

## SELF-CONTROL ENGINEERING

*Manuel A. Utset\**

Professor Miriam Baer’s article, *Confronting the Two Faces of Corporate Fraud*, is an important contribution to the growing literature on self-control problems and criminal misconduct.<sup>1</sup> Professor Baer is concerned with both time-consistent (TC) and time-inconsistent (TI) misconduct.<sup>2</sup> An actor engages in TC misconduct when, from a long-term perspective (time  $t$ ), it concludes that engaging in misconduct (to “disobey”) at time  $t + 1$  will yield an expected benefit that is greater than the expected costs, and at time  $t + 1$ , it follows through, as planned.<sup>3</sup> An actor engages in TI misconduct when, from a long-term perspective, it concludes that it is better off forgoing misconduct (to “obey”) at time  $t + 1$ , but when that period arrives and it is faced with the opportunity to engage in misconduct, it reverses its long-term intentions and disobeys.<sup>4</sup> This reversal, moreover, occurs not because the actor has acquired new information regarding the costs and benefits of misconduct, but because disobeying yields immediate gratification<sup>5</sup>—for example, a crime provides an immediate return—and the attendant costs, such as criminal sanctions, are delayed.

A “sufficiently rational” TI actor will try to predict its future willpower and take prophylactic actions, such as adopting a commitment device.<sup>6</sup> But such a forward-looking TI actor may mispredict its future propensity to yield to the pull of immediate gratification, and either fail to pre-commit or adopt under-detering commitment devices. TI actors therefore may engage in misconduct even though doing so makes them worse off—as compared to the ideal TC actors. Society has an interest in deterring TI misconduct, since it leads to a decrease in aggregate social welfare. In other words, the benefit received by the offender is less than the harm it produces.

A necessary condition for both TC and TI misconduct is that an actor has the *opportunity* to engage in misconduct. One way to effectively deter TC and TI actors is to completely remove the opportunity to engage in

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\* William & Catherine VanDerCreek Professor and Associate Dean for Academic Affairs, Florida State University College of Law.

1. Miriam H. Baer, *Confronting the Two Faces of Corporate Fraud*, 66 FLA. L. REV. 87 (2014).

2. *Id.* at 89–90.

3. *See, e.g., id.* at 88–89 (describing how Bernard Madoff “adhere[d] to and carrie[d] out his maleficent plans.”).

4. *See, e.g., id.* at 88 (describing how a corporate manager might falsify records to show effort in implementing a good faith plan).

5. *Id.* at 90.

6. *Id.* at 91.

misconduct. If the costs of identifying future misconduct opportunities or of removing them from the set of available options is sufficiently high, then an actor will have the ability to engage in opportunistic behavior. One of the important contributions of Professor Baer's article is its careful analysis of opportunistic misconduct, particularly in contexts in which actors may have TC preferences or varying degrees of preference for immediate gratification.<sup>7</sup> A second contribution is its analysis of the costs and benefits of various mechanisms for deterring TC and TI opportunistic behavior.<sup>8</sup>

The standard analysis of opportunistic behavior starts by adopting two behavioral assumptions—that transacting parties have bounded rationality and are guilefully self-interested—and that the transaction costs of identifying and fully deterring opportunism will, in most instances, exceed the benefits of doing so. To the extent that the goal is to maximize aggregate social welfare, contracting parties and lawmakers should pay close attention to the relative costs of the different mechanisms for dealing with opportunistic behavior. The task of designing and implementing more effective and efficient governance mechanisms to deal with potential opportunism can be labeled “transaction cost engineering.”<sup>9</sup> While this summary is an oversimplification of a the general theory developed by Coase, Williamson, Hart and Moore, and others, it helps bring to the foreground the interesting way that Professor Baer approaches the problem of opportunistic behavior by corporate actors.<sup>10</sup>

First, Professor Baer adds an additional behavioral assumption: the fact that actors may have varying degrees of TI preferences.<sup>11</sup> Second, Professor Baer underlines the importance of combining standard transaction cost engineering with what I will call “self-control engineering.” The latter involves the design and implementation of effective and efficient mechanisms to deal with TI opportunistic behavior. Her biggest contribution in this article is her insightful comparison and analysis of policing and corporate-architecture

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7. See *id.* at 98–102 (analyzing opportunistic misconduct among agents).

8. See *id.* at 125–40 (describing enforcement strategies for reducing fraud).

9. See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 255 (1984).

10. See generally Elizabeth Hoffman & Matthew L. Spitzer, *The Coase Theorem: Some Experiment Tests*, 25 *J.L. & ECON.* 73 (1982); Oliver Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 *J. OF POL. ECON.* 1119 (1990).

11. Baer, *supra* note 1, at 94–102; In the present article, Professor Baer does not focus on the problem of bounded rationality. For a discussion of bounded rationality and TI preferences, see Ted O'Donoghue & Matthew Rabin, *Self-Awareness and Self-Control*, in *TIME AND DECISION: ECONOMIC AND PSYCHOLOGICAL PERSPECTIVES ON INTERTEMPORAL CHOICE* 217, 236–38 (George Loewenstein et al. eds., 2003).

approaches to self-control engineering. Professor Baer's article, both by what it addresses and by the issues and problems it identifies, makes clear that in order to effectively deal with misconduct by corporate actors, it is necessary to take into account the transaction cost and self-control sources of opportunistic behavior.

Professor Baer's article opens a number of potential avenues for future research. An important area involves the interaction of complexity and self-control problems. Public corporations in many industries are highly complex not just due to their size, but also to the nature of their balance sheets and the financial instruments they use in the regular course of business. As the level of complexity increases, so do the transaction costs and potential for TI misconduct. For example, complexity increased the immediate costs of identifying future opportunism and designing effective governance mechanisms; as a result, complexity increases the likelihood that TI actors will procrastinate dealing with the risks of future opportunism. More generally, the more complex the transactional environment, the more likely that parties will leave their contracts incomplete, not due to standard transaction cost rationales, but due to the parties' repeatedly procrastinating making their contracts more complete.<sup>12</sup>

In order to deter TI misconduct in complex environments, it is best to directly address the link between complexity and time-inconsistency. The policing approach, by itself, requires adding additional parties to engage in monitoring and screening. It also requires a greater number of interactions: in addition to the interactions between principals and agent, one adds an additional layer, in which the monitors interact with both parties. As the number of parties and interactions increase, so do the overall complexity.

A better way to address the complexity problem is through the architectural approach described by Professor Baer. Under this approach, one would manage the complexity problem by re-engineer the organization. One possible approach is to divide an organization into self-contained modules, and clearly define when and how these modules interact. One can then reintroduce the policing approach but at the more abstract level of interacting modules. For example, under the standard approach of deterring corporate misconduct, the state may impose sanctions at the entity level—the module encapsulating all other parts of the corporation—or on executives engaged in misconduct. Each of these approaches has well-known limitations, even when one is dealing with fully rational actors with perfect self-control. When one introduces TI corporate actors, the standard problems become even more pronounced.

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12. See Manuel A. Utset, *A Theory of Self-Control Problems and Incomplete Contracting: The Case of Shareholder Contracts*, 2003 UTAH L. REV. 1329, 1335–36.

Under the modular approach one makes parts of a complex system less transparent, by hiding interactions and information within modules. While this makes the corporation less transparent, at the entity level, it allows for better deterrence of TI actors. One can extend this modular approach by dividing each module into a set of interacting modules, and so on, until one reaches the individuals whose collective behavior lead to the corporation “acting” in one way or another.

Professor Baer’s project helps underline the importance of analyzing the self-control engineering problem across different types of industries. Parties who are identified as potential opportunists may find it worthwhile to offer to enter into contractual mechanisms that will increase the future costs of opportunism (or that completely forecloses it). But by symmetry, the same argument applies to situations in which TI parties are sufficiently aware of their self-control problems: They may offer to enter into contractual mechanisms whose sole aim is to deter TI opportunism. More generally, one would expect that corporate contracts will include provisions to deter both TC and TI opportunism, and that in the latter case, a party may agree to enter into such a provision even if the other side finds no value in it. For example, a manager may engage in TI misconduct that exposes her to criminal sanction, but which does not otherwise hurt shareholders or other corporate constituencies. Such a manager may see value in contract-based commitment devices that will deter her future self from engaging in TI opportunistic behavior.

Professor Baer’s article is an important contribution to the literature on corporate misconduct and the extent to which the self-control problems of corporate actors can make it increasingly difficult to effectively deter corporations. Her analysis of the distinction between the policing and architectural approaches, by itself, will help further our understanding of the social costs associated when policymakers, corporate gatekeepers, and shareholders assume that managers and board members have perfect self-control.