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OPENING THE BLACK BOX OF "CORPORATE CULTURE" IN LAW & ECONOMICS

by

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Opening the Black Box of "Corporate Culture" in Law and Economics

by

DONALD C. LANGEVOORT

ABSTRACT: In contrast to the sociological literature, conventional economic analysis of organizational behavior in the face of legal incentives has largely ignored the concept of "corporate culture." Building on the small, emerging work in economics that does take culture seriously as well as contributions from sociology and social psychology, this paper suggests that the emergence of belief systems that determine what is paid attention to and what is ignored has an important effect on compliance with law under conditions of ambiguity and will itself be a function of the competitive conditions that the firm faces – the more competitive the pressures, the more robust and powerful the culture necessary to facilitate productive activity. In other words, corporate culture as a coordinating device operates most powerfully when the firm has a strong incentive to be focused in its behavior in order to survive or prosper. Illustrations of the relevance of this to legal analysis are taken from environmental law, equal employment law and corporate/securities law.

JEL CLASSIFICATIONS: K22, K42

1 Introduction

Theory-based legal scholars have had difficulty finding a comfortable place for "corporate culture" in legal analysis. Public policy advocates frequently point to dysfunctional corporate cultures as a major factor in many examples of wrongdoing, and so treat the development of healthy, ethical cultures as essential. Yet it is far from clear what this means, or what legal interventions or incentives might make a significant difference in cultural terms.

For academics, the problem is partly one of interdisciplinary divergence. The organizational behavior genre grounded in sociology and social psychology, from which many legal and business scholars have long drawn (see Stone 1975; Vaughn 1982), makes culture a foundational building block. Culture is the subject of extensive investigation, typically on the assumption that it has determinative influence but differs considerably from firm to firm (Martin 1992; Schein 1985). Under this approach, the potential legal significance of corporate cultures seems self-evident, and a rich socio-legal literature focusing on the organization has emerged in recent decades (see Edelman & Suchman (1997) and Sitkin & Bies (1994) for useful reviews).

By contrast, economics-oriented legal scholarship has largely looked in other directions to understand behavior inside the firm. In fact, the older strand of law and economics largely disregarded any distinction between the behavior of the firm and the behavior of individuals, assuming that the firm will respond to legal incentives much the same way as any rational actor. That assumption is no longer all that commonplace, however: agency cost theories have amply demonstrated the ways in which the interests of the firm's agents diverge from the firm's own interest, and the difficulties encountered by the various strategies (e.g., corporate governance, incentive contracting) that seek to align them (Cohen & Alexander 1999). Hence, for example, legal scholars have debated whether the right response to the agency cost problem is a focus on enterprise liability, so as to create the incentive for the firm and its shareholders to find the right solutions to the problem of internal control, or whether the effort should instead be to individual agents the primary focus of legal directives (e.g., Arlen & Kraakman 1997). Within this debate, however, culture has still played no significant role: agents are assumed to respond rationally (and opportunistically) to an exogenous set of incentives in order to maximize their individual utility. The sociologists' anti-functionalist obsession with culture has largely been pushed aside as fuzzy and under-theorized. The result is two distinct genres of legal scholarship on the behavior of the firm in the shadow of the law (which Edelman and Suchman (1997) term materialist and culturalist perspectives, respectively), each suspicious of the others' methodological assumptions and hence reluctant to engage in much common conversation.[1]

My effort here will be to make the case for common ground and a particular direction for interdisciplinary convergence that should interest those working in law and economics. Although a non-functionalist approach to institutions such as culture is indeed strong in much of sociology, some scholars – especially in the business management literature – have sought to link culture with incentives. My article starts by examining two related research programs in economics that address, explicitly or implicitly, corporate culture, and a handful of places where legal scholars have begun to make use of these insights. Building from this,

[1] Even behavioral economics, which otherwise embraces cognitive and social psychology, has largely ignored organizational cultures in favor of emphasis on individual judgment and decision-making. See Dibadj (2004).

I suggest a number of ways to think about corporate culture that are consistent with economists' reasonable insistence that social forces inside the profit-seeking firm are unlikely to be of much interest unless they demonstrate a high level of competitive fitness – that is, are an adaptive response to external incentives in those settings where uncompetitive firms risk being weeded out and the competitive thrive. I will then turn briefly to illustrate the potential payoffs from this approach by looking at legal topics such as environmental protection, equal employment opportunity and corporate/securities law.

2 Defining Corporate Culture

One of the main objections to invoking corporate culture in rigorous legal analysis is that there is no clear definition of corporate culture. Ultimately, organizations are collections of individuals, who bring their own particular knowledge, preferences, and cognitive habits to work. Much socialization has occurred before any given person becomes part of the firm, and the boundaries between work and other spaces occupied by that person are blurred so that other cultural influences will constantly compete with corporate culture, even at work. Moreover, within any given firm there will be many different cultures that can emerge – some firm-wide, others much more local (within individual units or among teams of people). These, too, will often be in tension, and any useful theory of corporate culture will have to take account of the resulting pluralism.

As scholars working in the related subject of “norms” analysis have long noted, the simple observation that many firm employees behave similarly is not by itself evidence of "culture" as a particularly distinctive or interesting phenomenon. Obviously, we can expect employees facing similar incentives to respond similarly in a given situation without needing to resort to any theory of cultural influences. It is also important not to confuse corporate culture with the process of information flow and discovery with the firm. Information is diffused, so that the process of learning is difficult, and employees must piece together bits of information in their possession with cues from others. Learning, then, is a collective process, and the structure, norms and habits of those in the firm will influence how (and how well) learning occurs. While this learning process may be the product of the one or more cultures inside the firm, it is not by itself what we usually mean when we refer to a firm's culture.

The definitional dilemma is further apparent when we consider how often corporate cultures are seen as a top-down phenomenon, with the "tone at the top" setting the normative standards inside the firm. It is certainly true that senior managers can design compensation systems, hiring and promotion rules and workplace environments that favor some behaviors or outcomes over others. Here again, however, there is nothing particularly "cultural" simply because such designs lead to common patterns of behavior.

To be distinctive, corporate culture should have a strong normative effect – defining for agents of the firm what is right or valuable apart from the simple economic exchange underlying the employment relationship. As we shall see, the emerging literature in economics usefully treats culture as a coordination device. It is a set of common understandings that facilitates productive activity by reducing transaction costs in the endless set of interactions that occur among agents of the firm: that is, a solution to a complex collective action problem. If so, then culture has a broad scope that includes customs and conventions, which may become engrained as path dependencies emerge. But customs and conventions often have little in the way of normative weight; indeed, they can just as easily be seen as bad habits that are hard to break. Corporate culture has more bite when it describes shared belief systems that identify certain perceptions and behaviors as legitimate and authoritative, the "right" things to think and do. The strongest expressions of culture are those that are internalized by the agent and become part of his or her identity (Akerlof & Kranton 2005), removing the distractions of conflict and doubt that can otherwise burden productive activity. In this sense, culture plays its most distinctive role when it alters the utility preferences of the corporate actor, making behavior vis-à-vis the firm, other employees or third-parties a matter of something different from simple calculative self-interest.

2.1 Drawing from the Economics Literature

Two strands in the economics literature have addressed the subject of corporate cultures in a constructive way. The more explicit is a relatively small body of theoretical work on corporate culture, of which a paper by Kreps (1991) is considered seminal. Kreps uses game theory to describe culture as a substitute for contracting inside the firm, in which repeat play provides an opportunity for the development of a set of norms of appropriate behavior. The key insight is that this operates as an efficient solution to the vexing problem of coordination in sizable firms with an interest in maintaining a stable reputation where there are multiple equilibria among possible courses of action. The individual negotiation of such rules is unwieldy; the generation of such norms as a coordinating device permits a large, flexible body of "taken for granted" assumptions that is stored and administered informally, but powerfully. Others have taken up on this coordination idea. Cremer (1993), for example, emphasizes the need to economize on communication and hence the role of common language in generating coordinated activity. In a recent review of the corporate culture literature in economics, Hermalin (2001) extends these ideas to other often-observed practices in organizations, such as norms of fair play and the mechanisms that underlie effective leadership. Sorensen (2002) links strong cultures with reliability, which is valuable in the marketplace, and Van den Steen (2004b, 2005) has constructed a model of corporate culture that generates strong internal homogeneity through both sorting and learning: strong leaders choose followers who share their views, and the shared learning that follows strengthens that effect.[2]

This literature provides us with a good base for a plausible theory of corporate culture for legal analysis, one that is congruent with much of what sociologists have said as well. First, culture plays a simplifying role, identifying perceptions and behavior that need not constantly be negotiated in the endless interactions among agents of the firm. Absent a strong mechanism for determining what can be taken for granted, far less productive work would get done in the firm. Second, such cultures potentially add value, and should be seen as a counterweight to, not necessarily a manifestation of, group-level agency costs. This productive image of corporate cultures and norms has caught the attention of some legal scholars. In a well-known article, for example, Cooter and Eisenberg (2001) argue that firm-specific fairness norms are crucial to firm efficiency because they can be internalized by agents and thereby offer a stable platform for the cooperative (rather than opportunistic) behavior necessary for the firm to be productive.

A second helpful strand of economics literature is a much larger one that often addresses corporate culture implicitly rather than explicitly. Extending back to classic works by Herbert Simon, Kenneth Arrow and James March, work on the economics of organizations has emphasized the informational barriers that make rational collective action difficult. Knowledge of the prevailing situation and appreciation of the foreseeable consequences of various actions are diffused among many people and subject to multiple interpretations. Ambiguity, in other words, is a common problem in organizational life, and must be resolved if the firm is to be productive. In the decades since, scholars have generated numerous insights about how firms respond to and manage uncertainty – the heuristics employed, the perceptions invoked (e.g., Feldman & March 1981; March 1994; Gibbons 1997, 2003). The important move here is the emphasis on the cognitive dimension to the coordination problem. What must be coordinated is not only the process of interaction among agents but the ways in which agents develop common perceptions of their environment

[2] For other significant contributions in the economics literature, see Rob & Zemsky (2002); Carillo & Gromb (1999); Lazear (1995).

and common understandings about what to pay attention to and what to put off or ignore.[3]

My point here is not to debate disciplinary boundaries or to try to survey the rich "bounded rationality" strand of the organizational economics literature, which of course addresses far more than corporate cultures. Instead, I want to make an argument about the nature of corporate cultures that joins the two strands of thinking just described. One thing missing from many legal accounts of culture is sustained attention to the economist's prime directive: that incentives matter.[4] Seeing culture as a simplifying mechanism to induce more efficient interactions leads naturally to the supposition that the strength and scope of the culture will depend on how important efficiency is (and precisely what the interaction demands are) given the firm's competitive position.

In other words, opening the black box of corporate cultures to aid in legal analysis requires a theory of what kinds of cultures are likely to be adaptive and hence persist in the face of competition, and what kinds are more fragile and unlikely to last. My suggestion is this: The primary role of corporate culture is to operate as a sense-making device (Weick 1995) that simplifies the cognitive tasks within the group or organization, creating a buffer that gives priority to that which facilitates cooperative exchange among agents of the firm over that which is distracting or anxiety producing. Hence, the most adaptive (and strongest) corporate cultures will be those that (a) simplify and focus the group's perceptions, reducing uncertainty rather than adding to it; and (b) motivate the group and its constituents by giving them reason to cooperate and invest firm-specific human capital rather than defect and keep that capital nimble.

Presumably, the process by which this occurs is a form of natural (social) selection,[5] only partly in the control of senior managers. Managers do have the power of hiring and promotion, so that agents with certain traits and preferences to conform (or change) can be selected (Van den Steen 2005). But once in place, I would argue, these traits and preferences become dominated by the situational pressures the agents face, which will thus be a more powerful influence over cultural evolution. Over a large number of interactions, productive activity will occur more easily when certain things are taken as understood rather than negotiated. Those who

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[3] Much of this work, obviously, ties into the judgment and decision-making literature and behavioral economics. And from there, there is a seamless transition to the management studies literature in which social psychology and sociology are the more dominant social science traditions. Simon, Arrow and March are influential there, too.

[4] For a prominent sociologist's point that "competitive cultures" can produce unlawful behavior, see Coleman (1987, pp. 420-23). This point is also emphasized in Vaughn (1998).

[5] Lazear (1995) offers a evolutionary model of the development of corporate cultures.

take behave accordingly will be sought out and favored – they will be "grease" in a high-velocity environment (Langevoort 2004b). Those who resist or contest the common assumptions are "grit," and disfavored. Over time, this selection process produces a culture that makes sense of the environment by simplifying it and narrowing the issues that deserve attention.

If this is right, then there is a natural fit with conventional economics. The sense-making is tested against the competitive conditions the firm and its agents face, and evolves in response to those conditions. Take, for example, a firm that faces severe competition and a high risk of failure. Culture is likely to be important here because distraction and doubt can be lethal. Moreover, the group has a strong incentive toward cohesion in order to survive. As the competitive environment softens, on the other hand, we would expect less potent cultures to emerge – or for cultures inside the firm to be more localized and protective of the collective interests of the agents themselves (e.g., a culture of bureaucratic slack). Or, as many sociologists suggest (e.g., Edelman & Suchman 1997), such organizations simply take on the cultural norms of the larger society.

To be sure, that is an abstract formulation. The remainder of the paper will seek to provide more specificity. For now let me simply provide an example that illustrates the point and provides an important corollary – that it is not essential that the cognitive work done by adaptive corporate cultures be entirely accurate or realistic. Indeed, moderate illusions can be more adaptive than the truth in generating productive behaviors. Assume, for instance, a corporate culture that inflates the group's sense of self-efficacy, instilling the belief that the firm will thrive even against intense competition. Such a belief system will have the following benefits: by framing the future in terms of expected gains rather than feared losses, it will motivate the group toward more trust and cooperation as well as greater energy and persistence.[6] The pie will seem larger, allowing for a greater number of integrative solutions to internal coordination problems. Conversely, the kinds of "final period" temptations that are predictable in the face of loss, which generate selfish behaviors, are put out of the collective mind. And these benefits will come even if – and in many ways *because* – the cultural perceptions are (moderately) unrealistic (Langevoort 1997, 2004b). The contribution of the Simon-March *et al*. genre is that it invites us to see that in the face of extensive ambiguity and uncertainty, corporate cultures are free to evolve in the direction of productive sense-making rather than Bayesean accuracy. Reality is simply too complex.

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[6] This, of course, mimics the same function played by optimism and self-efficacy at the individual level. See, e.g., Van den Steen (2004a).

We can identify other manifestations of corporate culture that are likely to be particularly robust and adaptive in a competitive marketplace as well. As Akerlof and Kranton (2005) point out in their recent work on this subject, workplace cultures that confer on group members a strong and distinctive sense of identity will produce a level of motivation that may exceed what wages alone would induce, and also generate trust, loyalty and cooperation vis-à-vis those who share that identity. Just as importantly, perhaps, it may produce a heightened level of aggressiveness toward non-members. A firm in a very competitive market might well benefit from an internal culture where strong internal bonds induced via savvy leadership and team-building efforts produce a set of attitudes that not only get the group "pumped up" but also inculcate the sense that competitors (and even customers, perhaps) are opponents in a contest. That will legitimate more aggressive tactics than might otherwise be socially appropriate, which could be a form of competitive adaptation.

This last point is worth stressing, tying into a more general point that will be quite important when we turn to the legal significance of corporate cultures. If the main contribution of the corporate culture is to simplify the process of judgment and decision-making and hence "grease" the interactions among members of the team, its principal aim in a highly competitive atmosphere should be to deflect attention from that which produces doubt and distraction about the main task of the group – presumably, to compete successfully in its market. In many ways, this involves a process of rationalization that justifies paying little or no attention to conflicting demands that have less immediate connection to the bottom line.

2.2 Caution: The Incomplete Influence of Corporate Culture

As noted earlier, one of the obvious difficulties in analyzing corporate culture is the problem of pluralism. Individuals in the firm are subject to many different cultural influences that compete with whatever message the "corporate" culture seeks to convey, and there may in fact be subgroups within the firm with their own unique cultures. We can speculate that the pluralism problem arise most severely in firms where the internal set of interactions among employees is fairly diffuse – group members interact not simply repetitiously with each other in a way that develops what sociologists call "strong ties" but regularly move outside the group for interactions. Where such outside interactions are commonplace, efforts to overcome the problem and maintain a strong internal cultural influence will have to be intense. One would expect, for example, more deliberate efforts at team-building and motivation among sales and marketing personnel than manufacturing groups because of the outside orientation of the former.

A bigger issue to struggle with, however, is the residual relationship between cultural influences and individual self-interest. It may well be in the interest of the firm to generate a strong internal culture of loyalty and cooperation. Yet the hierarchical structure of authority in most firms also means that employees are constantly in competition with each other to search of increases in power and compensation. If the firm's promotion practices are organized in tournament fashion, tournament survivors will have to show competitive fitness at demonstrating superiority over their peers (Chen 2003). One would think that those who internalize too strongly the values of loyalty and cooperation are at a disadvantage vis-à-vis those who have the capacity to adapt to teamwork demands but maintain the nimbleness to defect from the interests of the group when necessary to stand out.

This is a difficulty with the otherwise very insightful analysis of Cooter and Eisenberg, who argue that it is in the interest of the firm to select for and encourage agents with "good firm character," that is, the internalized traits associated with acting cooperatively and fairly within the firm's interest so that this is done reflexively, not opportunistically or simply to cultivate a good reputation. It follows that agents have an incentive to develop such character traits in order to make themselves more attractive for selection and promotion. (Cooter and Eisenberg recognize that this is different from good character generally – firms may prefer to have their agents act fairly inside, while being opportunistic outside.)

The problems are two-fold. First, in emphasizing internal character traits, they probably underestimate the difficulty of dealing with a problem they acknowledge, that the firm may want a person who is honest and fair internally, but able to shift traits when dealing with outsiders. The ability to make such a shift is not likely to come from anything that could be described as a stable trait, because it would seem to require some rationalization. And once we admit that a capacity for moral rationalization is desirable, then the question is whether such persons truly have a stable "good character."

That becomes important once we put firm agents in competition with each other internally. Cooter and Eisenberg are right that visible non-cooperators will be disfavored in the promotion tournament, because it is in the firm's interest to select for those with good agent character. But the advantage would seem to go to those who can appear loyal when the situation demands but subtly defect so as to make themselves look good or their peers look bad. A strongly internalized good agent character is unlikely to leave the moral flexibility necessary for this to occur; if so, the character trait that is competitively fit in the corporation promotion tournament is more Machiavellian in nature (Langevoort 2004b). That requires some reserved cognitive space in which agents resist the firm's cultural influence.

That may be significant in a number of respects of interest to the law. Most significantly, it suggests some diversity in how strongly the firm's culture is internalized among employees, with an unexpected twist. The employees who strongly internalize the fairness and cooperation norms may do much of the important day-to-day work, and do it well precisely because of that internalization. But they are less likely to be promoted than those who are psychologically more nimble. The firm's senior executives, then, may be less likely to possess the officially preferred character traits than their subordinates. In turn, if the senior executives are careless enough so that subordinates come to realize this, the entire system can unravel and more selfish behaviors quickly spread throughout the organization (Hermalin 1998; Trevino 1997).

3 Lessons for Law About Corporate Cultures

As is frequently the case, it is easier to describe a phenomenon such as corporate culture than make confident claims about how the law should take account of these insights. There are two principal directions of inquiry. First, is it possible that a well-established culture could substitute for law, thereby requiring *less* legal intervention (e.g., where norms among managers such as profit maximization make it less necessary to impose a strong duty of care (Rock & Wachter 2001))? Second, will some cultures exacerbate motives or opportunities to violate the law, thereby demanding *more* legal intervention? To these ends, we shall turn to a series of legal subjects to see if there are useful lessons.

An approach to corporate cultures that emphasizes situational incentives must take into account the varying kinds of demands the law imposes. Two dimensions are particularly important. One is the degree of ambiguity in the law itself – the ease of accessibility and interpretation (see Feldman & Levy 1994). The other is the frequency of its reach into the interactions within the firm facilitated by the prevailing culture. While some forms of law (e.g., tax withholding rules) are both simple and frequently encountered, other forms of law are only infrequently encountered and more dimly understood. My prediction is that the latter poses the more interesting interactions between law and corporate culture because the culture's adaptation to the law will be less constrained and more imaginative.

3.1 Environmental Protection

Environmental protection is an important area in which to study firm behavior: firms are the major sources of pollution, and there is a large, diverse literature on the economics of decision-making in firms regarding environmental responsibility. It is also a difficult area to study because business decisions affecting the environment occur at many different places in the organization. There are certainly top-level decisions about environmental compliance, as well as many different places where the aggregate of many different lower-level decisions (e.g., on matters of the maintenance or replacement of aging machinery) determine the firm's level of compliance.

We should avoid overgeneralization, then, and look instead for interesting commonplace patterns of interest. By way of illustration, consider Levy's account of massive waste discharge into Boston Harbor at the Nut Island sewage treatment facility, a state-controlled entity with the explicit mission of pollution control (Levy 2001). The group in question was very close-knit, physically isolated from frequent interactions with non-group members because they worked in a stand-alone facility on a small peninsula in the harbor. Initially, the team performed in a skilled, self-sufficient fashion, which gradually caused senior managers (located elsewhere) to divert attention and resources elsewhere, leading to increased frustration. When problems did occur, the team felt unfairly blamed. In response, then, the team became more inward-directed, increasingly devoted to solving or covering up problems quickly so as to minimize higher-level scrutiny. At Nut Island, this had the effect of taking off the table inquiries into whether short-term fixes were compromising other goals; test data that indicated problems were simply interpreted as unreliable, and increasing amounts of oil designed to lubricate old digester tank pumps was seen as a necessary element of the on-going script even though the oil eventually was released into the harbor.

Though anecdotal, Levy's account nicely illustrates the adaptivity of "cultural" group cognitive processes. The team was not subject to strong competitive pressures; the dominant incentive was to keep the plant running with minimal contact with senior managers, and the belief system evolved to justify and rationalize behaviors that facilitated interactions among team members rather than make them more difficult. It illustrates a general point: adaptive cultures are likely to favor the immediate to the remote, the more likely to the less. For the most part, regulatory and compliance issues tend to involve second and third level effects removed from the primary set of incentives, and so become culturally disfavored because taking account of them complicates and burdens otherwise productive interactions within the group.

There is also a point about normative rationalization. Groups work hard to justify to themselves that what is efficient is also right – conflict in that dimension is particularly disabling. One common form of resistance to external demands (such as regulatory compliance) is to neutralize it by doubting its legitimacy: the Nut Island group, for example, could well have rationalized taking some environmental risks by stressing the unfairness of being given too few resources to carry out their primary task and then being asked also to accommodate strict environmental demands. Spence's study of environmental compliance argues that a large amount of noncompliance is in response to the excessive complexity of the regulatory demands (Spence 2001). The time and effort necessary to respond in a high-stress setting is interpreted as unfair, which diminishes the legitimacy of the demands and produces a lower rate of compliance. I would add that such group perceptions are likely to be self-serving: in fact, the complexity may be perfectly legitimate (necessary in light of the problems being addressed), but construing it as illegitimate may be a way of preserving internal coherence and, hence, near-term efficiency.

In this light, we can also understand better the costs and benefits of the kinds of interventions that the law might use to overcome the cultural resistance to environmental regulatory demands. Spence, for example, recommends greater reliance on negotiated rulemaking and other open processes designed to give greater legitimacy to those demands. The question, however, is whether effective communication of legitimacy will be transmitted deeply enough into the organization to have its desired effect, which might not be so if the group involved in the negotiation is in headquarters and the group carry out the tasks are elsewhere. Moreover, an internal culture dominated by self-serving inferences may require too much compromise of external societal interests to have any effect, compromise that regulators may rightly be unwilling to make.

An alternative way of responding to cultural resistance is through more aggressive monitoring and information gathering (e.g., Malloy 2003). Here, again, the cost/benefit tradeoffs are crucial. Merely asking subordinates to "report up" will not counter tendencies to skew the reports to conform to the cultural norms; instead, influence activity remains foreseeable. Some audit process skeptical of those motives and norms would be necessary, and as Akerlof and Kranton (among others) have pointed out, intrusive monitoring has its own costs in terms of threatening group identity and diminishing the forms of cooperative behavior that flourish when there is a greater feeling of autonomy. None of this is to suggest that such interventions may not be necessary in some instances, but we should not underestimate the costs or challenges associated with making the interventions successful.

3.2 Discrimination

"Cultures" are often blamed when firms violate legal rules relating to equal employment opportunity in hiring, promotion and hostile workplace environments. The interesting question, long debated in the legal literature, is why such practices (or supportive cultures) persist in the face of significant legal threats and the widely recognized competitive need to attract a diverse, skilled workforce.

One answer may well be that such cultures – though surely illegitimate and self-serving manifestation of agency cost problems in one sense -- also have significant efficiency benefits that make it costly, especially in the short run, for senior management to contest (Carbado & Gulati 2003). Commonalities in language, preferences and habits "grease" the sorts of interactions necessary in a high-velocity firm – communication and trust are thereby facilitated. Although research shows that these efficiency benefits diminish in the face of careful, persistent efforts at diversity, the costs associated with transition may still be such that old cultures remain unchallenged except when there is a compelling competitive reason otherwise.

As in the environmental field, a number of legal scholars in the "new institutional governance" genre have given thought to the best ways to engage sticky corporate cultures in order to promote equal opportunity. For example, Sturm (2001) examines successful diversity initiatives at such firms as Deloitte & Touche, Home Depot and Intel and finds that they exhibit consistent patterns of (a) strong and vocal leadership from senior management to support the legitimacy of pro-diversity reform; (b) patterns of interaction with all employees so that reforms are designed cooperatively rather than by fiat; and (c) careful data gathering so that pockets of resistance are made transparent. Though her sample is small and perhaps underestimates the difficulties of implementation more generally, her observations are consistent with the idea that legal interventions have to go beyond "command and control" threats and deal with issues of legitimacy and opaqueness – features common to adaptive cultures inside firms.

3.3 Corporate Governance

The recent corporate scandals in the U.S. (Enron, Worldcom), Europe (Royal Ahold, Parmalat) and elsewhere have focused much attention on particular corporate cultures that may have permitted illegal behavior to become systemic (Dallas 2003). In the United States' scandals, at least, one interesting feature is that so many of the firms caught up in fraudulent misreporting were in technology-based markets characterized by intense competition and the expectation that only a handful of firms would likely survive the current period of innovation, consolidation and shake-out (Langevoort 2004a). That fits neatly into a theory of corporate cultures in which cultures adapt to competitive conditions by eliminating distractions and doubts so as to facilitate efficient high-velocity interactions among agents – the more intense the external competition, the more the protective cultural shell hardens to rationalize the activities (including the taking of significant legal and moral risks) needed to compete and survive, rather than become mired in doubt and debate.

For instance, anecdotal reports suggest that Enron's culture was heavily premised on the sense that technology-based changes in energy and related markets were such that "the rules had changed" in terms of how markets were structured and that the firm was involved in changing those rules in a "win-win" way for Enron's employees, investors and the American economy. That belief facilitated financial misreporting in a number of respects: old-style accounting rules (generally accepted accounting principles) were from a prior industrial era and hence artificial and illegitimate; only the fit would survive the transition, so that the whole truth needed to be concealed from competitors as well as others (regulators, suppliers of debt capital) who had not yet come to understand the market transition that was going on and might therefore resist innovation. As Michael Jensen has recently pointed out, agents of the firm can then easily become captives of the marketplace illusions they create (Jensen 2004).

Many interesting legal insights follow from this characterization. First, culture as "sense-making" raises the possibility that those embedded in the culture of the time will now become aware of information, risks, etc. that might be more clear to an external observer, not to mention one making judgments in hindsight. If so, then any legal standard that assigns liability based on a showing of actual knowledge or appreciation may not reach such corporate actors. To be sure, the legal system may assign blame anyway given the difficulties that judges and jurors might have imagining the culture from the inside – but that would be a de facto restatement of the law, risking inconsistent application and (perhaps) some element of scapegoating.

One notable feature of the Sarbanes-Oxley Act of 2002, the U.S. Congress' response to the scandals, poses an interesting question. Presumably sensing the cultural influences that can create internal rationalizations and other forms of silencing, Congress insisted that public corporations design, implement and regularly test and evaluate systems of internal reporting and disclosure controls designed to assure high quality information flow from all facets of the business up to the key participants in the disclosure process – including the outside directors who make up the audit committee, who are (by law) formally independent of management. Various other external participants (i.e., those not culturally embedded in the firm) such as outside lawyers and independent auditors were then given specific legal responsibility to act as the eyes and ears of the audit committee and the board (see Hazard & Rock 2004). The same strategy has been employed in other areas as well, including the response to the mutual fund scandals arising out of late trading and market timing activities.

There are obvious questions about the efficacy of such strategies, both cultural and more conventionally economic. Outsiders such as directors, lawyers and auditors have their own cultures (and conflicts of interest), such that the direction and power of their incentives might be less clear than imagined, especially if the law is not aggressively enforced. That aside, however, there is an intriguing problem in assessing the likely costs and benefits of a step-up in external monitoring to overcome cultural and other obstacles. The direct costs of such increasing monitoring – where in the U.S. there is now a double layer to internal controls, with management required to implement a system, and then the auditors investigate and attest to management's efforts – have received ample attention. Other costs, however, are more hidden. What if the monitoring succeeds in breaking through the cultural resistance to oversight, requiring a new set of negotiations, questions and routines? A cultural approach would ask about the efficiency costs associated with such disruption, which is most likely to show up in employee motivation and morale and the speed with which interactions occur (Langevoort 2002). Without doubting that some benefits are likely to accrue as well, the balance of costs and benefits becomes very hard to estimate. We might also predict that the more competitively fit a culture is, the harder (more costly) it will be for monitoring to have its desired effect. In hyper-competitive industries that are heavily dependent on agent aggressiveness and enthusiasm (investment banking, for example), the identity-laden culture will be very hard to penetrate and the costs of succeeding particularly high, especially if other firms in the industry are able to maintain more cultural autonomy for key teams of agents.

4 Conclusion

To some extent, an internal competitive fitness account of corporate cultures is simply an elaboration on the standard economic model that assumes that situational incentives dominate anything unique about individual or group preferences or traits. (Social psychologists would concur in one respect: that same idea is the basis for the fundamental attribution bias, which claims that we tend to over-attribute outcomes to individual personality traits compared to situational influences).[7] My

[7] Scott (2000) makes this point in his critique of some of the legal scholarship relating both to norms and behavioral economics.

account indeed suggests that corporate cultures can produce behaviors that are largely self-serving responses to their particular economic environment, and in the face of strong competition, make very few trade-offs in pursuit of survival and success.

If so, it is reasonable to ask whether there is any purchase from opening the black box of corporate cultures, if predicted group behaviors come so close to the standard economic model. However economists might respond to that question, economics-oriented legal scholars surely have reason to look inside the box. So many of the concepts that the law regularly relies upon (e.g., culpability, intent) can be accurately applied only by understanding how groups inside the firm make sense of their environment. In turn, the law's deterrence capacity will depend on how the internal culture interprets its demands, so that the question of how much resources (probability of detection, magnitude of sanction) to devote to policing corporate behavior will depend on the nature and degree of cultural deflection of the law's demands.

Individuals do the same thing, of course – the judgment and decision-making literature and behavioral law and economics teach that how people construe the law's demands will not always reflect Bayesean rationality. Moreover, many of the protective strategies that corporate cultures employ resemble individual defense mechanisms (Brown 1997). My suggestion here, which is consistent with comparisons of group and individual behavior generally, is that corporate cultures can moderate individual biases, exacerbate them, or do both. What varies is the task at hand: individual biases simply have to protect (and aid the function) of a single person; corporate cultures have to work on many people simultaneously, and for that reason have to be that much simpler, more efficient and more focused – and potentially, more distortive of any complex reality.

On overriding issue for law arising out of this discussion is whether it is meaningful to make judgments about a firm's culpability by assessing the state of its culture at the time of the wrongdoing. That has certainly become a common step at both the prosecutorial and sentencing stages in the U.S. recently (Khanna 2004). If we see cultures as generally efficient responses to situational demands, however, then the culture itself is really only a starting point to further inquiry. A culture where compliance with law was compromised because of perceived threats to the firm's ability to survive is different from one where it is compromised because senior managers impose unreasonable expectations on subordinates and are harshly punish those who lag behind – even though both may generate "cultures of noncompliance." What should be important from a deterrence perspective is whether the managers deserve blame either for the way the incentives were designed or a failure to intervene with a *useful* way of making compliance demands more salient inside the firm. Simply assessing the culture is unhelpful.

The foregoing, then, is merely suggestive of how an economic theory of corporate culture might aid legal analysis. There are many fruitful lines for further inquiry. How do cultures in firms in less competitive markets differ from those in hyper-competitive ones? Do the former have weak internal cultures (or ones more reflective of general social norms), or simply ones that are more self-serving from their agents' perspectives? Conversely, what is the effect of a consistent pattern in firm cultures on generally social norms? In societies that foster more rather than less competition among (or perhaps within) firms, are general social norms likely to be more or less cooperative, which will also have something to say about how law is formulated and transmitted (see Schlicht 2002)? These and related questions are more than enough to sustain a research program that brings together ideas from law, economics, psychology, sociology and related disciplines.

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