the federal mail and wire fraud statutes than under traditional criminal law statutes. In other cases, Congress created crimes with lower *mens rea* (criminal intent) requirements than their traditional counterparts. Finally, Congress created secondary offenses on which prosecutors may fall back when they are unable to prove the principal charges against a corporate defendant. Perhaps the best known recent example was the prosecution of Martha Stewart not for insider trading but rather for obstructing justice.

Third, the federal sentencing guidelines create incentives for corporate defendants to self-incriminate by turning over to prosecutors results of internal investigations. The guidelines also encourage corporations to set up ongoing mechanisms for self-incrimination by creating internal law compliance programs. Finally, they also encourage corporate defendants to waive rights that might protect individual employees, as where the corporation waives attorney-client privilege so that corporate counsel may testify against employees who may have confided in the counsel.

Taken together, these trends have significantly increased the probability of criminal conviction when corporate entities or their managers are indicted for white collar crimes. These trends have also inflated the nominal sanctions associated with corporate governance defalcations, by applying criminal sanctions to behavior that traditionally would have brought only exposure to civil suits.

As noted, if we were confident in the ability of prosecutors, judges, and juries to distinguish between malfeasance and misfeasance, this trend might be a matter of little concern. If managers and directors worry that a jury with the benefit of hindsight might conclude that a risky decision that turned out badly was “too risky,” however, the increased sanctions that have followed upon the criminalization of agency costs is likely to deter not just criminality but also risk taking.

In *Trapped*, Hasnas persuasively argues that criminalizing agency costs not only discourages risk taking, but may also induce organizations and managers to behave unethically. Using a series of plausible case studies, Hasnas identifies situations in which the ethical business decision would expose both the corporate employer and the decision maker to significant liability risk. Avoiding enterprise liability, for example, may require corpora-
tions and top management “to violate their employees’ privacy in ways that conflict with the organization’s ethical obligations not to do so” (66). Indeed, in each of Hasnas’ case studies, it turns out that the option that is least attractive from an ethical perspective is also the most attractive from a perspective emphasizing avoidance of legal liability.

Ethical business strives to do well while doing good. John Hasnas has made a very important contribution by showing that the criminalization of agency costs is making it harder not only for business to do well but also to do good.

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