

# ESSAY

## CHASING THE GREASED PIG DOWN WALL STREET: A GATEKEEPER'S GUIDE TO THE PSYCHOLOGY, CULTURE, AND ETHICS OF FINANCIAL RISK TAKING

*Donald C. Langevoort*<sup>†</sup>

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### INTRODUCTION

Of all the questions about why the recent financial mess happened, the most perplexing have to do with the immense risk taken on by supposedly sophisticated financial institutions.<sup>1</sup> There were many different kinds of transactions that shifted subprime mortgage

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<sup>†</sup> Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center. This Essay is an extension of the Day Family Ethics Lecture given at Cornell University in April, 2010. My thanks to Claire Hill, Dana Radcliffe, Mitt Regan, Avishalom Tor, attendees at the Day Lecture at Cornell, and workshop participants at the University of Western Ontario for their comments and suggestions.

<sup>1</sup> Various commentators provide helpful overviews of the crisis and its institutional and regulatory context. *See generally* Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 J. ECON. PERSP. 77, 82–98 (2009) (providing an event logbook of the 2007–2008 financial crisis and discussing the amplifying mechanisms that can turn shocks into financial meltdowns); Gary Gorton, *The Subprime Panic*, 15 EUR. FIN. MGMT. 10, 12–37 (2009) (describing the intricate chain of risk distribution that lead to the financial panic); Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 16–36 (2010) (tracing the evolution and regulation of financial markets and explaining how such changes led to riskier behavior by financial intermediaries).

risk from originators to end-of-the-line buyers.<sup>2</sup> Most of it moved rapidly into securitization vehicles or derivatives and then into the portfolios of institutional investors—banks, pension funds, mutual funds, hedge funds, sovereign wealth funds and the like—around the world.<sup>3</sup> However, financial middlemen—large investment banks like Lehman, Bear Stearns, and Citigroup—retained some of the risk either by design<sup>4</sup> or because they could not fully sell off these instruments by the time the downturn suddenly hit in 2007.<sup>5</sup>

How did the distributors so easily sell so much risk, and why did institutional buyers so willingly take it? Tentative answers fall into three general categories, each of which takes complexity—of the products, the firms, and the financial system generally—as a starting point.<sup>6</sup> The first category of explanations claims that neither buyers nor sellers (nor their facilitators, like the credit rating agencies) ever really appreciated the full extent of the risk.<sup>7</sup> This category of explanations raises questions about the psychology and sociology of risk perception, to which we shall soon turn, because it assumes that there was a systematic underestimation of the risk regarding what buyers and sellers should have rationally perceived at the time.

The second category of explanations is that neither the sell side nor the buy side was fooled: both appreciated the risk from the subprime debt and the threat to liquidity. Perhaps institutional buyers perceived that the risk was actually small enough to justify in light of

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<sup>2</sup> See MARTIN NEIL BAILY ET AL., BROOKINGS INST., *THE ORIGINS OF THE FINANCIAL CRISIS* 8–9 (2008), available at [http://www.brookings.edu/~media/Files/rc/papers/2008/11\\_origins\\_crisis\\_baily\\_litan/11\\_origins\\_crisis\\_baily\\_litan.pdf](http://www.brookings.edu/~media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf). For an explanation of the structure of these mortgages and the aggressive sales practices at origination, see Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073, 1096–1107, 1129–32 (2009).

<sup>3</sup> See Whitehead, *supra* note 1, at 4–6, 25–30.

<sup>4</sup> See Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 241 (2009) (“In the subprime crisis, for example, underwriters customarily purchased some portion of the subordinated ‘equity’ tranches of ABS CDO securities to demonstrate their belief in the securities being sold.”).

<sup>5</sup> Cf. John P. Harding & Stephen L. Ross, *Regulation of Large Financial Institutions: Lessons from Corporate Finance Theory*, 16 CONN. INS. L.J. 243, 250 (2009) (“While most large investment banks and bank holding company subsidiaries that originated subprime mortgages operated with the intent to pool and sell mortgage-backed securities as soon as a sufficient number of loans had been originated, at any given time, they nevertheless had significant exposure to subprime loans because they were holding mortgages as inventory awaiting future sales or holding securities as part of their underwriting and trading operations.”).

<sup>6</sup> See Schwarcz, *supra* note 4, at 216–36 (discussing how complexity can prompt market failures).

<sup>7</sup> See Bar-Gill, *supra* note 2, at 1081–82 & n.15, 1118–23; see also Schwarcz, *supra* note 4, at 221–25 (discussing how the complexity of modern investment securities can hinder disclosure and conceal consequences).

the expected returns,<sup>8</sup> but mainly, this second category involves stories about agency costs and moral hazards. Implicit government subsidies and regulatory distortions (many of the “too-big-to-fail” sort) plus insurance in various forms encouraged shifting the risk elsewhere, including to taxpayers.<sup>9</sup> Market participants simply exploited those externalities, which is far from irrational.<sup>10</sup> Or perhaps buy-side institutions were the instigators for purely selfish reasons because compensation arrangements enriched portfolio managers in the near term based on the above-normal profits that the subprime and related investments generated, which also shifted the risks to the unsophisticated beneficiaries whose assets they managed.<sup>11</sup>

The third category of explanations looks to informational asymmetry. This category of explanations claims that the sell side, including the rating agencies, privately understood the excess risk they sold but concealed it from the buy side.<sup>12</sup> This claim is a bit jarring because it assumes that the professional portfolio managers on the buy side lacked the information and expertise to discover the risk on their own when that risk was so clear to their counterparties. We know that some investors bet aggressively on a coming crisis.<sup>13</sup> They estimated

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<sup>8</sup> For a good discussion of the facts available to investors and analysts that might suggest the foreseeability of the subprime meltdown, see Kristopher Gerardi et al., *Making Sense of the Subprime Crisis*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2008, at 69, 127–42. On the residual uncertainty that may have made this investment a rational response to rapid financial innovation while learning evolved by trial and error (with an unfortunate paucity of error until too late in the game), see Alessio M. Paccos, *Uncertainty and the Financial Crisis*, 29 J. FIN. TRANSFORMATION 79, 82–87 (2010). This latter view is hard to accept today given the massive losses those portfolios have suffered, but that difficulty may just be the hindsight bias at work. Events always seem to have been much more foreseeable at the time after we know what later came to pass. See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 571–81 (1998).

<sup>9</sup> See Schwarcz, *supra* note 4, at 251–52 & n.232 (discussing moral hazards in institutions deemed too big to fail).

<sup>10</sup> See RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* 106–08, 114–15 (2009) (discussing rational profit-maximizing behavior and the need for government regulation to control the negative externalities of this behavior); see also Richard A. Posner, *Shorting Reason*, NEW REPUBLIC, Apr. 15, 2009, at 30, 31–32 (reviewing AKERLOF & SHILLER, *infra* note 54, and criticizing the conflation of being right and being rational in investment decisions).

<sup>11</sup> See Charles W. Calomiris, *The Subprime Turmoil: What's Old, What's New, and What's Next*, J. STRUCTURED FIN., Spring 2009, at 6, 12–13.

<sup>12</sup> See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2049–50 (2007) (discussing information asymmetry between lenders and investors as to riskiness of subprime loans and potential for exploitation); Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. TIMES, Jan. 12, 2008, at A1 (discussing New York's investigation as to “whether Wall Street banks withheld crucial information about the risks posed by investments linked to subprime loans” from rating agencies and investors).

<sup>13</sup> See Claire A. Hill, *Who Were the Villains in the Subprime Crisis, and Why It Matters*, 4 ENTREPRENEURIAL BUS. L.J. 323, 345 (2010). Some notable examples include John Paulson, whose involvement in constructing Goldman Sachs' Abacus deal came under scrutiny in the suit that the Securities and Exchange Commission (SEC) filed against the investment

correctly, so why did so many buyers trust the salespeople? Plenty of academics and journalists, moreover, warned about the subprime risk beginning early in the decade.<sup>14</sup> The answer might be a rational-agency-cost story similar to the one just given, i.e., that portfolio managers had compensation-based incentives to deliberately ignore the long-term risk, or the answer might again bring us back to possible biases in risk perception.

To lawyers especially, these three categories are richly interesting and important. Understanding what mash-up of explanations was at work is crucial to the success of any regulatory reform in this area.<sup>15</sup> The many lawsuits arising from the financial crisis that both public enforcers and private plaintiffs are litigating depend on sorting these explanations out because some of these explanations fit with state of mind standards like scienter, willfulness, recklessness, gross negligence, and bad faith, but others do not.

This Essay, however, is about neither regulatory reform nor the flood of pending litigation, though it will look briefly at the highly publicized lawsuit that the Securities and Exchange Commission (SEC) filed against Goldman Sachs.<sup>16</sup> Instead, my interest here is in the cognitive challenge faced by those who play a “gatekeeper” role in financial firms and similar business organizations and therefore become involved in the institutional processes of risk perception and risk management.<sup>17</sup> By most accounts, the gatekeepers at many financial firms did a poor job in the events leading up to the crisis.<sup>18</sup> I am especially interested in corporate lawyers, whose task is to help their publicly-owned or publicly-regulated clients to identify firm-specific risk with enough accuracy to enable them to satisfy mandatory disclosure responsibilities under federal securities and banking laws. Ongoing risk disclosure at many financial institutions was of low quality, and their shareholders suffered considerable losses when the undis-

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bank, see Louise Story & Gretchen Morgenson, *S.E.C. Accuses Goldman of Fraud in Housing Deal*, N.Y. TIMES, Apr. 17, 2010, at A1, and Jeff Greene, whose profits in betting against the housing market became a political liability in his failed Senate bid, see Jeff Ostrowski, *Feud Simmers over Greene's Subprime Bet*, PALM BEACH POST, July 11, 2010, at 1A.

<sup>14</sup> See POSNER, *supra* note 10, at 77–78 (arguing that “[t]here were plenty of warnings of a housing bubble, beginning in 2003; warnings about excessive leverage in financial firms; and even rather precise predictions of the debacle that has ensued,” which included papers from economists and news articles).

<sup>15</sup> See Hill, *supra* note 13, at 346–49.

<sup>16</sup> See *infra* Part IV.

<sup>17</sup> See JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006) (defining gatekeepers).

<sup>18</sup> See Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure and the Business Education of Lawyers*, 35 J. CORP. L. 363, 365 (2009) (“Among the many leitmotifs of the financial crisis is the failure of lawyers as regulators and gatekeepers.”).

closed risks came to pass.<sup>19</sup> In this sense, there is a strong similarity in this crisis with the round of financial reporting scandals from earlier in the decade—Enron, WorldCom, and the like—that provoked Congress to pass the Sarbanes-Oxley Act in 2002.<sup>20</sup> Lawyers are at the heart of the disclosure risk management that Sarbanes-Oxley demands,<sup>21</sup> as are independent directors, especially those on the audit committee, and the firm’s independent auditors.<sup>22</sup> Something did not work the way it was supposed to, and there is pressure to do much better.<sup>23</sup>

My aim in this Essay is to draw a heuristic map to help lawyers, directors, and auditors navigate the challenges of institutional risk perception going forward, drawing from what we have learned from these recent painful experiences. All three of the explanatory categories are crucial to this exercise, but I am going to narrow the focus. To the extent that there are entirely rational, self-interested explanations for managers’ behavior on the sell side (or on both the sell and buy sides), these problems are fairly conventional. Auditing, internal controls, and other monitoring devices have long been designed to try to prevent or expose intentional, opportunistic breaches of duty. Monitoring is not easy by any means: there is a serious gap in terms of what regulators and the public expect from gatekeepers in terms of fraud prevention and what they can actually do at a reasonable cost. I make no effort to contribute to the existing body of knowledge and expertise about monitoring. On the other hand, if psychological or cultural forces alter or bias risk perception inside firms, then the lawyer’s, director’s, or auditor’s challenge is different. The firm’s managers may well have come to believe in good faith (a cognitively-loaded legal construct, to be sure) that no risk or problem is big enough to worry about, while an outside observer in possession of the same information would disagree. As one organizational behaviorist has said,

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<sup>19</sup> See Deborah R. Meshulam & Grayson D. Stratton, *Lessons from the Credit Crisis: Can Market Participants Bear the Risk?*, BUS. L. TODAY 2–4 (Aug. 2, 2010), <http://www.abanet.org/buslaw/blt/content/articles/2010/08/mt0001.pdf> (providing examples of alleged inadequacies in disclosure during the financial crisis and the lawsuits they engendered).

<sup>20</sup> Cf. COFFEE, *supra* note 17, at 9 (“In response to the epidemic of corporate financial scandals that broke out in the United States between 2000 and 2003, Congress enacted the Sarbanes-Oxley Act of 2002, which principally focused on the role and responsibilities of gatekeepers.”).

<sup>21</sup> See *id.* at 216–23. See generally Roger C. Cramton et al., *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725 (2004) (providing an overview of duties imposed on lawyers by Sarbanes-Oxley and relevant rules).

<sup>22</sup> See COFFEE, *supra* note 17, at 17, 25–30, 170–71.

<sup>23</sup> Most recently, the SEC revised its corporate governance disclosure rules to require a description of the board’s role in risk oversight. See *Proxy Disclosure Enhancements*, 74 Fed. Reg. 68,334, 68,344–45, 68,364–65 (Dec. 23, 2009) (to be codified at 17 C.F.R. § 229.407(h)) (revising item 407 of Reg. S-K).

“[o]nce you’ve been in the water long enough[,] you no longer perceive you’re in water.”<sup>24</sup> This statement is true even when the water starts getting hot, as long as it happens gradually, as with boiled frogs.<sup>25</sup> For the outside observer, substitute judge, juror, or regulator, the importance of the gatekeeper’s cognitive role is clear: The gatekeeper’s task is to bring the outsider perspective to work *ex ante*, as a risk management device.

The map I sketch here identifies what lawyers, directors, and auditors should look for as gatekeepers when measuring the risk perceptions inside the institution. There is both a legal and an ethical dimension to this journey. Lawyers, as opposed to managers, must meet professional expectations—loyalty to the organizational client and the need to avoid assisting a client’s wrongful course of action—to which the task relates closely. Here, however, I am more concerned about the client’s own business ethics. Perceived ethical breaches can do severe reputational damage to a firm even if the firm’s actions might technically have been lawful. Moreover, ethical slippage is often the precursor to what later becomes a violation of law: moral rationalization leads to small levels of opportunism about which no guilt is felt, leading to sequentially bigger levels of cheating before the reality of legal wrongdoing becomes clear.<sup>26</sup> Compromised ethicality in both individual managers and larger groups is an institutional risk about which gatekeepers must constantly worry.

The gauntlet I throw down here is directed at those gatekeepers who are inclined—indeed motivated—to infer that nothing is amiss so long as the people they meet and the behaviors they observe show none of the visible markings of disloyalty: extreme selfishness, sloth, dishonesty, etc. Once gatekeepers find markers of hard work, intensity, optimism, and enthusiasm by people inside the organization who seem dedicated and sincere, they relax their guard. More than anything, what I want to show here is how hard work, intensity, optimism, and enthusiasm can sometimes be the source of the trouble.

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<sup>24</sup> Dennis K. Berman, *Tourne: A Hero in Villain’s Garb?*, WALL ST. J., Apr. 27, 2010, at C1 (quoting Professor Adam Galinsky of Northwestern University’s Kellogg School of Business).

<sup>25</sup> Eugene Volokh, *The Mechanisms of the Slippery Slope*, 116 HARV. L. REV. 1026, 1105 (2003) (“If a frog is dropped into hot water, it supposedly jumps out. But if a frog is put into cold water that is then heated, the frog doesn’t notice the gradual temperature change, and eventually dies. . . . The frog doesn’t notice the [temperature] increase because of a sensory failure; it senses not absolute temperature but changes in temperature.”).

<sup>26</sup> See John M. Darley, *The Cognitive and Social Psychology of Contagious Organizational Corruption*, 70 BROOK. L. REV. 1177, 1179–85 (2005).

## I

## SKETCHING OUT THE COGNITIVE MAP

## A. The Centrality of Corporate Culture

Like law, organizational behavior is a field in which the main disciplines of the social sciences—particularly economics, psychology, and sociology—do battle. Economics assumes that firms and their managers act as if they are rational, while the other two disciplines raise serious doubts about this assumption.<sup>27</sup> Sociology and its sibling, cultural anthropology, question the methodological individualism found in much of economics and psychology.<sup>28</sup> Many sociologists also doubt the extreme functionalism that is central to economic theory, including its behavioral branch.<sup>29</sup> Like most battles that turn into prolonged sieges, a large amount of intellectual intermarrying has occurred among those frustrated by the stand-offs among the purists; hence behavioral economics, rational choice-based sociology, social and economic psychology, and other interdisciplinary genres have emerged.<sup>30</sup> Legal academics have become adept in the last two decades at picking from all of these when analyzing the behavior of business firms.

No single cognitive map will ever satisfy all of these disciplines, so some simplifying methodological assumptions are necessary. I have already pushed rational choice aside not because it is wrong or unimportant—lawyers and other gatekeepers surely must understand the economic incentive structure embedded in any firm with which they

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<sup>27</sup> See Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1500–02 (1998).

<sup>28</sup> See generally LARS UDEHN, *METHODOLOGICAL INDIVIDUALISM: BACKGROUND, HISTORY AND MEANING* 1–6 (2001) (reviewing the debate over methodological individualism). Psychologists may disagree, of course. For commentary, see, for example, Martin Kilduff & David Krackhardt, *Bringing the Individual Back In: Structural Analysis of the Internal Market for Reputation in Organizations*, 37 ACAD. MGMT. J. 87, 87–88, 105–06 (1994) (summarizing structuralism’s rejection of individualism, arguing for the integration of “psychology and the role of individuals . . . [into] social network analysis,” and “challeng[ing] the claimed incommensurability of individualism and structuralism by pointing to the influence on structural analysis of the psychology it has purported to reject”); Barry M. Staw & Robert I. Sutton, *Macro Organizational Psychology*, in *SOCIAL PSYCHOLOGY IN ORGANIZATIONS: ADVANCES IN THEORY AND RESEARCH* 350, 352–67 (J. Keith Murnighan ed., 1993) (reviewing individualist and collectivist perspectives of psychology and sociology, respectively, and providing a rationale for macro-organizational psychology, which employs psychology to explain organizational behavior).

<sup>29</sup> See Geoffrey Ingham, *Some Recent Changes in the Relationship Between Economics and Sociology*, 20 CAMBRIDGE J. ECON. 243, 251–52 (1996) (“[T]here is widespread agreement amongst sociologists that functionalism of the most flawed kind pervades a great deal of economic analysis . . .”).

<sup>30</sup> For an extensive analysis of the application of behavioral economics and the firm, see Colin F. Camerer & Ulrike Malmendier, *Behavioral Economics of Organizations*, in *BEHAVIORAL ECONOMICS AND ITS APPLICATIONS* 235, at 235–73 (Peter Diamond & Hannu Vartiainen eds., 2007).

are dealing—but because this particular map is meant for travel outside that realm. Next, we come to the matter of individual versus culture and psychology versus sociology and anthropology. Here, purely for heuristic purposes, I take functionalism—in familiar evolutionary terms—as my starting point. I do this with one further narrowing in mind: I designed my map for firms in highly competitive markets. The functional task is to coordinate the activities of perhaps thousands of agents in pursuit of competitive success externally, while recognizing that agents' individual self-interest may be antagonistic to the common good. Conventional economics explores many possible ways of mediating this problem—external monitoring, incentive contracts, and the like—none of which offers anywhere near perfect solutions.<sup>31</sup> A strong corporate culture, however, can help considerably. George Akerlof and Rachel Kranton have argued, for instance, that instilling a strong sense of bonded identity with others in the group, as the United States Marines do, can reduce agency cost frictions and make self-interested defection less likely.<sup>32</sup> A strong in-group versus out-group cultural orientation can also encourage the maintenance of a highly aggressive, opportunistic stance toward outsiders, such as customers and competitors, while softening in-group competition—an attitude that, right or not, is fairly commonplace in hypercompetitive industries like retail, financial services, and computer technology.<sup>33</sup>

My heuristic postulates that organizations that have had sustained marketplace success will have highly adaptive, functional cultures. I accept that as we dig deeper into the human dimension of any organization, as ethnographers do, we will find practices, routines, and beliefs that are unique to each institution's history and situation, many of which seem far from functional. All organizations have myths, ceremonies, totems, fetishes, and the like: they are profoundly human institutions, not abstractions.<sup>34</sup> My hunch, however, is that competitive pressures temper these considerably. This bow to the conventional economic lesson that incentives matter suggests that in digging into

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<sup>31</sup> See, e.g., PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* (1992) 185–88 (analyzing monitoring and incentive contracts as solutions for controlling moral hazards in the field of organizational economics).

<sup>32</sup> See George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9, 9–16, 27–29 (2005).

<sup>33</sup> See Donald C. Langevoort, *Opening the Black Box of "Corporate Culture" in Law and Economics*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 80, 86 (2006). For a thoughtful exploration of cultural effects on lawyers' decision making, see generally Milton C. Regan, Jr., *Moral Intuitions and Organizational Culture*, 51 ST. LOUIS U. L.J. 941 (2007).

<sup>34</sup> For a classic exposition, see John W. Meyer & Brian Rowan, *Institutionalized Organizations: Formal Structure as Myth and Ceremony*, 83 AM. J. SOC. 340, 343–48 (1977).

the competitively successful organization as a social institution, we begin by looking for competitively adaptive aspects to its culture.<sup>35</sup>

I do not mean to suggest that individuals are not important. Power matters in organizations, individuals, and small groups. In particular, the CEO and the board have a substantial degree of agency to make important decisions. They have their own private information, dispositions, and situations. Here again, however, we can try to bridge the gap by presuming that competition (both external and internal) pressures individuals and that individual judgment and decision making should also adapt for them to succeed. To me, there are more similarities than differences in how that adaptation is likely to play out inside firms and inside managers' minds.

## B. Adaptive Cultures

The idea that corporate cultures affect business, legal, and ethical judgment is old news; we can take that much as given. Rarely, though, does the legal literature attempt to theorize about how or why cultures evolve and persist. Instead, the literature presumes that cultures are sorted easily into the healthy and the unhealthy so that the law can simply punish the bad and reward the good. My argument here is that cultural influences on risk taking—the good and the bad—can best be understood by considering their functionality, focusing on value added in terms of coordination, motivation, or both. What we look for, in other words, are ways that cultures have of facilitating the efficient coordination among agents of the firm by promoting common beliefs, perceptions, and inferences about the prevailing situation and legitimate ways of responding to it.

I have written at some length elsewhere about the efficiency of corporate cultures,<sup>36</sup> as have others in the organizational behavior and economics literature,<sup>37</sup> and will not repeat my claim in detail because I want to move on quickly to new material connected to the

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<sup>35</sup> For an illuminating study of the psychology and culture of risk taking by traders at London investment banks that is sensitive to these competitive constraints, see MARK FENTON-O'CREEVY ET AL., *TRADERS: RISKS, DECISIONS, AND MANAGEMENT IN FINANCIAL MARKETS* 74–145 (2005).

<sup>36</sup> See Langevoort, *supra* note 33, at 83–94.

<sup>37</sup> On the economics of corporate culture from a variety of perspectives, see, for example, Benjamin E. Hermalin, *Economics and Corporate Culture*, in *THE INTERNATIONAL HANDBOOK OF ORGANIZATIONAL CULTURE AND CLIMATE* 217, 218–42 (Cary L. Cooper et al. eds., 2001) (summarizing and assessing economists' previous studies and writings on corporate culture); Eric Van den Steen, *On the Origin of Shared Beliefs (and Corporate Culture)*, 41 *RAND J. ECON.* 617, 619–21, 638–40 (2010) (reviewing economics literature on corporate culture and conceiving of corporate culture as shared values and beliefs). See generally David M. Kreps, *Corporate Culture and Economic Theory*, in *PERSPECTIVES ON POSITIVE POLITICAL ECONOMY* 90, 90–141 (James E. Alt & Kenneth A. Shepsle eds., 1990) (exploring corporate culture from the perspective of economic theory). Kreps's model is discussed at length in Hermalin, *supra*, at 218–30.

financial crisis. My basic point is simple enough and draws from evolutionary theory. Firms that generate an adaptive culture (deliberately or otherwise) are more likely to thrive and survive competitive marketplace stresses than those that do not.<sup>38</sup> We should concede to the sociologists that over time even the most adaptive cultures eventually tend to weaken and gradually transform to ones dominated by narrowed focus, routines, myths, and ceremonies until they die out completely as unfit for competitive survival.<sup>39</sup> But, for the time when they have found a high level of adaptive competitive fitness, they are profoundly powerful in the economy and the capital markets. Think Google, Apple, Goldman Sachs, or—sadly—Enron and Countrywide.

What is the likely content of an adaptive corporate culture? Again, at a high level of generality, the point is simple. The set of external stimuli facing a firm's agents is constantly changing, uncertain, and complex, and if hundreds or thousands of agents disagree and have to negotiate a shared interpretation, the firm will collapse due to indecision, disunity, worry, and paralysis. To preserve the capacity for action and motivation, this sense making must be simplified into a coherent interpretive script.<sup>40</sup> Here, we see the departure from conventional Bayesian rationality.<sup>41</sup> If ambiguity and uncertainty threaten internal coherence and coordination, the ambiguity and uncertainty have to be edited down, if not out. This is especially so when the firm is in a highly-competitive setting in which work is completed at a high velocity, the risk of failure is considerable, and the profits from success immense. In other work, I have used the term "grease" to describe cultural beliefs that facilitate competitive drive.<sup>42</sup> Well-greased cultures deflect doubt and uncertainty, and they enable the focus and intensity necessary to sustain high-velocity effort. The key point is that well-greased cultures will often substitute warmly adaptive

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<sup>38</sup> See Daniel Denison, *Organizational Culture: Can It Be a Key Lever for Driving Organizational Change?*, in THE INTERNATIONAL HANDBOOK OF ORGANIZATIONAL CULTURE AND CLIMATE, *supra* note 37, at 347, 356 ("Organizations that are strong in adaptability usually experience sales growth and increased market share.").

<sup>39</sup> See Richard R. Nelson, *Recent Evolutionary Theorizing About Economic Change*, 33 J. ECON. LITERATURE 48, 78–79 (1995) (discussing some sociologists' organizational ecology models and noting that "the set of things a firm can do well at any time is quite limited," and despite their ability to "learn to do new things, these learning capabilities also are limited"); *cf.* Bo Hedberg & Christian Maravelias, *Organizational Culture and Imaginary Organizations*, in THE INTERNATIONAL HANDBOOK OF ORGANIZATIONAL CULTURE & CLIMATE, *supra* note 37, at 587, 594 (noting that "[a] distinct and strong culture" in an organization "might improve its capability to handle specific environmental circumstances" but may hamper that organization's "capabilities to adapt to changing environments").

<sup>40</sup> See Langevoort, *supra* note 33, at 83–86.

<sup>41</sup> See *id.* at 85–86 ("[I]n the face of extensive ambiguity and uncertainty, corporate cultures are free to evolve in the direction of productive sense-making rather than Bayesian accuracy.").

<sup>42</sup> *Id.* at 85.

beliefs for coldly realistic ones.<sup>43</sup> Competitive success then reinforces those perceptions and inferences, gradually turning them into temporarily useful, sustaining myths.

This sort of idea has substantial intellectual support within now-mainstream (if not orthodox) economics, in a body of theoretical and empirical literature on overconfidence in individuals, which links directly to the financial crisis.<sup>44</sup> Psychological research shows that moderate—as opposed to severely unrealistic—overconfidence has a number of payoffs, including inducing greater persistence, effort, and risk taking than otherwise.<sup>45</sup> The risk taking is crucial—those that take greater risks and have good luck will outperform those who are realistically more cautious.<sup>46</sup> A streak of good luck can put substantial competitive distance between the risk takers and the realists. And without getting too far ahead of ourselves, the fact of risk-taking success, even if largely good fortune rather than skill, can become a self-fulfilling prophecy as the success enables the gathering of resources (e.g., capital, support of allies) that creates a real competitive advantage in successive rounds. Well-known economists who have explored this area apply it both at the level of executives competing in the internal promotion tournament and at the level of the firm competing with others in its product markets.<sup>47</sup>

An overly optimistic or confident internal corporate culture should have precisely the same effect. It is easy to see how the common perceptions that mildly excessive optimism and confidence gen-

<sup>43</sup> See *id.* at 85–86.

<sup>44</sup> For such an argument, see Malcolm Gladwell, *Cocksure: Banks, Battles, and the Psychology of Overconfidence*, NEW YORKER, July 27, 2009, at 24, 26–28.

<sup>45</sup> See, e.g., *id.* at 27 (discussing social scientists' view of overconfidence as “an adaptive trait”); Shelley E. Taylor & Jonathon D. Brown, *Illusion and Well-Being: A Social Psychological Perspective on Mental Health*, 103 PSYCHOL. BULL. 193, 199 (1988) (“[R]esearch evidence indicates that self-enhancement, exaggerated beliefs in control, and unrealistic optimism can be associated with higher motivation, greater persistence, more effective performance, and ultimately, greater success.”).

<sup>46</sup> See Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 299–300 (2004).

<sup>47</sup> See, e.g., Simon Gervais & Itay Goldstein, *The Positive Effects of Biased Self-Perceptions in Firms*, 11 REV. FIN. 453, 479–81 (2007) (concluding that worker overconfidence encourages harder work, reduces free-riding, and ultimately increases firm productivity); Anand M. Goel & Anjan V. Thakor, *Overconfidence, CEO Selection, and Corporate Governance*, 63 J. FIN. 2737, 2737–41, 2769–72 (2008) (discussing the effects of managerial overconfidence on internal promotion and CEO overconfidence on firm value); cf. Eric Van den Steen, *Rational Overoptimism (and Other Biases)*, 94 AM. ECON. REV. 1141, 1141–43 (2004) (discussing the “‘choice-driven overoptimism’ mechanism” that results in an agent’s positive bias “about the consequences of his own actions, relative to others”). For empirical evidence of overconfidence, see, for example, Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661, 2667–79 (2005) (constructing “three measures of overconfidence . . . based on the personal portfolio decisions of CEOs” and providing evidence of such behaviors).

erate are organizationally adaptive. They reduce worry and anxiety, which facilitates focused work. They prompt thoughts of a bountiful future, a larger pie to share, which facilitates intrafirm trust and cooperation, while a depressed culture does just the opposite: it frames the situation as a last-period risk that generates selfishness and defection.<sup>48</sup> Thus, integrative solutions to the endless negotiations that make up the day-to-day work inside the firm are easier to find.

And that, of course, is also the problem.<sup>49</sup> If those deeply enmeshed in this culture are responsible, say, for accurately disclosing the level of risk that the firm faces, they will often get it wrong—albeit often in good faith—because they are too optimistic. Lawyers or independent directors who are naively willing to accept overly-confident risk assessments from insiders simply because they have greater firm-specific knowledge, without adjusting for the risk of perceptual bias, will produce inaccurate, unrealistic disclosures. A recent, well-publicized paper by Catherine Schrand and Sarah Zechman offers both theory and empirical evidence that traces the slippery slope to financial misreporting that executive overconfidence sets in motion.<sup>50</sup>

Cultural overoptimism is just one example of adaptive bias. My broader argument is that any belief system will be similarly adaptive if it simplifies, reduces distractions, and facilitates focus on the work at hand. Here, we see the connection to the large body of common heuristics and biases at the individual level that psychologists have identified. Gerd Gigerenzer and others argue that many of these belief systems are evolutionarily adaptive precisely because they promote quick (and usually functional) judgments rather than force the brain to exert the effort through a more elaborate analysis.<sup>51</sup> To be sure, the brain evolved these heuristics thousands of years ago, and they are hardwired within us,<sup>52</sup> whereas cultural adaptation works completely

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<sup>48</sup> See Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 154–56 (1997).

<sup>49</sup> The term “groupthink” often refers to the downside of narrowed focus and intensity. For both an exposition and review, see generally Roland Bénabou, *Groupthink: Collective Delusions in Organizations and Markets* 1–27 (Nat’l Bureau of Econ. Research, Working Paper No. 14764, 2009) (examining how groupthink arises and continues in organizations).

<sup>50</sup> See Catherine M. Schrand & Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Fraud* 9–35, (Sept. 2010) (unpublished manuscript), available at <http://ssrn.com/abstract=1265631>. I developed a similar argument in Langevoort, *supra* note 48, at 121–26, 135–41. See also Langevoort, *supra* note 46, at 307–08 (positing that as the threat to incumbency grows, overconfident CEOs will embark on a slippery slope of obfuscation, concealment, and greater risk taking to retain office).

<sup>51</sup> See GERD GIGERENZER ET AL., *SIMPLE HEURISTICS THAT MAKE US SMART* 14–24, 30–31 (1999).

<sup>52</sup> See *id.* at 57 (noting that recognition heuristic employs “a capacity that evolution has shaped over millions of years”).

differently. But the analogy can still be useful. The basic idea is that whatever cognitive simplification is adaptive within a single brain, far more is necessary to coordinate the perceptions and inferences of multiple actors within a large firm.

## II

### INSTITUTIONAL RISK PERCEPTION

Institutional judgment and decision making take many different forms, making it hard to generalize about risk perception. Individuals (the CEO or CFO, for instance) or small groups (boards of directors) clearly make some key decisions, but even these decisions are made in a highly social setting, based on information gathered, processed, and refined through institutional channels. In addition, much that is important in risk perception is what is *not* noticed or taken into account. Though we can tie failures to notice to individual or small-group judgment—that is what plaintiffs do when bringing bad faith claims against officers and directors<sup>53</sup>—this is a domain that seems especially social and cultural, as I argued in Part I.

My argument is that we can plausibly project individual cognitive biases onto the larger organizational culture to the extent that they serve either a simplifying or motivating function that greases the firm's competitive machinery. Thus, in analyzing the recent financial crisis, it makes sense to consider the kinds of individual heuristics and biases that might lead to a systematic underestimation of risk, even though the risk might be objectively significant. Fortunately, others have taken up this task with respect to the kinds of risks that led to the crisis, and we do not need to repeat what they have said except for a brief summary.<sup>54</sup>

Like most bubbles, housing prices, and the value of the securitizations and derivatives tied to them, rose over the course of an extended period of time under circumstances that seemed unprecedented historically and could be explained (the “this-time-it’s-different” phe-

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<sup>53</sup> See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006); *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969–70 (Del. Ch. 1996).

<sup>54</sup> This is an important theme in a number of books, perhaps the best known of which is GEORGE A. AKERLOF & ROBERT J. SHILLER, *ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM* (2009) 5–7, 11–56, 86–96, 169–71. See also, e.g., Emiliios Avgouleas, *The Global Financial Crisis, Behavioural Finance and Financial Regulation: In Search of a New Orthodoxy*, 9 J. CORP. L. STUD. 23, 34–45 (2009) (discussing the behavioral factors and failures of risk control linked to the causes of the financial crisis); Hersh Shefrin, *How Psychological Pitfalls Generated the Global Financial Crisis*, in *INSIGHTS INTO THE GLOBAL FINANCIAL CRISIS* 224, 224–32, 250–54 (Laurence B. Siegel ed., 2009) (positing that “specific psychological reactions,” such as overconfidence and risk-seeking, to external economic factors “took the global financial system to the brink of collapse,” instead of those economic factors themselves).

nomenon)<sup>55</sup> by reference to shifts in the technology of finance that allowed for a much more efficient diffusion and dispersion of real-estate-related risk. What appeared to be a continuous trend could therefore be extrapolated forward without much pause, especially when authoritative figures like Alan Greenspan at the Federal Reserve offered justifications for the perception, and other major institutions showed no signs of hesitation.<sup>56</sup> Financial firms used risk-modeling technology that institutionalized this trend, demanding data as inputs to complex mathematical algorithms where the only available data was from the recent run-up.<sup>57</sup> And we can add the obvious: the mind's tendency to justify that which is profitable—motivated inference—which no doubt caused some people in these firms to ignore facts they did not want to confront.

I agree that all of these biases, which Geoff Miller and Gerald Rosenfeld call “intellectual hazards,”<sup>58</sup> played a causal role in judgment and decision making on both the sell and buy sides. They fit readily into my account of cultural perceptions that simplify and motivate, but there is a predictable objection to excessively psychologically-based accounts of the crisis to which we must first attend.<sup>59</sup> After all, senior executives are presumably selected for their strong cognitive ability and managerial skills; if so, that presumably should weed out those prone to bias. This kind of assumption has led many, like Richard Posner, to infer that financial firms simply took calculated risks (admittedly in the face of great informational ambiguity) given the attractive rates of return, with distortions from the optimal being the

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<sup>55</sup> See CARMEN M. REINHART & KENNETH S. ROGOFF, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* 207–15 (2009).

<sup>56</sup> See *id.* at 208–10; see also Posner, *supra* note 10, at 31 (“Since very few economists and no government officials warned of a bubble, it was not irrational for people to think that houses were a good investment, even though house prices had risen steeply since the 1990s.”).

<sup>57</sup> See Joe Nocera, *Risk Mismanagement*, N.Y. TIMES, Jan. 4, 2009, § 6 (Magazine), at 24, 46 (“VaR [Value at Risk model] didn’t see the risk [of AAA-rated mortgage-backed securities] because it generally relied on a two-year data history.”); see also Gerardi et al., *supra* note 8, at 133–34 (discussing deficiencies of subprime loan performance data that hindered risk modeling).

<sup>58</sup> See Geoffrey P. Miller & Gerald Rosenfeld, *Intellectual Hazard: How Conceptual Biases in Complex Organizations Contributed to the Crisis of 2008*, 33 HARV. J.L. & PUB. POL’Y 807, 818 (2010); see also *id.* at 808 (defining intellectual hazard as “the tendency of behavioral biases to interfere with accurate thought and analysis within complex organizations”); sources cited *supra* note 54.

<sup>59</sup> Cf. POSNER, *supra* note 10, at xiv, 100, 112 (declining to list “psychological factors among the underlying causes of the depression” and arguing that “[t]here is no need to bring cognitive quirks, emotional forces, or character flaws into the causal analysis”); see also Posner, *supra* note 10, at 30, 32–33 (disagreeing with the notion of behavioral economics that irrational behavior is a cause of economic depressions).

result of conventional agency cost and moral hazard problems, not bias.<sup>60</sup>

This alternative account cannot easily be ruled out; I will leave to others the question of exactly how well the conventional explanation fits the observed data. At the very least, we should try to drill deeper to ground the case for caring about psychology and culture as causal forces in suboptimal decision making in highly competitive firms. Part I of this Essay gave one kind of justification that responds directly to Posner's assumption. CEOs and other senior executives may be chosen precisely because they exhibit certain traits—overconfidence being the most obvious—that are adaptive in terms of generating cohesion and motivation even though they generate certain predictable costs as a result of the bias. Alternatively, we could say that overconfident CEOs are the natural product of promotion tournaments monitored by people who lack the information, incentive, or both to make more finely-textured choices.<sup>61</sup> This promotional process is exceedingly important when the economy has been on a long winning streak; good luck will be bountiful and promotions will disproportionately go to the lucky risk takers. Thus, a critical mass of the overconfident may come to dominate the organization and its culture.

Even if we assume that CEOs will display a higher level of cognitive skill and prudence, their information sources are diffused broadly within the organization, making them dependent on institutional risk perception. Where risk is deeply embedded in a portfolio of unimaginable complexity, as in the case of securitizations and derivatives, that dependency can be both considerable and disabling. Finally, even if we put aside all these points, a psychological account could join up with the conventional agency cost analysis and emphasize motivated inference: CEOs have compensation and career incentives to perceive the situation in a near-term time frame and dismiss risks that could be rationalized away. Of course, revealed preferences are all that matters to conventional economic analysis, but again, it is not all that matters to legal analysis, where state of mind is almost always of determinative importance. State of mind is, necessarily, a psychological inquiry.

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<sup>60</sup> See POSNER, *supra* note 10, at 75–116 (attributing causes of the financial crisis to “rational self-interested decision-making” of managers, consumers, and financial institutions, which imposed negative externalities on the economy as a whole); see also *id.* at 284–85 (arguing that “[c]apitalism is Darwinian” and that it is unrealistic to expect market participants to control their rational self-interested behavior because of the possibility that such actions in the aggregate may trigger an economic crisis).

<sup>61</sup> See Goel & Thakor, *supra* note 47, at 2771 (concluding that, because of the corporate promotion process, which favors promotion of overconfident managers, a corporate board is “likely to end up with a pool of overconfident managers from which to choose a CEO”); see also Langevoort, *supra* note 46, at 292–95 (discussing constraints on the board's ability to effectively monitor management).

## III

## THREE VARIATIONS ON A THEME BY CHUCK PRINCE

A year or so before the crisis hit, the *Financial Times* quoted Citigroup's CEO, Chuck Prince, as saying that he understood that "[w]hen 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."<sup>62</sup> Countless books, articles, blogs, and the like repeat this reference to the children's game of musical chairs,<sup>63</sup> not only because it hints at some contemporaneous awareness of a looming risk, but because it is so eerily evocative. Without for a moment suggesting that I know precisely what he meant, which may in fact have had little or nothing to do with subprime risk,<sup>64</sup> I think we can dig deeper into organizational psychology and culture by considering three ways in which his dancing reference might be read.

## A. Feeling the Music

Dancing evokes a form of emotional expression, not usually a logical one. One of the problems with the arid reference to heuristics and biases in much of the legal literature is that it fails to capture the emotional aspect of judgment and decision making as it relates to risk. In fact, in a growing body of work on cognitive neuroscience, researchers have come to better understand the strong role of emotions in financial risk taking. Among many things, this work suggests that different portions of the brain are activated when emotions such as fear and greed are prompted, moving the locus of decision away from the rational processing of information that is centered in the prefrontal cortex.<sup>65</sup> Without trying to review this emerging field, interesting inferences can be drawn that connect closely to the financial crisis. Consider the following Congressional testimony offered by Andrew Lo, an economics professor at MIT and a hedge fund adviser:

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<sup>62</sup> Michiyo Nakamoto & David Wighton, *Bullish Citigroup is 'Still Dancing' to the Beat of the Buy-Out Boom*, FIN. TIMES (London), July 10, 2007, at 1-1.

<sup>63</sup> See POSNER, *supra* note 10, at 88-89; GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 148 (2009); Dealbook, *Citi Chief on Buyouts: 'We're Still Dancing.'* NYTIMES.COM (July 10, 2007, 10:54 AM), <http://dealbook.nytimes.com/2007/07/10/citi-chief-on-buyout-loans-were-still-dancing>; Steven Pearlstein, *The Art of Managing Risk*, WASH. POST, Nov. 28, 2007, at D1.

<sup>64</sup> In testimony before the Financial Crisis Inquiry Commission, Prince explained that the reference was to the "leveraged lending business" of private equity financing and had nothing to do with subprime. See Cyrus Sanati, *Prince Finally Explains His Dancing Comment*, NYTIMES.COM (Apr. 8, 2010, 2:04 PM), <http://dealbook.blogs.nytimes.com/2010/04/08/prince-finally-explains-his-dancing-comment>.

<sup>65</sup> See Peter Bossaerts, *What Decision Neuroscience Teaches Us About Financial Decision Making*, 1 ANN. REV. FIN. ECON. 383, 394-95 (2009).

During extended periods of prosperity, market participants become complacent about the risk of loss—either through systematic underestimation of those risks because of recent history, or a decline in their risk aversion due to increasing wealth, or both. In fact, there is mounting evidence from cognitive neuroscientists that financial gain affects the same “pleasure centers” of the brain that are activated by certain narcotics. This suggests that prolonged periods of economic growth and prosperity can induce a collective sense of euphoria and complacency among investors that is not unlike the drug-induced stupor of a cocaine addict. Moreover, the financial liberalization that typically accompanies this prosperity implies greater availability of risk capital, greater competition for new sources of excess expected returns, more highly correlated risk-taking behavior because of the “crowded trade” phenomenon, and a false sense of security derived from peers who engage in the same behavior and with apparent success.<sup>66</sup>

Unpacking this paragraph is difficult, but it offers an intuition of considerable interest. Within financial firms, individuals may become more aggressive in their risk taking in response to positive feedback and other forms of anticipation that light up the nucleus accumbens.<sup>67</sup> Of course, their fear and revulsion create the opposite effect: the amygdala, located within the temples, acts as the brain’s emotional center to trigger panic responses.<sup>68</sup> But during a prolonged bubble, there may be a gradual domination of emotional justification for risky activity, protected from any opportunity to learn from hard experience: the visceral excitement of the dance that makes it hard to slow down, much less stop.

The last sentence in Lo’s claim brings us to another aspect of dancing to which the emotions relate: its social dimension. The positive feedback that generates increasing levels of excitement and di-

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<sup>66</sup> Andrew W. Lo, Hedge Funds, Systemic Risk, and the Financial Crisis of 2007–2008, Written Testimony Prepared for the U.S. House of Representatives Committee on Oversight and Government Reform Hearing on Hedge Funds 12–13 (Nov. 13, 2008) (internal footnote omitted), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1301217](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301217). For some of Lo’s work in financial neuroscience, see Andrew W. Lo & Dmitry V. Repin, *The Psychophysiology of Real-Time Financial Risk Processing*, 14 J. COGNITIVE NEUROSCIENCE 323, 332–33 (2002) (studying physiological responses of professional securities traders and finding “that emotional responses are a significant factor in the real-time processing of financial risks”). For a more general discussion relating to the financial crisis, see Gary Stix, *The Science of Bubbles and Busts*, SCI. AM., July 2009, at 78, 80–85.

<sup>67</sup> See William J. Bernstein, *Of Laws, Lending, and Limbic Systems*, 66 FIN. ANALYSTS J., Jan.–Feb. 2010, at 17, 19 (noting that the nucleus accumbens “respond[s] most intensely to the anticipation of reward” and labeling it the “greed center”).

<sup>68</sup> See *id.* (noting that the amygdala “activate[s] in reaction to revulsion, fear, and financial loss,” labeling it “the financial market’s horsemen of the apocalypse”). While fear reduces the tendency toward risk-taking, anger does the opposite. See Jennifer S. Lerner & Dacher Keltner, *Fear, Anger, and Risk*, 81 J. PERSONALITY & SOC. PSYCHOL. 146, 146–47, 154–56 (2001).

minished risk perception can be personal success or the observed success of others.<sup>69</sup> This success suggests a connection to adaptive corporate cultures, particularly their motivational function. A contagion of enthusiasm energizes those segments of the organization responsible for the creation and marketing (or purchase) of complex financial products, enabling the extraordinarily hard work that goes into the high-velocity deal flow.<sup>70</sup> This is high-grade corporate grease. It is likely to energize, if not enthuse, even the support staff in the back office—far from the trading desks and sales calls—because of the feeling of purpose and profitable future. Moreover, those central to the excitement, who easily achieve the “high” that Lo refers to, will be favored in the corporate promotion tournament.<sup>71</sup> They quickly take on more seniority and power, in turn silencing expressions of risk from people who might want to turn down the music. Maybe that is why the dancing Chuck Prince described was so frenzied for so long.

This emotional and social account meshes fairly well with what we observe inside highly competitive financial firms. There is a strong emotional emphasis on team building and bonding—fraternity-like excesses included. “Wins” by one person or team are celebrated visibly, with ample loathing for the losers, which sends multiple loaded messages to their colleagues (who are also their internal competitors). Of particular interest along these lines is an ethnographic study of Wall Street investment bankers by Karen Ho.<sup>72</sup> She describes two key cultural tropes: an obsession with the notion of “the market” as a way of justifying whatever financial services will sell at the moment and an obsession with the near-term as the only way to achieve synchronicity with the market.<sup>73</sup> There is a fatalistic element to this because, even in good times, the market shifts rapidly, and layoffs of bankers are

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<sup>69</sup> Cf. AKERLOF & SHILLER, *supra* note 54, at 55–56 (“Confidence is not just the emotional state of an individual. It is a view of other people’s confidence, and of other people’s perceptions of other people’s confidence. . . . Just as diseases spread through contagion, so does confidence. . . .”).

<sup>70</sup> Cf. Langevoort, *supra* note 48, at 153–55 (discussing the proliferation and motivational effect of confidence within firms).

<sup>71</sup> See Goel & Thakor, *supra* note 47, at 2745–50; see also Langevoort, *supra* note 46, at 288 (arguing that “traits such as overoptimism, an inflated sense of self-efficacy and a deep capacity for ethical self-deception are favored in corporate promotion tournaments, so that people who possess them are disproportionately represented in executive suites”) (emphasis omitted); cf. Lo & Repin, *supra* note 66, at 332 (“The extraordinary degree of competitiveness of global financial markets and the outsize rewards that accrue to the ‘fittest’ traders suggest that Darwinian selection—financial selection, to be specific—is at work in determining the typical profile of the successful trader. After all, unsuccessful traders are generally ‘eliminated’ from the population after suffering a certain level of losses.”).

<sup>72</sup> Karen Ho, *Disciplining Investment Bankers, Disciplining the Economy: Wall Street’s Institutional Culture of Crisis and the Downsizing of “Corporate America,”* 111 AM. ANTHROPOLOGIST 177 (2009). For a more extended discussion, see generally KAREN HO, LIQUIDATED: AN ETHNOGRAPHY OF WALL STREET (2009).

<sup>73</sup> See Ho, *supra* note 72, at 10–11, 242–43; Ho, *supra* note 72, at 178–80, 184–87.

common when their expertise goes out of style. Hence, as a matter of psychological defense if nothing else, the professional culture stresses acting in the moment.<sup>74</sup> She writes:

[T]he rampant job insecurity in investment banks, the fetishization of hard work that fosters an internalized sense of hyperefficiency and extreme responsiveness to the demands of the market, an emphasis on instant action and performance that is bolstered by banks' approaches to compensation not only truncate and tighten bankers' temporal registers but also demand a total "real-time" identification with financial markets.<sup>75</sup>

What we see here is the grease: routines and rationalizations that support a high-velocity deal-making machine. The coating of grease deflects disabling reflection on the particular risk hidden within all the complexity, especially if the risk will play out more than a brief time into the future, even while there is an inchoate, ever-present foreboding that the good times never last. I will have more to say about these rationalizations shortly.

How does this play out on the ground? What it suggests is that profitable deal flow takes on a dance-like momentum that is very hard to stop, in part because of the emotional and financial attachment so many powerful people have to it. In a very prescient set of commentaries published well before the financial crisis hit, Rick Bookstaber, a former senior risk manager at Salomon Brothers and Morgan Stanley, warned of the coming debacle and, at one point, described a hypothetical negotiation between a trader and an in-house risk manager who wanted to slow down the aggressive activity.<sup>76</sup> Presumably, after responding with the usual bluster, the trader might insist that the risk manager explain *exactly* what the level of risk is in the particular deal that would justify foregoing the attractive fees and returns.<sup>77</sup> In a setting of high uncertainty and complexity, this is impossible to answer persuasively, especially by an overworked, underresourced (and often inexperienced) risk manager.<sup>78</sup> Absent the ability to give a precisely quanti-

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<sup>74</sup> See Ho, *supra* note 72, at 186–87.

<sup>75</sup> *Id.* at 179.

<sup>76</sup> See Rick Bookstaber, *Conversations with the Trading Desk*, RICKBOOKSTABER.COM (Dec. 2, 2007), <http://rick.bookstaber.com/2007/12/conversations-with-trading-desk.html>. Bookstaber, now an SEC official, elaborated on this and the market becoming more vulnerable to crisis before the meltdown. See RICK BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 5–6, 255–60 (2007).

<sup>77</sup> Lo described a similar hypothetical to Congress, noting that during the boom, a Chief Risk Officer's recommendation to reduce collateralized debt obligation (CDO) activity because of a potential downturn in the real estate market would decrease profits and prompt an exodus of traders, rendering such a reduction "difficult to justify." Lo, *supra* note 66, at 13–14.

<sup>78</sup> See Bookstaber, *supra* note 76 (noting that "the risk manager is always at a disadvantage when dealing with the trading desk" in part because the traders have greater expertise

fied answer, it is a matter of judgment and therefore politics, a negotiation the risk manager will not win. Here, the well-known technology failure comes into play because the elaborate risk models these firms built, the so-called VaR models, were compromised by historic data of very recent vintage that was insufficiently representative of future risk.<sup>79</sup> In the background is a question that is always lurking: if there is too much risk today, what about yesterday, when things were hardly any different and yet no objections were raised? This, of course, is the basis for a common bias that, I suspect, often affects organizations fairly severely: cognitive conservatism. When change happens slowly, it is perceived poorly<sup>80</sup> for reasons that are related to the well-known psychological phenomenon of cognitive dissonance and the so-called sunk cost fallacy.<sup>81</sup> A voluntary commitment to a course of action prompts the perception that it was a reasonable course of action, which motivates resistance to disconfirming information even as things change.<sup>82</sup> Any prior period of time when the organization did not limit risk taking is open to criticism (and even potential liability) in hindsight once the risk is acknowledged. This means that even risk managers may be motivated not to notice the change. They may also get emotionally caught up in the dancing, at least as spectators.

## B. Dance Competition

If Chuck Prince's quote is read as referring to the children's game of musical chairs, then it evokes another possible reading—that the dancing was impossible to slow down because Citigroup was in competition with others, each with their eyes on a diminishing num-

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of their own markets and risk managers are generally “too busy to really focus on risk management”).

<sup>79</sup> See *supra* note 57 and accompanying text. See also Erik F. Gerding, *Code, Crash, and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 139–43, 170–74 (2009). See also Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 151–52 (2009) (discussing data deficiencies in operational risk models).

<sup>80</sup> See Sara Kiesler & Lee Sproull, *Managerial Response to Changing Environments: Perspectives on Problem Sensing from Social Cognition*, 27 ADMIN. SCI. Q. 548, 564 (1982); cf. Volokh, *supra* note 25 (describing the boiling frog and its inability to detect gradual temperature changes).

<sup>81</sup> The sunk-cost fallacy refers to the economic behavior of tending “to continue an endeavor once an investment in money, effort, or time has been made.” Hal R. Arkes & Peter Ayton, *The Sunk Cost and Concorde Effects: Are Humans Less Rational Than Lower Animals?*, 125 PSYCHOL. BULL. 591, 591 (1999).

<sup>82</sup> See Kiesler & Sproull, *supra* note 80, 558–59 (asserting that “decision makers’ commitments are to programs, policies, and procedures first, and to data second” and hypothesizing that the more invested managers are in particular scenarios, the more likely they are to discount detrimental information); cf. *id.* at 564 (noting that the “corporate penchant for elaborate forecasting and planning activities discourages the development of schemas for extreme change. . . . [and] increases the likelihood that, for motivational reasons, stimuli substantially inconsistent with the forecast or plan will be ignored”).

ber of chairs. This reading raises the issue of how the nature of organizational or individual judgment and decision making shifts as a result of competition in ways beyond the self-evident effects on the payoff structure of the game. Given my focus on firms in hypercompetitive industries, this inquiry is particularly important. We already have some ideas on which to build. As sports coaches stress, competition demands especially high levels of focus and intensity; thus, distractions are dangerous. Intuitively, the more intense the competition, the more essential the grease.<sup>83</sup>

We have interesting evidence from recent research on the psychological and physiological effects of competition. A common laboratory finding regarding auctions is that they can trigger a desire to win that carries over even if success is more costly than not winning—the tendency to overpay,<sup>84</sup> which is one explanation for why mergers and acquisitions are often value destroying. The “competitive arousal” model of decision making suggests that situational factors such as rivalry, heavy time pressures, and the presence of an audience prepared to judge the competition stimulates physiological and psychological arousal that pushes motivation away from simple goal attainment to an obsession with winning and crowding out more thoughtful consideration of risks and costs.<sup>85</sup> Another study indicates that the intensity of competitive effects strengthens as the participants are highly ranked or close to an identifiable standard of comparison.<sup>86</sup> Note how deeply all these situational conditions—especially

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<sup>83</sup> Karen Ho’s description of the felt need at all times for bankers to be synchronized with the market attests to this: “The quickness of investment banks’ reaction to market trends signifies their absolute identity with the market; their cultural distinction is the ability to channel the market immediately.” Ho, *supra* note 72, at 186.

<sup>84</sup> See, e.g., Gillian Ku et al., *Towards a Competitive Arousal Model of Decision-Making: A Study of Auction Fever in Live and Internet Auctions*, 96 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 89, 99–100 (2005) (finding in laboratory auction experiment that “[r]ivalry and sunk costs increased the likelihood of overbidding”); Deepak Malhotra, *The Desire to Win: The Effects of Competitive Arousal on Motivation and Behavior*, 111 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 139, 139 (2010) (discussing studies showing that “the desire to beat rival bidders can lead auction participants to pay more than an item is worth to them”).

<sup>85</sup> See Ku et al., *supra* note 84, at 100–02; Malhotra, *supra* note 84, at 140–42, 144–45. For a more general discussion, see Deepak Malhotra et al., *When Winning Is Everything*, HARV. BUS. REV., May 2008, at 78, 80–83. Interestingly, the authors note that competitive arousal seems more likely when lawyers are involved in the process. See *id.* at 82. This literature and its antecedents have been invoked to explain bidder overpayment in corporate takeovers. See *id.* at 78, 80, 83–84 (illustrating the impact of competitive arousal through Boston Scientific’s acquisition of Guidant and the Redstone-Diller battle for Paramount Pictures); see also Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 625–27 (1989) (discussing winner’s curse theory in the context of overpayment in corporate takeovers).

<sup>86</sup> See Stephen M. Garcia et al., *Ranks and Rivals: A Theory of Competition*, 32 PERSONALITY & SOC. PSYCHOL. BULL. 970, 970–72, 980–81 (2006).

the first three—affect the financial services industry, particularly when firms aim to dominate a new financial technology.

Connected to the psychophysiology of competitive arousal are studies indicating hormonal effects. Testosterone, for example, is linked to a variety of competitive behaviors including power seeking, social dominance, reduction in fear response, i.e., the “desire to be socially visible, influential, and dominating,”<sup>87</sup> as well as financial risk taking.<sup>88</sup> The intuition that hypercompetitive firms select for high testosterone individuals, as evidenced by prior status achievement and tendency to promote overconfident, risk-taking managers,<sup>89</sup> suggests that this effect will replicate and intensify once such people are thrown into their probationary crucibles. Here, of course, we are connecting back to the psychophysiology of emotional arousal in risk taking.

In turn, hypercompetition generates other organizational consequences. To meet high expectations, firms establish “stretch” goals, which may lead to a more frequent aggressive and unethical behavior as the risk of loss becomes more palpable, a form of loss aversion.<sup>90</sup> Even without explicit goals and quotas, agents sensing competition will likely set their own aspiration levels. There is a curious duality here. The robust psychological phenomenon of loss aversion triggers greater risk taking when, perhaps pessimistically, individual agents

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<sup>87</sup> Michael J. Zyphur et al., *Testosterone-Status Mismatch Lowers Collective Efficacy in Groups: Evidence from a Slope-as-Predictor Multilevel Structural Equation Model*, 110 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 70, 71 (2009); see also Maurice Levi et al., *Deal or No Deal: Hormones and the Mergers and Acquisitions Game*, 56 MGMT. SCI. 1462, 1463, 1476 (2010) (using CEO age as a proxy for hormone levels and discussing the impact of testosterone on acquisition activity, in particular withdrawn bids and tender offers). Although there is a perception that this hormonal effect is largely found in males, evidence shows that “alpha”-like behavior is found fairly equally between genders, based on relative testosterone levels within gender. See Zyphur et al., *supra*, at 71 (noting that despite its greater presence in men, testosterone “has been shown to have an equivalent impact on social dominance in both males and females after controlling for the difference” in gender-associated testosterone levels). That said, evidence of male cultural domination on Wall Street is disturbingly substantial. See Christine Sgarlata Chung, *From Lily Bart to the Boom-Boom Room: How Wall Street’s Social and Cultural Response to Women Has Shaped Securities Regulation*, 33 HARV. J.L. GENDER 175, 177–81 (2010).

<sup>88</sup> See Coren L. Apicella et al., *Testosterone and Financial Risk Preferences*, 29 EVOLUTION & HUM. BEHAV. 384, 387–89 (2008); J.M. Coates & J. Herbert, *Endogenous Steroids and Financial Risk Taking on a London Trading Floor*, 105 PROC. NAT’L ACAD. SCI. 6167, 6170–71 (2008).

<sup>89</sup> See Goel & Thakor, *supra* note 47, at 2745–50; Langevoort, *supra* note 46, at 288, 299–302.

<sup>90</sup> See Lisa D. Ordóñez et al., *Goals Gone Wild: The Systematic Side Effects of Over-Prescribing Goal Setting* 5, 9–13 (Harvard Bus. Sch., Working Paper 09-083, 2009) (discussing the negative side effects of “stretch goals,” which include “shifting risk attitudes, promoting unethical behavior, and triggering the psychological costs of goal failure”); Maurice E. Schweitzer et al., *Goal Setting as a Motivator of Unethical Behavior*, 47 ACAD. MGMT. J. 422, 423–24, 429–30 (2004) (studying the impact of goal setting in motivating unethical behavior when individuals fail to attain such goals).

frame their decision in terms of the risk of falling short of expectations.<sup>91</sup> On the other hand, to the extent that organizational or individual overconfidence blunts the fear of failure, the resulting overconfidence implies excessive risk taking apart from any framing effects.<sup>92</sup> Calibrating the corporate thermostat to reduce the heat of competitive excess is difficult without also cooling things down so much that the firm loses its intensity and focus.

### C. Dancing for the Crowd

Chuck Prince said that everyone must get up and dance,<sup>93</sup> but why? Perhaps it is the feeling of the competitive imperative just described, but dancing can also be performance art, meant for any number of audiences. The final reading I offer is the possibility that the reason Citigroup and others were dancing so fast was because the crowd—investors in the stock market—was demanding it.

Investment banks had shifted their ownership structure from private partnerships to public companies decades before the crisis.<sup>94</sup> Hence, their stock prices were crucially important in terms of the net worth of company insiders (whose compensation packages depended on the stock price) and as a means of comparing them with their intense competitors.<sup>95</sup> An inflated stock price would attract people and create expansion opportunities; a depressed price would repel investment and make the firm a target.

If markets are efficient, their pricing rational and then their stock prices generate a constructive discipline. If they are not efficient, the discipline diminishes and may become dysfunctional. One branch of behavioral finance studies potential market inefficiencies brought about by some combination of animal spirits at work in supply and demand and institutional constraints (e.g., short-sale restrictions) that limit the opportunities for arbitrage as a corrective, and it analyzes

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<sup>91</sup> See Scott Rick & George Loewenstein, *Hypermotivation*, 45 J. MARKETING RES. 645, 645–46 (2008) (discussing hypermotivation, “a visceral state that leads a person to take actions he or she would normally deem to be unacceptable,” and how it arises in response to loss aversion and perhaps in response to unattainable or overly ambitious goals); see also Langevoort, *supra* note 46, at 306–08 (discussing the “slippery slope” that leads to unethical behavior in CEOs who fall short of expectations and fear termination). Especially for prominent firms, a period of high performance may ratchet up expectations so high that improper behavior becomes the only way of avoiding falling short. See Yuri Mishina et al., *Why “Good” Firms Do Bad Things: The Effects of High Aspirations, High Expectations, and Prominence on the Incidence of Corporate Illegality*, 53 ACAD. MGMT. J. 701, 703–06, 715–18 (2010).

<sup>92</sup> See *supra* notes 44–50 and accompanying text.

<sup>93</sup> Nakamoto & Wightton, *supra* note 62.

<sup>94</sup> See Claire Hill & Richard Painter, *Berle’s Vision Beyond Shareholder Interests: Why Investment Bankers Should Have (Some) Personal Liability*, 33 SEATTLE U. L. REV. 1173, 1177–78 (2010).

<sup>95</sup> See *id.* at 1181–86; Langevoort, *supra* note 46, at 294.

how firms and their managers respond to these distortions.<sup>96</sup> This latter step may assume rationality on the part of the managers, or it may not.<sup>97</sup>

Much has been written about the crisis that claims that stock market investors overvalued firms that threw themselves into the subprime securitization and derivatives business, underpricing the risk.<sup>98</sup> This is contestable; critics like Posner point out that investors' limited liability and the moral hazard issues that explicit government guarantees raised could incline them toward risk taking when they stood to make money from taking the gamble.<sup>99</sup> My own sense from the evidence is that the stocks were mispriced because of irrational exuberance but especially because the firms failed to disclose information necessary to assess the risk properly. A recent article by Bill Bratton and Michael Wachter contains a striking graph<sup>100</sup> comparing the relative prices of Countrywide (the most enthusiastic dancer in the bunch), Bank of America, and JPMorgan Chase (by most accounts the also-ran, now praised in hindsight as the smartest of the competitors).<sup>101</sup> The dramatic price dispersion strongly suggests that the wilder the dancing, the more excited the stock market reaction.

If so, this phenomenon created a dangerous incentive to which the firms had to respond. Gillian Tett's insightful book on J.P. Morgan,<sup>102</sup> which in many ways invented the kind of synthetic derivatives sold so freely during the frenzy but withdrew from the most lucrative segments of the market later on,<sup>103</sup> shows how the company was threatened by its reticence. Its merger with Chase, not on the most favorable of terms, was one such consequence, and the pressure grew even stronger postmerger.<sup>104</sup> Morgan's competitors did far better, until the bubble burst.<sup>105</sup> Even if we assume pervasive rationality on the

<sup>96</sup> See e.g., Malcolm Baker & Jeffrey Wurgler, *Investor Sentiment in the Stock Market*, 21 J. ECON. PERSP. 129, 131–35 (2007) (discussing investor sentiment, mispricing of hard-to-arbitrage stocks, and reaction to mispricing by corporate insiders).

<sup>97</sup> See, e.g., Malcolm Baker et al., *Behavioral Corporate Finance*, in 1 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 147–48 (B. Espen Eckbo ed., 2007) (distinguishing research based on the “irrational investors approach” from the “irrational managers approach”).

<sup>98</sup> See generally sources cited *supra* note 54 (providing behavioral finance explanations for crisis).

<sup>99</sup> See *supra* notes 59–60 (criticizing psychology-based explanations for the crisis and attributing it to risky, yet rational, self-interested behavior); see also POSNER, *supra* note 10, at 85–86, 92–93 (discussing limited liability as a factor).

<sup>100</sup> William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 720 (2010).

<sup>101</sup> See *id.* at 718–21 (describing Countrywide and JPMorgan Chase's respective strategies and approaches to risk).

<sup>102</sup> See TETT, *supra* note 63.

<sup>103</sup> See *id.* at ix–x, 19–22, 51–56, 120–42.

<sup>104</sup> See *id.* at 75–86, 120–42.

<sup>105</sup> See *id.* at 140, 244–45; Bratton & Wachter, *supra* note 100, at 720.

part of managers, an irrational stock market can produce distorted behaviors if stock price becomes the metric to which the company is managed.

If we relax the assumption of managerial rationality, these biases become mutually reinforcing. It is worth revisiting Karen Ho's ethnography of Wall Street banking, which stresses the extraordinary extent to which the market and market prices become a fetish within the culture.<sup>106</sup> Her subjects insist that there is no truth but the market; those things which the market prizes should be delivered instantly. The primary form of rationalization was to claim the moral high ground of shareholder value; the prime imperative is to maximize stock price for the shareholders, thereby "reclaiming the 'rightful' capitalist unity between ownership (of stock) and control over corporations that they believe had been sundered during the heyday of managerial 'welfare' capitalism, which in turn fosters the values of responsibility, efficiency, and individual proprietorship."<sup>107</sup> Importantly, this rationalization—a myth, really—was strong enough to convince bankers that the same principle legitimately applies to their own publicly-held employers, even when it threatens their own careers through layoffs and downsizings.<sup>108</sup> Perhaps the dance was simply its ritual expression.

To a corporate law professor, this ideology is familiar, even though as a matter of law it is grossly inflated. Shareholders are not really owners even though they are residual claimants,<sup>109</sup> and control of the firm is in the directors' hands with largely unreviewable discretion, which they are free to exercise in most states to the derogation of short-term shareholder interests.<sup>110</sup> Even Delaware courts have carefully avoided any endorsement of "manage to the market."<sup>111</sup>

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<sup>106</sup> See *supra* notes 72–75 and accompanying text.

<sup>107</sup> See Ho, *supra* note 72, at 180; see also Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1640–63, 1697–99 (2001) (describing the extent to which this view is widely held among business people and also describing the effects on corporate governance).

<sup>108</sup> See Ho, *supra* note 72, at 181–87.

<sup>109</sup> See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. REV. 547, 563–64 (2003); Bratton & Wachter, *supra* note 100, at 662–65.

<sup>110</sup> Cf. Bainbridge, *supra* note 109, at 568–74 (arguing that shareholder primacy "exists in neither law nor fact," but rather that "[p]rimacy within the corporation is vested in the power of directors").

<sup>111</sup> See Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523, 523–30, 556–75 (2003) (arguing that in regard to takeover defenses, Delaware courts employ a management-discretion model that provides "managers with the freedom to ignore financial market valuations when setting corporate policy"); see also Bratton & Wachter, *supra* note 100, at 713 (discussing the legal model of the corporation, which "imposes no duty to manage to the market when the directors' views about value differ from the market's view").

But cultural myths are part of the grease, and fetishizing the market could well prompt the kind of focus and intensity that promotes competitive success. Doubting the market and its pricing mechanisms can be disorienting because there is nothing in its absence but human judgment, over which there are endless, distracting arguments. We should be cautious here, of course. Ho's study investigates bankers involved in mergers and acquisitions, and their script was specific to that market niche. We know that investment bankers often doubt the accuracy of market prices: hedge funds and proprietary trading desks exploit pricing inefficiencies very profitably, and we know that some of them privately turned bearish on subprime debt well before the market turned downwards.<sup>112</sup> Synchronicity does not imply respect for other market players, and bankers notoriously display contempt for lesser intellects, a category that often seems to include nearly everyone else in the world on matters of money and markets.<sup>113</sup> My sense, which we will explore further in Part IV, is that this cultural belief about the legitimacy of markets and prices is mainly a normative one—that the market *deserves* what it wants and gets—which is consistent with a culture that is also quite arrogant.

That said, the market as a scoreboard has an undeniable emotional pull. When the stock price rises abnormally for a firm or industry, it is hard not to construe it as an endorsement of its strategy and direction, as part of a feedback loop that combines with internal cultural optimism and self-interest to reinforce the belief that this is the right course of action. The market's wild applause and the deep fear that all performers have of disappointing the crowd surely fed Chuck Prince's.

#### IV

#### GOLDMAN SACHS AND GOD'S WORK

In a newspaper interview with *The Times* of London in August 2009, Goldman Sachs' CEO, Lloyd Blankfein, said that he was simply a banker "doing God's work."<sup>114</sup> Presumably Blankfein meant this statement facetiously. If so, it was a good example of Wall Street's public relations learning disability, but in any event, it was as evocative and

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<sup>112</sup> See examples cited *supra* note 13.

<sup>113</sup> See, e.g., Ho, *supra* note 72, at 57 ("Central to Wall Street's construction of its own superiority is the corollary assumption that other corporations and industries are 'less than'—less smart, less efficient, less competitive, less global, less hardworking . . ."); Ho, *supra* note 72, at 186 (quoting a corporate finance associate who described the influence of Wall Street on corporate America: "We've made everyone smarter. We know much more about how global competition works, about how to create efficiency. . . . [W]e understood shareholder value and strategy before anyone else").

<sup>114</sup> John Arlidge, *Inside the Goldmine*, *TIMES* (London), Aug. 11, 2009, (Magazine), at 12.

infamous as Prince's dancing reference. The irony became evident soon enough when the SEC brought a high-profile deception case against Goldman, accusing it of misleading a large German bank (IKB) and the portfolio manager (ACA) about how a large synthetic collateralized debt obligation (CDO) had been structured.<sup>115</sup> By most accounts, this case generated enough public resentment that the massive legislative reform work in Congress, which had stalled, restarted in earnest.<sup>116</sup>

Many on Wall Street called the SEC's case a cynical political move,<sup>117</sup> and as a legal matter, Goldman had plenty of strong defenses,<sup>118</sup> most of which focused on the ability of IKB—a large, well-staffed player in the securitization market—to understand the actual makeup of the securitization portfolio it bought from Goldman.<sup>119</sup> If IKB and ACA were indeed misled, as the SEC claims, it raises a more interesting set of questions about how institutional buyers behave than why sellers might be tempted to take advantage of that behavior. The federal securities laws are not particularly solicitous in cases of imprudent reliance by a sophisticated purchaser.<sup>120</sup>

I am more curious about the psychological and cultural background to a transaction like this, on both sides. IKB may not be a

<sup>115</sup> Complaint at 1–3, 11–17, SEC v. Goldman Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010), available at <http://www.sec.gov/litigation/complaints/2010/comp21489.pdf>. Goldman settled with the SEC a few months later by agreeing to a record-setting payment of \$550 million. See SEC Litig. Release No. 21592 (July 15, 2010), available at <http://www.sec.gov/litigation/litreleases/2010/lr21592.htm>. The thrust of the claim was that both IKB and ACA were misled by not being informed that Paulson & Co., the initiating party that was taking the short side of the deal, had negotiated to include in the reference portfolio securities that it deemed particularly susceptible to the looming subprime risk. Complaint, *supra*, at 11–19.

<sup>116</sup> See Julie Creswell, *Goldman Was Regulators' First Prize, and It May Be the Last*, N.Y. TIMES, July 17, 2010, at B4; John E. Morris, *The SEC Tests Goldman's Teflon*, THE SOURCE, (Apr. 19, 2010, 10:18 AM), <http://blogs.wsj.com/source/2010/04/19/the-sec-tests-goldmans-teflon>.

<sup>117</sup> See Andrew Ross Sorkin, *A Crowd with Pity for Goldman*, N.Y. TIMES, Apr. 27, 2010, at B1.

<sup>118</sup> See Zachary A. Goldfarb and Tomoeh Murakami Tse, *Goldman Says Its Clients Knew the Product*, WASH. POST, Apr. 21, 2010, at A12.

<sup>119</sup> See Zachary A. Goldfarb, *SEC Confident on IKB Part of Goldman Suit*, WASH. POST, Apr. 24, 2010, at A8 (“Much of the criticism of the SEC case . . . is that IKB and ACA were sophisticated investors who knew what they were doing.”); see also Fared Zakaria, *Cross of Gold*, NEWSWEEK, May 3, 2010, at 24 (noting that IKB was “a large German bank that had whole departments devoted to analyzing just these products” and that it “surely knew that someone was betting against them” who thought they “were garbage”). But see Goldfarb, *supra*, (“[G]overnment officials say that IKB came to Goldman for help explicitly because it wanted objective advice on what to invest in, and that Goldman did not tell the German bank that the product contained mortgages that Paulson believed would fail. So, SEC officials say, it doesn't matter whether IKB was a sophisticated investor or not because Goldman did not provide the objective investment advice the German bank was seeking.”).

<sup>120</sup> See C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1086–94.

perfect example of a risk-assuming buyer because it apparently transferred much of its interest in the CDO to smaller institutional investors, including many municipalities in the United States, through its own special investment vehicle.<sup>121</sup> It was thus something of a middleman, trying to profit from the spread. But there is enough to the story to suggest that IKB can be treated as a purchaser that believed that the risk was low enough relative to the expected returns to justify the transaction. This interpretation brings us back to the two main possibilities: either its portfolio managers were deliberately ignoring the risk because of their own compensation incentives, or the managers underestimated the risk.<sup>122</sup> From my reading of the complaint, the SEC does not adduce any evidence to suggest that Goldman acted in a fiduciary-like capacity with respect to IKB, which was a large part of Goldman's defense.

On the buy side, we have already considered some of the biases that might lead to underestimation. One additional point deserves emphasis. IKB regularly bought these kinds of securities and derivatives to fill a very large appetite for securitized debt.<sup>123</sup> I suspect that it had developed a routine associated with purchases that had become somewhat habitual, with nothing but positive, profitable feedback through early 2007. As we saw earlier, routines—especially when they move to high velocity—take on a life and logic of their own, making it hard to perceive the need to rethink at any particular moment.<sup>124</sup> To me, the most compelling aspect of the SEC's case comes from the appearance that Goldman's salesman in the transaction, Fabrice Tourre, was working fairly hard to convey the impression that nothing was particularly new or unusual about this transaction, so as not to trigger any pause or doubt in the buyer's routine.<sup>125</sup> If so, and in fact there was something new or unusual that might give IKB pause, then the SEC has a good bit of material with which to work. We would have to know much more about what was said and what was understood to judge.

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<sup>121</sup> See Carrick Mollenkamp & Laura Stevens, *German Bank: Victim or a Contributor?*, WALL ST. J., Apr. 22, 2010, at C2; Nathaniel Popper, *Main St. Paid for Wall St. Maneuvers*, L.A. TIMES, Apr. 29, 2010, at B1.

<sup>122</sup> See Mollenkamp & Stevens, *supra* note 121 (noting that "IKB proved an avid buyer of much that Wall Street had to offer").

<sup>123</sup> See *id.* (chronicling IKB's expansion into the CDO investment business, noting that IKB had touted itself as a "leading investor in CDOs" in marketing materials).

<sup>124</sup> See *supra* Part I.B. This is true in terms of ethics as well. See Francesca Gino & Max H. Bazerman, *When Misconduct Goes Unnoticed: The Acceptability of Gradual Erosion in Others' Unethical Behavior*, 45 J. EXPERIMENTAL SOC. PSYCHOL. 708, 709 (2009).

<sup>125</sup> See Complaint, *supra* note 115, at 11–12, 16–17 (describing Tourre's efforts to portray the Abacus portfolio as having been selected by an independent third party and his efforts to conceal Paulson's role).

The sell side is more interesting. The criticism against Goldman has been twofold: first, of its failure to give background information as to how this particular CDO had been structured; and second, of its failure to disclose the many respects in which the firm was by this time (and maybe in this transaction itself, though that is far from clear) starting to bet that real estate prices and the value of subprime mortgages were going to drop.<sup>126</sup> I want to put aside the murky legal question of what the duty to disclose is in a situation like this. Instead, I want to consider mainly the ethical and reputational risk that Goldman took in the deal and imagine how it might have perceived that risk internally.

Recall the claim that the bankers' culture is of-the-moment and bows to the innate legitimacy of the market mechanism, seeking an unquestioning synchronicity with it. As I mentioned, this view probably cannot be construed as a belief in the unerring accuracy of the market at any given moment so much as a Hayekian view of the necessary freedom of persons and firms to be tested in the crucible of the marketplace.<sup>127</sup> The market evolves toward accuracy and innovative efficiency, but it only does so through trial and error in which rewards and punishments are apportioned rigorously for good and bad choices.

While I have difficulty calling this God's work, I suspect that the culture within Goldman did (and does) embrace this myth. When Goldman defended itself in the press, it said that it was being a "market maker," playing a central inventive role that assumes no moral or ethical obligations to either side of the transaction.<sup>128</sup> It was a manufacturer of market crucibles in which willing participants could test their skills, knowledge, and mettle, with economic resources moving to the winners. The marketplace's willingness to compensate Goldman handsomely for playing this role was a recognition of its intrinsic value and the legitimacy of its work. So construed, there is no obligation (beyond a legal one) owed to anyone else<sup>129</sup> that might be

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<sup>126</sup> See Gretchen Morgenson & Louise Story, *Banks Bundled Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at A1.

<sup>127</sup> For a short overview of F.A. Hayek's views of the marketplace and spontaneous ordering, see Kevin T. Jackson, *The Scandal Beneath the Financial Crisis: Getting a View from a Moral-Cultural Mental Model*, HARV. J.L. & PUB. POL'Y 735, 771-73 (2010).

<sup>128</sup> See *Charlie Rose: Lloyd Blankfein, Chief Executive Officer and Chairman of Goldman Sachs* (PBS television broadcast Apr. 30, 2010), available at <http://www.charlieroose.com/view/interview/10989>. Goldman Sachs executives defended the firm's actions similarly before the Senate Subcommittee on Investigations. See Matthew Goldstein, *Goldman's More Than a Wall Street Toll Collector*, REUTERS (Apr. 28, 2010), <http://www.reuters.com/article/2010/04/28/us-goldman-maker-analysis-idUSTRE63R5JA20100428>.

<sup>129</sup> For an example of such an assertion by Blankfein, see Goldstein, *supra* note 128 ("[Blankfein] said the firm's only real obligation [when acting as a market-maker] is to make sure that a transaction is 'suitable' for clients based on their level of sophistication and financial means."). During his interview with Charlie Rose, Blankfein distinguished

distracting in generating deal flow. Simply be smarter, faster, and stronger, and take the rightful spoils.

Once again, we have found a thick coating of grease. Doing God's work, even in reduced dosage, is a classic form of moral rationalization that facilitates corner cutting and rule bending.<sup>130</sup> Excessive anxiety about whether the means are right burdens the pace of economic innovation, which is the legitimate end that society should want. Insiders seem to believe that as long as market players are acting by free will, those market players are on notice of the rules by which the game is played, and those rules are not the least bit paternalistic.

The problem with this mindset is that it is an ideology, not a truth. Our society tends to acquiesce in it (and a great deal of lobbying by Wall Street seeks to assure the continued acquiescence)<sup>131</sup> during good times, which can support the internal cultural belief in its legitimacy for a sustained period of time. But downturns and crises happen predictably, and investors and taxpayers facing losses of various sorts—and who do not feel personal responsibility for the poor investment decisions that led to those losses—are not enchanted by the social Darwinism in Wall Street's "just making markets" defense for actions that seem exploitative.<sup>132</sup>

Viewed through this newly recolored lens, the relationship between Goldman and IKB looks different, ethically but maybe legally, too. "Fabulous Fab's" egotistical celebration<sup>133</sup> (and the bonus he presumably expected) suggests to me that he was not just a table setter inviting willing parties to a market transaction, but actively persuading IKB to throw in its ante yet again. The act of salesmanship in high-end settings is extraordinarily demanding and challenging because it

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between the firm's roles as advisor and transaction facilitator, with fiduciary obligations and duties attaching to the former.

<sup>130</sup> For more information on these rationalization processes as they pertain to financial self-interest and wealth-based inequity, see Francesca Gino & Lamar Pierce, *Dishonesty in the Name of Equity*, 20 PSYCHOL. SCI. 1153, 1153–54, 1159 (2009).

<sup>131</sup> See Eric Lichtblau & Edward Wyatt, *Pro-Business Lobbying Blitz Takes on Obama's Plan for Wall Street Overhaul*, N.Y. TIMES, March 28, 2010, at A19 ("In the last decade, the financial sector has spent more money than any other industry to influence Washington policy—more than \$3.9 billion, according to the Center for Responsive Politics.").

<sup>132</sup> Cf. *Wall Street's New Shape: Rearranging the Towers of Gold*, ECONOMIST, Sept. 10, 2009, at 75, 76 (noting that despite Goldman's claims about being a market-maker and its simultaneous roles as principal and agent, its huge profits in the first six months of 2009 "have turned the media as well as the mob against it").

<sup>133</sup> For a summary of the most troubling of the Tourre e-mails released by Goldman Sachs, see Steve Eder and Karey Wutkowski, *Goldman's 'Fabulous' Fab's Conflicted Love Letters*, REUTERS (Apr. 25, 2010), <http://www.reuters.com/article/2010/04/26/goldman-emails-idUSN2516585020100426>. The full text of the Goldman Sachs e-mails—including some of those sent by Tourre—can be found at *Goldman Sachs and the Financial Crisis*, NYTIMES.COM, <http://documents.nytimes.com/goldman-sachs-internal-emails> (last visited Feb. 1, 2011).

involves manipulating and managing desires, usually after building some level of trust. That is why good salespeople are paid so much. Confronted with salient evidence of damage resulting from a sale, ordinary people passing judgment in hindsight may tend to see the salesmanship for what it is and blame the seller.

That is also why deeply-held cultural ideologies inside firms can be risky, especially when they edge toward the God's work frame. A close look at the Enron scandal shows its unmistakable influence there too: Enron exuded the greasy cultural ideology that making new kinds of markets for energy would revolutionize the delivery of water, electricity, and natural gas supplies globally.<sup>134</sup> No one would ever want to stop that headlong rush by telling the truth when that would jeopardize financing arrangements, contracts, and other tools necessary to the desired end of marketplace success and the energy revolution.<sup>135</sup> In fact, it is striking how many financial frauds took place within industries undergoing a technological "revolution." In those revolutions, inflated self-confidence caused by early marketplace success joined with a destiny myth to override the constraints that reputation and law otherwise imposed.<sup>136</sup>

There are other cultural rationalizations as well. Cultures can denigrate outsiders, including customers and competitors, by projecting onto them an inflated disposition for selfishness and guile,<sup>137</sup> thereby justifying tit-for-tat exchanges. Rules of the game that are self-serving can be imagined as universally understood and accepted through sports and military metaphors and imagery. The danger point comes when a long enough time passes without the firm and its people being called out on their self-deception because during that time, the culture feeds on itself, and people rise up the ranks who are its exemplars and cheerleaders and who are risk takers, too.<sup>138</sup> More-

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<sup>134</sup> See BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* 73–84 (2003); see also Donald C. Langevoort, *Technological Evolution and the Devolution of Corporate Financial Reporting*, 46 WM. & MARY L. REV. 1, 2 (2004) (noting Enron's transition to an "energy-based investment bank . . . [from] a traditional supplier of natural resources").

<sup>135</sup> See Langevoort, *supra* note 46, at 287–88; see also Langevoort, *supra* note 33, at 91 ("[A]necdotal 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."). This is a general theme in MCLEAN & ELKIND, *supra* note 134, at 114–22 (describing the impact of corporate culture on ineffectiveness of risk management).

<sup>136</sup> See Langevoort, *supra* note 134, at 2–6 (2004) (arguing that technologically-based innovation was a causal factor in notable corporate scandals of the early 2000s).

<sup>137</sup> Cf. Langevoort, *supra* note 33 (discussing in-group culture and increased aggressiveness toward outsiders).

<sup>138</sup> At the individual level (and probably cultural level as well), there is also the connection between transactional velocity and possible rationalization to consider, especially when people are repeatedly put under moral stress. Cf. Nicole L. Mead et al., *Too Tired to*

over, the increasing presence of money and wealth in the immediate surroundings tends to prompt more selfishness and the inclination to rationalize by reaching to ideologies like these.<sup>139</sup>

Thus, we can take this back to the level of the individual, too. One way that firms perpetuate belief systems is by selecting individuals who are culturally compatible. In his famous ethnographic work on business ethics, Robert Jackall describes the plasticity common to successful managers, a cognitive style that easily rationalizes away moral doubt when it is competitively useful to do so, while also adhering to the norms of in-group loyalty that may make the person seem, on the surface, to be a cooperative team player.<sup>140</sup> Plainly, firms select for in-group loyalty traits but probably also for “flexibility,” to use the sanitized term for plasticity. There is a special danger here because when ethically plastic contestants are put through a series of “probationary crucibles,”<sup>141</sup> innate, unconscious skill at plasticity is probably rewarded. Up-and-comers do have to be stars at teamwork and exhibit genuine loyalty, but if they lack the willingness to do their fellows in by finding a way to step in front when winners are being chosen after each round, they probably will not move up.<sup>142</sup> Those who get all the way to the top are often quite gifted at rationalization and dissembling—a high Machiavellian style—carrying very little of the heavy baggage of moral anxiety. Power, in turn, tends to increase moral hypocrisy.<sup>143</sup> That is another enterprise risk to put on the map.

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*Tell the Truth: Self-Control Resource Depletion and Dishonesty*, 45 J. EXPERIMENTAL SOC. PSYCHOL. 594, 596–97 (2009) (finding that “[w]hen people’s self-control resources have been taxed by a prior act of self-control, cheating increases” and discussing possible explanations).

<sup>139</sup> See Francesca Gino & Lamar Pierce, *The Abundance Effect: Unethical Behaviors in the Presence of Wealth*, 109 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 142, 152 (2009) (concluding that unethical behavior increases among laboratory subjects when wealth is proximately displayed); see also Kathleen D. Vohs et al., *The Psychological Consequences of Money*, 314 SCIENCE 1154, 1156 (2006) (finding that money promotes self sufficiency and interpersonal disharmony).

<sup>140</sup> See ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 203 (1988) (“Only those with an inexhaustible capacity for self-rationalization, fueled by boundless ambition, can escape the discomfort such [ethical] compromises produce.”).

<sup>141</sup> See *id.* at 192–93.

<sup>142</sup> For a discussion of the impact of “negative activities” in the promotion process, see Kong-Pin Chen, *Sabotage in Promotion Tournaments*, 19 J.L. ECON. & ORG. 119, 120–34, 137–38 (2003).

<sup>143</sup> See Joris Lammers et al., *Power Increases Hypocrisy: Moralizing in Reasoning, Immorality in Behavior*, 21 PSYCHOL. SCI. 737, 738, 742 (2010). For a useful overview of moral hypocrisy and the self-deception strategies that enable it, see C. Daniel Batson et al., *Moral Hypocrisy: Appearing Moral to Oneself Without Being So*, 77 J. PERSONALITY & SOC. PSYCHOL. 525, 525–27, 534–36 (1999). Interesting research is emerging on the connections among moral decision making, utilitarian rationalization, and testosterone. See Dana R. Carney & Malia F. Mason, *Decision Making and Testosterone: When the Ends Justify the Means*, 46 J. EXPERIMENTAL SOC. PSYCHOL. 668, 670 (2010).

## V

## INDIVIDUALS WITHIN CULTURES

This last point brings us back to the intersection of sociology, psychology, and economics. As noted earlier, it goes too far simply to assume that organizational outcomes in risk taking are attributable to an inchoate corporate culture without considering the ability of powerful individuals to intervene and take control of decision making, perhaps to cause greater mindfulness—or perhaps to override mindfulness that might otherwise occur.<sup>144</sup>

The financial crisis gives us apparent examples of both, though we have to be cautious in relying on the largely journalistic accounts that have thus far appeared. One of the intriguing questions is to look at financial firms that did not take on excessive risk compared to their peers. JPMorgan Chase is the natural subject, because it was the one big Wall Street bank with identifiable hesitancy to go as deeply into synthetic mortgage-based derivatives as its competitors, and it suffered for a time as a result.<sup>145</sup> Gillian Tett's book, mentioned earlier, deals with this question, and the answer she arrives at is complicated. One explanation is cultural—Morgan's history and tradition did value somewhat greater conservatism and respect for risk,<sup>146</sup> and the people who ran the numbers and balked at holding the level of super-senior debt that other firms were came from that culture.<sup>147</sup> But how did that culture persist as against the competitive pressures to adjust, which are well described in the book and which the approach set forth in my Essay suggests should dominate? The answer is at least partly individual. At the point where the pressures were growing strongest, Morgan brought on as CEO an outsider, Jamie Dimon, whose professional background and experience led him to be particularly demanding that risk taking be justified rigorously and, ultimately, willing to support the skeptics.<sup>148</sup> Ironically, in light of our earlier discussion, it might well have been his own inflated self-confidence

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<sup>144</sup> There is a substantial literature on the psychology of CEO's and its influence on corporate decision making and performance. See, e.g., Arijit Chatterjee & Donald C. Hambrick, *It's All About Me: Narcissistic Chief Executive Officers and Their Effects on Company Strategy and Performance*, 52 ADMIN. SCI. Q. 351, 375–78 (2007) (studying CEO narcissism in the computer hardware/software industry and “find[ing] that narcissistic CEOs favor bold actions that attract attention, resulting in big wins and big losses, as well as wide swings between these extreme outcomes”).

<sup>145</sup> See TETT, *supra* note 63, at 120–25, 139–41.

<sup>146</sup> See *id.* at 80 (noting J.P. Morgan's risk-averse culture and emphasis on shedding risk prior to its merger with Chase).

<sup>147</sup> See, e.g., *id.* at 125–128 (discussing Bill Winters, a lifelong J.P. Morgan employee, and his recommendation to management to refrain from “open[ing] the spigots on its [CDO] pipeline”).

<sup>148</sup> See *id.* at 104–13, 120–25.

that—when coupled with this idiosyncratic background—made him *less* susceptible to either cultural or external pressures.

By contrast, an article on AIG's London affiliate by Michael Lewis suggests a very different dynamic.<sup>149</sup> AIG Financial Products became one of the largest global issuers of credit default swaps (CDS) tied to CDO tranches (mainly comprised of subprime debt) before finally backing off its aggressiveness just before the downturn.<sup>150</sup> Joe Cassano led that group, and he performed acceptably in his job even though he lacked deep financial expertise (he came out of back office operations), so long as his supervisor at AIG headquarters was Hank Greenberg, who had built the company.<sup>151</sup> Greenberg was strongly in control, which constrained Cassano. But due to unexpected legal difficulties, Greenberg was suddenly forced to resign, and in the course of the turnover in New York, Cassano found autonomy.<sup>152</sup> Having little sophistication at financial or risk management, Cassano drove the division to generate revenue in response to the positive feedback associated with continued prosperity in the housing markets. His sin, according to Lewis, was his ambition and arrogance that led him in well over his head, in ways that simply coincided with the economic and cultural pressures toward growth and expansion, unchecked by doubt.<sup>153</sup>

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<sup>149</sup> See Michael Lewis, *The Man Who Crashed the World*, VANITY FAIR, Aug. 2009, at 98, 137–39. An insider account of the failure of Lehman proceeds along similar lines, suggesting arrogance and incompetence at the senior executive level that walled itself off from groups within the firm that were, allegedly, trying to highlight the excessive subprime risk. See LAWRENCE G. McDONALD & PATRICK ROBINSON, *A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* 124–30, 201–02, 223–25, 233–36 (2009). If so, this emphasizes two important points. First, there will never be one single set of cultural perceptions in any large firm: there will potentially be many subcultures. Second, culture interacts with the economics of information and power dynamics: CEOs may surround themselves with those tied to some aspects of the culture and not others. There is an important litigation point here as well. Showing awareness of problems in one unit of an organization does not as a practical matter demonstrate contemporaneous awareness of risk elsewhere. On this interaction and the legal standards for attribution of knowledge, see Langevoort, *supra* note 48, at 157–63. In other words, the fact that some Lehman or Goldman Sachs traders were predicting and betting on a subprime downturn while others in the firm were aggressively selling products that would be valuable only in the absence of a downturn does not necessarily suggest intentionally wrongful behavior.

<sup>150</sup> See Lewis, *supra* note 149, at 137–38 (detailing how American International Group (AIG) FP's consumer-debt CDS became dominated by subprime mortgages). AIG backed off most of these trades by 2005. See Shefrin, *supra* note 54, at 242–43; Whitehead, *supra* note 1, at 31–32.

<sup>151</sup> See Lewis, *supra* note 149, at 136–37.

<sup>152</sup> See *id.* at 137.

<sup>153</sup> See *id.* at 139.

## CONCLUSION

This Essay offers a map to understanding organizational psychology and culture, for use by gatekeepers like lawyers, independent directors, and auditors. Its central claim is that both psychology and culture can play important cognitive roles by offering insiders scripts and schemas that simplify, coordinate, and motivate—essential elements of any business in a highly competitive marketplace. These scripts and schemas need not correlate with a high degree of perceptual accuracy, especially in risk assessment; instead, some degree of inflated confidence and diminished risk perception can be adaptive in terms of promoting intensity and focus rather than disabling fear and uncertainty. Firms that have this capacity are more likely to survive competitive pressures; in turn, once they have survived and flourished, they are likely to overattribute their success to internal skills and competencies, thus bolstering the prevailing belief system. Good fortune over time—even if just a matter of being in the right place at the right time—can bias perceptions considerably in this direction, leading to the promotion of leaders who are both products of this culture and mindset and evangelists for it.

This pattern is what gatekeepers should look for, though not necessarily what they will find. It is a heuristic, designed to help those whose job it is—often as a matter of law—to help the firm make accurate risk assessments. No doubt a close, careful exploration of the human inner workings of any business will expose ambiguity and banality that confounds the predictions of any mental model; all firms are different, with unique politics, path dependencies, routines, myths, and ever-changing situational pressures. But looking for and worrying about ways in which overconfidence, emotions, competitive pressures, ethical rationalizations, and an abundance of testosterone might bias the assessment of financial, legal, and reputational risk is necessary to manage those risks. At the very least, it instructs the gatekeeper not to fall prey to the illusion that because the company's leadership displays evidence of loyalty and commitment, their perceptions and inferences can safely be trusted. Intensity and passion can instead be a sign that the greased pig is running loose.

To be sure, the gatekeepers' right response to these possibilities is far from clear. By no means am I suggesting that upon discovering evidence of overconfidence or rationalization, the proper thing for a board of directors to do is to try to induce more realism. That is like trying to stop a fast-moving train simply by stepping in front of it, especially when the engineer is in a big hurry. Psychology and culture are much too powerful to easily be altered, and my central claim is that, on average, some lack of realism may well be a profitable, adaptive course for a firm that faces intense competition. To the extent that

the directors' job is to promote the long-term financial interest of the company and its shareholders, tolerating some organizational illusions may actually be the right decision. Moreover, trying to intervene and monitor is very costly in both economic and human terms, signaling lack of trust that can have many unintended consequences.<sup>154</sup>

The places where skepticism and, if necessary, intervention are required, however, are where the law demands objectivity in place of profitability—mandatory disclosure requirements, for example—or where there is a risk of catastrophic harm from the slippery slopes to which illusions and rationalizations often give the initial downward push. This is the cognitive dimension to enterprise risk management, and responsibility here lies with the board and its advisers.<sup>155</sup> One of the messages here may be the extent to which independent directors need more expert advice and resources of their own than is commonplace in most corporations. This is costly and perhaps awkward, to be sure, and these costs have to be justified in light of how much objective risk there really is. That is something only the directors can judge. Lawyers, with the corporation as client, have to recognize this as well, and they must support the objective assessment against the likely pushback from people who resent the lack of confidence in their assessments. They have to be grit, not grease, even if carriers of grit in organizations are an evolutionarily disfavored species.

Of course in offering these conclusions—indeed in drawing this map—I have thus far ignored the obvious. Gatekeepers are people too, and no less subject to psychological bias and cultural pressures than anyone else. Many independent directors lack any motivation or interest in objectivity, particularly because they have so little threat of personal liability.<sup>156</sup> It is hard work involving information not easily accessible, and it can be unpleasantly confrontational. Because lawyers and accountants are generally chosen by management, they have ample motivation to draw inferences in harmony with the inside view.<sup>157</sup> Psychological research has found evidence that auditors, for

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<sup>154</sup> See Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 374–77 (2004) (noting reputational stigma monitors acquire from intervention); Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1792 (2006) (“If monitoring causes officers to believe that they are strongly distrusted by the directors, the officers might decide to live up (or more precisely, down) to that view when they are not being monitored.”); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 96–100 (discussing possible negative effects of overly aggressive monitoring, including mistrust, cynicism, and decreases in motivation, morale, and compliance).

<sup>155</sup> See Michelle M. Harner, *Ignoring the Writing on the Wall: The Role of Enterprise Risk Management in the Economic Crisis*, 5 J. BUS. & TECH. L. 45, 48–49 (2010).

<sup>156</sup> See COFFEE, *supra* note 17, at 60–62.

<sup>157</sup> See *id.* at 3–4, 64–67 (discussing auditors' vulnerability to succumb to management pressure to secure more lucrative consulting income).

example, are prone to motivated inference—supporting management in the exercise of accounting judgments—even after the formal conflicts of interest (such as selling ancillary services) are removed.<sup>158</sup> Accounting quality seems to have gotten better since Sarbanes-Oxley,<sup>159</sup> but this improvement may have occurred because the statute caused the legally-mandated reordering of the auditor-manager relationship.<sup>160</sup>

Lawyers are in a different position. As Mitt Regan has shown, lawyers find themselves increasingly under hypercompetitive economic pressures, and the cultures of law firms have adapted in unsettling ways.<sup>161</sup> Lawyers anxious to project an image of responsiveness to client needs often talk about the process by which they decide if they can “get comfortable” with what the client proposes. That process is fraught with psychological risk. My frequent interactions with practicing lawyers have led me to the disturbing sense that grease drips from the walls and ceilings of some law firms.

I am not naïve, but I do not want to be naïvely cynical either. I also know plenty of very good lawyers who worry about their clients’ objectivity, though maybe not in the way informed by research in psychology and sociology that we have surveyed here. We are likely moving to a period where legal and reputational risk increases, especially in the world of financial services, making cognitive independence a more valuable commodity. There are well-motivated directors, too, though perhaps not as many as we would like; we know this because independent directors are more willing to fire management and otherwise exert control when the situation demands than in the past.<sup>162</sup> Auditors may be getting tougher as well.<sup>163</sup>

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<sup>158</sup> See Max H. Bazerman et al., *The Impossibility of Auditor Independence*, SLOAN MGMT. REV., Summer 1997, at 89, 91–93.

<sup>159</sup> See, e.g., Gerald J. Lobo & Jian Zhou, *Did Conservatism in Financial Reporting Increase After the Sarbanes-Oxley Act? Initial Evidence*, 20 ACCT. HORIZONS 57, 71 (2006). (providing evidence of increased conservatism in accounting judgments and financial reporting after Sarbanes-Oxley).

<sup>160</sup> See *id.*; see also COFFEE, *supra* note 17, at 342–43, 367 (discussing the importance of the Sarbanes-Oxley Act’s requirement that the auditor report to an independent audit committee, which “substituted a risk-averse principal in place of often risk-preferring corporate financial executives”).

<sup>161</sup> See MILTON C. REGAN, JR., *EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER* 31–41 (2004); see also Stephen M. Bainbridge, *The Tournament at the Intersection of Business and Legal Ethics*, 1 U. ST. THOMAS L.J. 909, 915–22 (2004) (describing tournament theory as applied to law firms and corporate lawyers and examining the efficacy of Sarbanes-Oxley § 307 in light of such dynamics).

<sup>162</sup> See, e.g., Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1029–32 (2010) (discussing the emergence of outside directors “as a power center independent of CEOs,” the declining tenure of CEOs, and the greater willingness of boards to replace CEOs).

<sup>163</sup> See *supra* notes 159–60.

In light of the immense economic pain that the financial crisis caused firms, their shareholders, and the public, maybe gatekeepers are now more willing to think about the risks that come from too much loyalty and intensity, not just the familiar risks from disloyalty and sloth. True, no one has yet cinched the case for a psychological or cultural explanation of why financial firms and institutional investors led us into the recent crisis; we still have to concede that maybe it was entirely about agency costs and moral hazards. But even if we estimate that the rational account is the more likely one, the possibility that it is wrong—that culture and psychology are robust explanations for excessive risk taking—is something that we should fit into our expected value calculation in deciding the right strategies for responding to the carnage. If cultural and psychological forces are as or more likely an explanation, then the need to attend to them is obviously that much greater.