

## REPUTATIONAL PENALTIES AFTER FCPA ENFORCEMENTS

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### RESUMO

Empresas que violam as Leis Anticorrupção, como a FCPA, sofrem perdas estatisticamente significativas no valor de mercado do patrimônio da empresa. Neste artigo, discutimos até que ponto as sanções impostas pelo mercado - o que chamamos de "*penalidades de reputação*" - podem impor custos significativos às empresas que violam a lei norte-americana *Foreign Corrupt Practices Act*. Também discutiremos como as penalidades de reputação têm relevância em outros campos, como crimes ambientais, e quão importantes elas são em países que lidam com corrupção e escândalos corporativos, como Japão e China. Nossa principal conclusão é que, considerando o acesso a informações sobre suborno internacional, o aumento das exigências da FCPA e as penalidades mais altas ao longo dos anos, um novo estudo empírico incluindo todas as recentes exigências da FCPA e aumento nas investigações deve ser realizado.

### ABSTRACT

Firms that violate anti-corruption laws like the FCPA suffer statistically significant losses in the market value of firm equity. In this paper, we discuss the extent to which market-imposed sanctions—what we label “reputational penalties”—might impose significant costs on firms that violate the Foreign Corrupt Practices Act. We will also discuss how reputational penalties are important in other fields, such as environmental crimes, and how important they are in countries dealing with corruption and corporate scandals, like Japan and China. Our main conclusion is that considering the access to information about international bribery, the increase in FCPA enforcements and higher penalties, a new empirical study including all recent FCPA enforcements needs to be performed.

### INTRODUCTION: REPUTATIONAL PENALTIES AND CORRUPTION

*“It takes many good deeds to build a good reputation, and only one bad one to lose it.”*

— Benjamin Franklin

Anti-corruption and anti-bribery laws around the world prohibit corporations and

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individuals from engaging in bribery and require corporations to maintain accurate financial records. Failure to adopt effective compliance programs and procedures can result in serious reputational damage, significant fines, imprisonment and debarment of organizations from conducting business with national governments.

Executives know the importance of their companies' reputations. According to Eccles<sup>2</sup>, "firms with strong positive reputations attract better people. They are perceived as providing more value, which often allows them to charge a premium. Their customers are more loyal and buy broader ranges of products and services. Because the market believes that such companies will deliver sustained earnings and future growth, they have higher price-earnings multiples and market values and lower costs of capital."

According to the author, "in an economy where 70% to 80% of market value comes from hard-to-assess intangible assets such as brand equity, intellectual capital, and goodwill, organizations are especially vulnerable to anything that damages their reputations."<sup>3</sup>

Over the years, there have been many efforts both from regulators and from the private industry itself to assess and manage risks in different areas, from supply chain systems, to environmental resources and even political instability or natural disasters. However, in the absence of agreement on how to define and measure reputational risk, according to most authors, it has been largely ignored.<sup>4</sup>

The importance and influence of the Foreign Corrupt Practices Act, the first of all anti-bribery laws<sup>5</sup> is more evident every year<sup>6</sup>. The increase in FCPA enforcement activity has started many

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<sup>2</sup> Eccles, Newquist and Schatz. *Reputation and Its Risks*. Harvard Business Review- <https://hbr.org/2007/02/reputation-and-its-risks>

<sup>3</sup> Id

<sup>4</sup> Id.

<sup>5</sup> Koehler, Mike, *The Story of the Foreign Corrupt Practices Act* (December 5, 2012). Ohio State Law Journal, Vol. 73, No. 5, 2012. Available at SSRN: <https://ssrn.com/abstract=2185406>

<sup>6</sup> See FCPA Clearinghouse enforcement list below.

international legal and policy debates, focusing especially on the scope of law and enforcement acts in comparison to initial congressional intent.<sup>7</sup> Some groups have suggested the American Congress should reform the FCPA as it is now. There was also a significant increase in FCPA enforcement actions after the 2008 financial crisis.

According to Stanford Foreign Corrupt Practices Act Clearinghouse, there was an increase from 15 FCPA investigation cases in 2008 to 29 in 2009. Until 2003, there was a maximum of 3 per year, and there were 27 companies that paid about \$2.48 billion to resolve FCPA cases in 2016. It was the biggest enforcement year in FCPA history. Both the number of enforcement actions and the overall amounts paid to resolve them were records. This trend seems to continue from 2017 to 2019, with more corruption scandals appearing internationally.

In this paper, we discuss the extent to which market-imposed sanctions—what we label “reputational penalties”—impose significant costs on firms that violate the Foreign Corrupt Practices Act. We will also discuss how Reputational Damages are important in other fields, such as environmental penalties, and other countries dealing with corruption and corporate scandals, as Japan and China. Our main conclusion is that with the increasing enforcement numbers of FCPA enforcements, more access to information about enforcements and higher penalties, a new empirical study including all recent enforcements needs to be performed.

As Benjamin Klein and Keith Leffler argue, reputation disciplines certain types of wrongdoing because market transactions internalize their costs<sup>8</sup>. Companies that defraud customers, for example, lose sales. Those that cheat employees or other suppliers face higher input costs or lost trade

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<sup>7</sup> Searle Civil Justice Center, *The Foreign Corrupt Practices Act: An Empirical Examination of Enforcement Trends* (Sept. 2012)

<sup>8</sup> Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981).

credit. The cost of the illegal activity is internalized because the cheating firm loses at least some of the gains that accrue from repeat business with consumers, employees, or suppliers.

Consistent with such arguments, previous research indicates that reputational costs are large for false advertising<sup>9</sup> product recalls<sup>10</sup>, lack of safety<sup>11</sup>, deceptive bidding practices, punitive damages lawsuits, defense, procurement fraud, and financial misrepresentation<sup>12</sup>. Jonathan Karpoff and John Lott find that over 90 percent of the penalties imposed on firms committing private frauds reflects lost reputation<sup>13</sup>. Only a small portion of the financial penalties imposed on such firms is due to criminal or civil penalties and other court-imposed costs.<sup>14</sup> Environmental scandals are also on the list of companies that damaged their reputation and were previously researched by the literature. Although the literature has previously researched corporate crimes and even bribery to obtain FDA Approval<sup>15</sup>, a new empirical research considering the increasing enforcement of FCPA sanctions needs to be done.

## I. THE FOREIGN CORRUPT PRACTICES ACT

The United States Congress approved the FCPA in with the intent to change and moralize how American companies conducted their business in foreign countries<sup>16</sup>. The FCPA is applicable to US citizens or residents and, virtually, to any entity that has its principal place of business or is organized

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<sup>9</sup> Sam Peltzman, *The Effects of FTC Advertising Regulation*, 24 J. Law & Econ. 403 (1981).

<sup>10</sup> Gregg Jarrell & Sam Peltzman, *The Impact of Product Recalls on the Wealth of Sellers*, 93 J. Pol. Econ. 512 (1985).

<sup>11</sup> Mark L. Mitchell & Michael T. Maloney, *The Role of Market Forces in Promoting Air Travel Safety*, 32 J. Law & Econ. 329 (1989).

<sup>12</sup> Jonathan M. Karpoff, D. Scott Lee, & Gerald S. Martin, *The Cost of Cooking the Books* (Working paper, Texas A&M Univ. & Univ. Washington 2004).

<sup>13</sup> *Id.*

<sup>14</sup> Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J. Law & Econ. 757 (1993).

<sup>15</sup> Cindy R. Alexander. *On the Nature of the Reputational Penalty for Corporate Crime*. The Journal of Law and Economics 1999 42:S1, 489-526

<sup>16</sup> Koehler, Mike, *The Story of the Foreign Corrupt Practices Act* (December 5, 2012). Ohio State Law Journal, Vol. 73, No. 5, 2012. Available at SSRN: <https://ssrn.com/abstract=2185406>

under United States law, including foreign companies that have securities (shares, ADRs or others), or that are subject to periodic filings with SEC. The law also applies to foreign individuals or companies operating in the United States or any US territory.

The SEC and the Department of Justice (DOJ) are the bodies responsible for restraining actions and divide responsibilities in the civil and criminal spheres. The SEC is responsible only for actions of civil restraint and its punishments are restricted to fines or the return of profits obtained in operations for which a bribe has been committed by both companies and individuals. The DOJ, which is responsible for criminal restraint actions, may apply fines of up to \$ 25 million and impose up to 20 years in prison for the accused executives.

There are two important moments in the corporate punishment process under the FCPA: the initiation of investigations and the disclosure of punishment itself. The investigation process is conducted in a court of law and therefore only the company is notified of the start of the investigation. The disclosure of the punishment is public. Some companies report, through a material fact, that they are under investigation by the SEC or DOJ under the FCPA.<sup>17</sup> However, such disclosure usually occurs after rumors that the company is being investigated. Due to the difficulty in establishing the precise date on which this information (beginning of investigations), the best date to measure reputational penalties is the date of the disclosure of the punishment. According to Nourayi, the information on the initiation of an investigative procedure has an effect on the price of the shares, but it is believed that the effective disclosure of the punishment applied to the company is a new fact that brings with it information that may still have effects on stock prices.<sup>18</sup>

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<sup>17</sup> For more information on enforcements, see <https://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml>

<sup>18</sup> NOURAYI, Mahmoud M. Stock price responses to the SEC's enforcement actions. *Journal of Accounting and Public Policy*, n. 13, p. 333-347, 1994.

One of the most iconic FCPA implementation cases was the one involving the German company Siemens, which was fined \$ 1.8 billion in 2008 (total penalties applied by the United States and Germany), one of the highest penalties applied, in addition to being a milestone in relation to cooperation between countries, at a level not previously observed between the United States and foreign countries.<sup>19</sup>

According to most authors, corruption can be studied under various approaches, such as economic, managerial or behavioral, or by examining corruption at a particular level, such as the individual, organization or economy. The consequences are also diverse. According to Cuervo-Cazurra, studies indicate that, for example, countries with high levels of corruption have low economic growth, low levels of direct investment or education and health, and low levels of foreign investment inflows.<sup>20</sup> That is, the existence of corrupt practices affects the economic activity of the countries, from the point of view of wealth creation and economic development.<sup>21</sup>

The consequences of corruption at the enterprise level are not consensus or clear<sup>22</sup>, or that knowledge about the impact on firm value is low<sup>23</sup>. More than the legal penalties imposed, there is a necessity to better study what is the effect of the disclosure of civil and criminal restraining actions against acts of corruption in the market value of companies' subject to the FCPA. This can be analyzed through the event study methodology, for example, that analyzes whether the stock prices of companies punished

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<sup>19</sup> SHEARMAN & STERLING LLP. *Shearman FCPA website: cases: SEC vs. Siemens Aktiengesellschaft*. Available at: <<http://shearman.symplicity.com/?mode=form&id=197>>.

<sup>20</sup> Id.

<sup>21</sup> MIARI, Renata C.; MESQUITA, José Marcos C.; PARDINI, Daniel J. Eficiência de mercado e corrupção organização: estudos dos impostos sobre o valor dos acionistas. *Brazilian Business Review*, BBR Special Issues. p. 1-26, 2015.

<sup>22</sup> CUERVO-CAZURRA, Alvaro. Corruption in international business. *Journal of World Business*, v. 51, n. 1. p. 35-49, 2016.

<sup>23</sup> LEE, Charles.; NG, David. Corruption and international valuation: does virtue pay? *Munich Personal RePEc Archive*. Paper nº 590, oct., 2006. Disponível em: <<http://mp.ra.ub.uni-muenchen.de/590/>>.

by the SEC or DOJ under the FCPA react in a statistically relevant way when disclosing the company's punishment to the market.

The SEC and the DOJ have been making increasing efforts to investigate and prosecute both corporations and executives in corruption and corporate fraud.<sup>24</sup> Based on this observation and the perception that corruption and its fraud in the accounting records are punishable by heavy fines and with all the negative spectrum for the company's image, it is sought to understand if the market perceives this fact negatively, pricing down the market value (stock price) of companies that have been subject to restrictions on account of the application of penalties under the FCPA. The work is supported in the approach of the company's evaluation in the sense that a conviction under the FCPA, with the payment of fines and other penalties that imply<sup>25</sup>, which can be expected to have a negative impact on future cash generation expectations.

In a more modern way, the assumptions of the work can be associated with the theory of signaling under the prism of corporate reputation, that is, that the signs emitted by the company influence its reputation and is able to establish the behavior of the stakeholders<sup>26</sup>. It is understood that the FCPA's punishment of the company negatively influences its reputation and, consequently, the stock price.

Several international initiatives have been adopted to promote the fight against corruption around the world. One of the most significant initiatives was the work carried out by the Organization for

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<sup>24</sup> GIRAUDO, John P. *Charitable contributions and the FCPA: schering-plough and the increasing scope of SEC enforcement*. *The Business Lawyer*, v. 61, n. 1. p. 135-154, 2005.

<sup>25</sup> DAVIDSON III, Wallace N.; WORRELL, Dan L. *The impact of announcements of corporate illegalities on shareholder returns*. *Academy of Management Journal*, v. 31, n. 1. p. 195-200, 1988.

<sup>26</sup> LUCA, Márcia M. M.; CARDOSO, Vanessa I. C.; LIMA, Gerlando A. S. F.; VASCONCELOS, Alessandra C. *Reputação corporativa e desempenho em empresas de capital aberto de diferentes países*. In: CONGRESSO USP DE CONTROLADORIA E CONTABILIDADE, XV, *Anais*, São Paulo, 2015.

Economic Cooperation and Development (OECD) in which the signatory countries have committed themselves to creating specific anti-corruption laws.<sup>27</sup> An example of this is UK Bribery in the United Kingdom, dated April 8, 2010<sup>28</sup>, and the Brazilian anti-corruption law itself enacted in 2013, Law 12,846, dated August 1, 2013.<sup>29</sup>

In addition, there is the situation experienced by the largest Brazilian company, Petrobras, involved in an investigative process related to corruption and bribery, including within the scope of the FCPA.

**a. Practical aspects and previous studies**

FCPA generally has two clauses that provide that the company and its executives can be prosecuted for their noncompliance: the anti-bribery clause and the accounting clause or record keeping.<sup>30</sup>

The anti-bribery clause punishes in the criminal sphere companies and persons who commit acts of corruption to public officials of foreign countries to obtain advantages or favors in the usual operations or to obtain or maintain contracts or services with organs, companies or agencies controlled by foreign governments.

According to Loughman and Sibery<sup>31</sup>, there are five elements that characterize the breach of this clause and that all must be present for the violation to be achieved by the FCPA: 1) *the violator is a regulated party* (domestic entities, bond issuers, or representative of domestic or issuer, and any non-US corporation that takes part, assists or supports any corrupt payment within the United States territory,

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<sup>27</sup> See Elizabeth K. Spahn, *Implementing Global anti-Bribery Norms: From the Foreign Corrupt Practices Act to the OECD anti-Bribery Convention to the U.N. Convention against Corruption*, 23 Ind. Int'l & Comp. L. Rev. 1, 34 (2013)

<sup>28</sup> Available at <https://www.gov.uk/anti-bribery-policy>

<sup>29</sup> Available at [http://www.planalto.gov.br/ccivil\\_03/\\_ato2011-2014/2013/lei/112846.htm](http://www.planalto.gov.br/ccivil_03/_ato2011-2014/2013/lei/112846.htm)

<sup>30</sup> See Karen Cascini, Rocco R. Vanasco, (1992) "FCPA: The American Antibribery Legislation", *Managerial Auditing Journal*, Vol. 7 Issue: 2, <https://doi.org/10.1108/EUM0000000001778>

<sup>31</sup> LOUGHMAN, Brian P.; SIBERY, Richard A. *Bribery and corruption: navigating the global risks*, ed. 3, Wiley, New Jersey, 2012.

2) *payment, offer, promise of payment or authorization to pay or offer money or anything of value*; (3) *a foreign public official* (any foreign government department or governmental agency, any government-owned or controlled entity, any official or candidate of a foreign political party, any public international organization, or any person acting with public authority on behalf of any two above); 4) *intent to corrupt*, intention to influence the recipient to misuse his position (extortion or coercion are not considered as corrupt payments due to a payment in response to a threat); and 5) *commercial purpose* (payments must relate to obtaining, maintaining or directing more favorable business and customs procedures or obtaining permits or licenses).

The FCPA provides exceptions and affirmative defenses for bribery.<sup>32</sup> The exception is facilitating payments or expediting payments, which refer to payments made to public officials to issue or ensure the execution of routine and common government functions and services, including licenses, document processing fees, and government services such as protection police and customs inspections. Generally, these are small-value payments made to low-level civil servants and must be correctly identified, commonly called *grease payments*<sup>33</sup>. Payment cannot be made to allow the employee to do something that is not expected of his role as a public agent. That is, to pay for the release of goods at customs would be allowed, but if the same payment was made to release goods prohibited in that country, it would violate the FCPA.

The accounting or record keeping clause operates in conjunction with the anti-bribery clause and provides that issuers of any security listed on US trading markets (including stocks, debt

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<sup>32</sup> BIEGELMAN, Martin T.; BIEGELMAN, Daniel R. *Foreign corrupt practices act compliance guidebook*, Wiley, New Jersey, 2010.

<sup>33</sup> There are many critics to these exceptions, *see* Perkins, Ivan. "Illuminating Corruption Pathways: Modifying the FCPA's Grease Payment Exception to Galvanize Anti-Corruption Movements in Developing Nations," *Cardozo Journal of International and Comparative Law* vol. 21, no. 2 (Winter 2013): p. 325-366.

securities or any other instrument that requires periodic filing of reports with the SEC), including its subsidiaries, must:

1) *maintain books, records and values, with a reasonable level of detail, that accurately and fairly reflect the transactions and expenditures of the issuer's assets*; and 2) *adopt internal controls to prevent the improper use of corporate resources* (policies and procedures for approvals of expenditures, authorizations, reconciliations of accounts and correct segregation of duties are among some of the controls necessary to prevent bribery payments from being disguised like other expenses and are occurring without the knowledge of the administration).

The US Congress has created this clause as an additional deterrent to bribery, since most companies hide the values used to bribe public officials in corporate accounting books as if they were payments of other natures.<sup>34</sup>

Under this clause, companies are required to accurately record all transactions, maintain supporting documentation for these releases, and maintain policy of retention and disposal of records and documents consistently.

Regarding internal controls, the clause calls for a robust compliance policy so that the control system is designed to prevent unregistered or unauthorized transactions for all company units.<sup>35</sup>

The DOJ is responsible for criminal charges and penalties may include high fines and imprisonment of those responsible. The violation of the anti-bribery clause criminally subjects businesses to fines of up to \$ 2 million and executives, fines of up to \$ 250,000 plus imprisonment for up to 5 years.

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<sup>34</sup> SECURITIES AND EXCHANGE COMMISSION (SEC). *FCPA: a resource guide to the U.S. foreign corrupt practices act 2012*. Available at: <http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf>.

<sup>35</sup> About internal controls, *see* Langevoort, Donald C. "Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's Duty of Care as Responsibility for Systems," *Journal of Corporation Law* vol. 31, no. 3 (Spring 2006): p. 949-974.

Already the intentional violation of the accounting clause and record keeping is criminally punishable with fines of up to \$ 25 million for companies and up to \$ 5 million more imprisonment for up to 20 years for individuals.

With respect to civil penalties, the SEC may investigate and indict issuers while the DOJ has the same role with domestic and non-US corporations and individuals. The maximum civil penalty for violations of the anti-bribery clause for both companies and individuals is \$ 16,000 per occurrence and fines imposed on individuals cannot be paid by their employers.

SEC has the power to initiate civil restraining proceedings against companies that violate the accounting clause and may impose fines or purge of profits (a kind of return of unlawfully earned gains imposed on wrongdoers by the courts). The fines can reach \$ 725,000 for corporations and \$ 150,000 for individuals. Some agreements are possible, including what softens the penalty under the condition that the administrator no longer hold executive positions, or the company has suspended the right to do business with the government.

There are many cases of frauds (bribes, disguises of operations, fraud to accounting books) made by companies to obtain or maintain contracts that generate them revenue<sup>36</sup>. This has led the SEC and DOJ to increase their investigative actions, as we will discuss in this paper, which shows the evolution in the number of companies punished and in the total amount of fines (sum of fines imposed by the SEC and DOJ).

Lee and Ng discuss how corruption can affect the economic drives used in assessing firm

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<sup>36</sup> ASHCROFT, John.; RATCLIFE, John. The recent and unusual evolution of an expanding FCPA. *Notre Dame Journal of Law, Ethics & Public Policy*, v. 26, n. 1. p. 25-38, 2012.

value under three points of view.<sup>37</sup> First, empirical evidence shows that high levels of corruption correlate with low economic growth. Thus, since the growth rate of the economy is a key premise, the value of the firm can be decisively impacted. Second, corruption can negatively affect the company's expectation of future cash flow, either directly, through the reduction of revenues from canceled business, for example, or indirectly, via transaction costs arising from the company's misconduct. And, finally, corruption can increase the cost of capital required. The authors argue that in countries with weak investor protection laws, homeowners will demand higher rates of return because corruption is favored by the low effectiveness of regulatory oversight.<sup>38</sup>

The work of Nourayi examines the effects of the SEC's announcement of the initiation of investigations of restrictive actions on the stock prices of listed companies in New York Stock Exchange (NYSE) and the American Stock Exchange (ASE). The author considered any notice of initiation of investigations for the application of restrictive actions, irrespective of the reason (fraud in the statements, violation of accounting principles, republishing of balance sheets or acts of corruption) between 1977 and 1984, comprising 82 firms. The conclusion shows that there was a negative reaction from the market to the announcement of the investigations, pricing down the value of the shares of the companies targeted by the SEC investigations.<sup>39</sup>

Using enterprise-level information, Lee and Ng investigated the relationship between corruption and corporate value. Analyzes show that firms from more corrupt countries have significantly smaller market multiples. The results indicate that corruption mainly impacts the expectation of future

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<sup>37</sup> LEE, Charles.; NG, David. Corruption and international valuation: does virtue pay? *Munich Personal RePEc Archive*. Paper n° 590, oct., 2006. Available at: <<http://mpira.ub.uni-muenchen.de/590/>>.

<sup>38</sup> LEE, Charles.; NG, David. Corruption and international valuation: does virtue pay? *Munich Personal RePEc Archive*. Paper n° 590, oct., 2006. Disponível em: <<http://mpira.ub.uni-muenchen.de/590/>>.

<sup>39</sup> NOURAYI, Mahmoud M. Stock price responses to the SEC's enforcement actions. *Journal of Accounting and Public Policy*, n. 13, p. 333-347, 1994.

cash flows, influencing the value to the owners.<sup>40</sup>

One limitation in most of these studies lies in the fact that it was previously possible to use the date of the initiation of investigations by the SEC. However, currently the only officially published date is the date of the punishment imposed by the SEC / DOJ, since investigations regarding the FCPA are conducted in secrecy until final disclosure of the result.

## II. REPUTATIONAL PENALTIES

### a. Different Fields

Reputational penalties can be observed in a variety of other topics other than corruption, being environmental damages the most empirically developed<sup>41</sup>. According to Karpoff and Lott<sup>42</sup>, analyzing the sizes of the fines, damage awards, remediation costs, and market value losses imposed on companies that violate environmental regulations; “*firms that violate environmental laws suffer statistically significant losses in the market value of firm equity.*” Those losses, however, according to the authors, are of similar magnitudes to the legal penalties imposed, and in the cross section, the market value loss is related to the size of the legal penalty. For this study, environmental violations are disciplined largely through legal and regulatory penalties, not through reputational penalties.

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<sup>40</sup> LEE, Charles.; NG, David. *Corruption and international valuation: does virtue pay?* Munich Personal RePEc Archive. Paper n° 590, oct., 2006. Available at: <<http://mpra.ub.uni-muenchen.de/590/>>.

<sup>41</sup> Jonathan M. Karpoff, John R. Lott, Jr. and Eric W. Wehrly. *The Journal of Law & Economics*. Vol. 48, No. 2 (October 2005), pp. 653-675

<sup>42</sup> Id.

wrongdoing because market transactions internalize their costs<sup>43</sup>. Companies that defraud customers, for example, lose sales. Those that cheat employees or other suppliers face higher input costs or lost trade credit. The cost of the illegal activity is internalized because the cheating firm loses at least some of the gains that accrue from repeat business with consumers, employees, or suppliers.

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#### **b. Corporate Corruption and Reputational Penalties in Japan**

In a study about Reputational Penalties in Japan with Evidence from Corporate Scandals, Tanimura and Okamoto reach the conclusion that *corporate interests appear to reign supreme in*

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<sup>43</sup> Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. Pol. Econ. 615 (1981).

<sup>44</sup> Sam Peltzman, The Effects of FTC Advertising Regulation, 24 J. Law & Econ. 403 (1981).

<sup>45</sup> Gregg Jarrell & Sam Peltzman, The Impact of Product Recalls on the Wealth of Sellers, 93 J. Pol. Econ. 512 (1985).

<sup>46</sup> Mark L. Mitchell & Michael T. Maloney, The Role of Market Forces in Promoting Air Travel Safety, 32 J. Law & Econ. 329 (1989).

<sup>47</sup> Jonathan M. Karpoff, D. Scott Lee, & Gerald S. Martin, The Cost of Cooking the Books (Working paper, Texas A&M Univ. & Univ. Washington 2004

<sup>48</sup> Id.

<sup>49</sup> Jonathan M. Karpoff & John R. Lott, Jr., The Reputational Penalty Firms Bear from Committing Criminal Fraud, 36 J. Law & Econ. 757 (1993). Cindy Alexander obtains similar results using a sample of purely criminal cases.

<sup>50</sup> Cindy R. Alexander. *On the Nature of the Reputational Penalty for Corporate Crime. The Journal of Law and Economics* 1999 42:S1, 489-526

*Japan.*<sup>51</sup>

In this paper, they provide empirical evidence on the reputational losses that Japanese firms suffer when they are implicated in corporate scandals. Reports of a scandal correspond to economically meaningful and statistically significant losses in the share values of culpable firms. Analyzing a large- sample evidence of a drop in stock price following corporate scandals in Japan, the authors reach the conclusion that the effects are significant given the widespread belief that reputation and trust play a major role in Japanese society.<sup>52</sup>

A firm suffers a reputational penalty if the total costs of a scandal, as measured by the market value decrease in the company's shares, exceed the direct costs of the breach. The direct costs include unbudgeted out-of-pocket spending for items such as legal and accounting fees and public and investor relations.

The existence and magnitude of this reputational penalty are important for Japanese public policy. *“The total penalty for a corporate scandal consists of the explicit legal sanctions imposed through criminal, civil and regulatory actions, plus any reputational losses. Given the negligible legal sanctions in Japan, a major portion of the total penalty comes from reputational losses”*<sup>53</sup>. For them, if those reputational losses are sufficiently large, recent developments that are intended to reduce the number of corporate scandals may be misguided.

According to the authors, those results have important implications for non-Japanese markets as well. The culpable firm in a corporate scandal should face an expected penalty equal to the total

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<sup>51</sup> Tanimura, Joseph K. and Okamoto, M. Gary, *Reputational Penalties in Japan Evidence from Corporate Scandals* (June 24, 2012). Asian Economic Journal, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=1591025> or <http://dx.doi.org/10.2139/ssrn.1591025>

<sup>52</sup> Id.

<sup>53</sup> They become even more important when there are not legal sanctions or they are not adequate.

social costs of the act for the penalty to be optimal, and we agree this is the main role of reputational penalties.

### c. Shaming and Reputational Penalties in China

In their article about *Reputational Sanctions in China's Securities Market*, Liebman and Milhaupt bring evidence that Chinese companies fear stock exchange sanctions precisely because of reputational effects.<sup>54</sup> Companies are required to disclose both the fact that they have been subject to criticism from a stock exchange and the reasons for such criticism in their annual report.

According to their study, the fact that a company or individual has been publicly criticized is virtually always reported in the Chinese media. Criticisms can also result in the exchanges taking steps to designate a company's stock as high risk. In Shenzhen, the direct effects appear clearer than in Shanghai.<sup>55</sup>

Both exchanges rate the quality of a company's information disclosure, and a sanction generally correlates with a low or non-passing rating from the exchanges. For Shenzhen such ratings are made public and posted on the exchange's website; in Shanghai the reports are apparently not made public. Although being sanctioned does not automatically lead to a listed company being designated as high-risk by the exchanges, Shenzhen officials state that multiple sanctions can contribute to such a designation.

The reputational effects of a sanction may be even more significant than the inability of a company to raise new funds. This may be particularly the case in China, where both individual

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<sup>54</sup> Liebman, Benjamin L. and Milhaupt, Curtis J., *Reputational Sanctions in China's Securities Market* (June 8, 2007). Columbia Law and Economics Working Paper No. 318. Available at SSRN: <https://ssrn.com/abstract=999698> or <http://dx.doi.org/10.2139/ssrn.999698>

<sup>55</sup> Id.

career prospects and corporate performance may depend heavily on reputation. According to the interviews in this study<sup>56</sup>, exchange sanctions will have a serious impact on companies' and individuals' reputations. One exchange official commented that *“criticism will result in “lots of pressure” on both the companies and individuals who are criticized. A lawyer remarked that being sanctioned will affect investors' trust in a company, particularly given that the market is moved by rumor”*.

Considering China's unique system, the consequences for non-state companies may be even more significant. According to the authors, being sanctioned would affect the company's ability to raise additional capital, its relationship with banks, and its ability to engage in restructuring and mergers. It will also affect the company's standing with investors.

The authors do not claim that shaming is necessarily more effective in China than elsewhere. But reputational sanctions may have particular force in China given both the underdeveloped status of China's legal institutions, and the strong emphasis on reputation evident in Chinese society today.

### **III. THE NECESSITY TO REVIEW REPUTATIONAL PENALTIES AFTER THE INCREASE IN FPCA ENFORCEMENTS**

Karpoff's article on reputational losses measure the long-term impact on the firm's operations and contracting with investors, suppliers, or customers. The results indicate that the revelation of bribery, by itself, has little long-term impact, if the bribery is not comingled with charges of financial fraud. Because non-fraud firms face relatively small costs even when they are caught bribing, the average

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<sup>56</sup> Id.

ex post NPV of the bribe-related activity is non-negative for the majority of firms without comingled fraud charges (+0.4% of market capitalization). Thus, even for firms that are caught, the net benefits of their bribe-related projects are non-negative (if the firm avoids comingled fraud charges).<sup>57</sup>

According to the authors, if companies face enforcement action for a combination of bribery and financial fraud charges, the bribe amounts and enforcement costs are larger and measures of the ex post value of the bribe related projects are significantly negative. A key reason fraud-related firms face higher costs is that they experience large reputation losses, and the driving force behind these losses appears to be the financial fraud, not the bribery per se. Their analysis of the FCPA enforcements from 1977 to 2013 reveal that bribery by itself, in contrast, has a small impact on firm reputation.

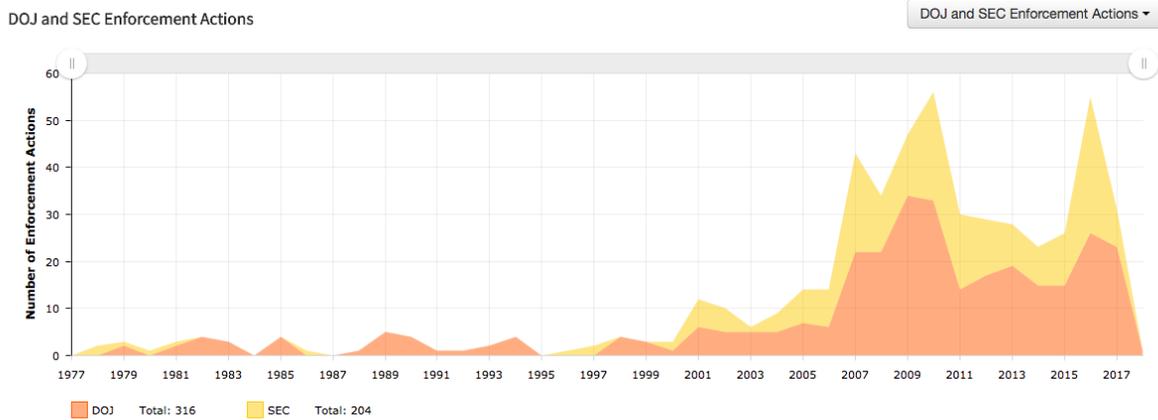
According to the authors, in this regard, bribery is more like an environmental violation and less like consumer or financial fraud. Bribery charges do not by *themselves* “... lead to irreparable economic hardship and reputational damage that may adversely affect the overall stability and competitiveness of any business,” as is claimed by critics of anti-bribery enforcement activities. At times, firms that are targeted by bribery enforcement actions experience large direct costs, especially in the form of large regulatory fines and penalties. On this period on average, however, the bribery charges do not harm the firm’s business relationships with its customers, suppliers, or investors. That is, the firm’s counterparties tend to care if the firm’s financial statements are misrepresented. But they do not, in general, alter their willingness to do business with the firm when it is caught bribing.

However, much of this scenario has changed. Observing the rise on enforcement sanctions it is possible to observe a need to review those empirical studies regarding reputational penalties after FCPA enforcements. With more access to information, the market losses might be statistically significant,

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<sup>57</sup> Karpoff, Jonathan M. and Lee, D. Scott and Martin, Gerald S., *Foreign Bribery: Incentives and Enforcement* (April 7, 2017). Available at SSRN: <https://ssrn.com/abstract=1573222> or <http://dx.doi.org/10.2139/ssrn.1573222>

contrasting with previous studies on reputational penalties after FCPA enforcements.



Description for DOJ and SEC Enforcement Actions  
This chart identifies the number of Enforcement Actions filed per year since enactment of the FCPA. By hovering over a year, users can see the number of Enforcement Actions filed by the SEC and the number of Enforcement Actions filed by the DOJ. If an Enforcement Action is filed jointly by the SEC and DOJ, it is counted once for the SEC and once for the DOJ. See About Us - Datasets for a definition of "Enforcement Action." There are many ways to define an FCPA enforcement action and to count the number of such actions filed per year. This graphic presents one possibility among several.

Source: FCPA Clearinghouse

There are now currently 520 enforcements and corruption scandals from 1977 to 2018 to analyze, according to Stanford's Clearinghouse Database with the enforcements on the rise<sup>58</sup> and considering that more anti-corruption laws are enacted every day, SEC and DOJ enforcements are more relevant than ever regarding a company's reputation.

The existence and size of any reputational penalty is important for public policy. Optimal penalty theory, as discussed by Gary Becker, requires that the expected total penalty for an illegal activity equals the activity's total social cost.<sup>59</sup> The total penalty consists of explicit legal sanctions imposed through regulatory, civil, and criminal proceedings, plus reputational penalties. If reputational penalties are large, then legal penalties optimally should be small. Conversely, small reputational penalties

<sup>58</sup> Ashcroft, John; Ratcliffe, John. "The Recent and Unusual Evolution of an Expanding FCPA," *Notre Dame Journal of Law, Ethics & Public Policy* vol. 26, no. 1 (2012): p. 25-38.

<sup>59</sup> Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968).

imply a more important role for legal penalties in an optimal framework. This can be represented as:

$$\text{Total Penalty} = \text{Explicit legal sanctions} + \text{Reputational Penalties}$$

We believe more studies about reputational penalties need to be performed regarding FCPA enforcements.

If we do not consider the deterrence effect of reputational penalties, the incentives for companies to comply with the law might be distorted.

#### IV. CONCLUSION

According to Susan Rose-Ackerman<sup>60</sup>, firms pay bribes to get favored treatment on contracts, concessions, and privatization deals. The benefits may consist of the actual award of the contract or of inside information that makes a bid more likely to succeed. Firms also pay to affect the terms of contracts and of the future regulatory environment. Even when a firm's managers believe that it has a strong chance of winning an honest competition, they may bribe if that is the accepted method of doing business in spite of laws to the contrary. The risks of both legal sanctions and reputational damage are judged low enough to justify payoffs.

According to the author<sup>61</sup>, there are two broad reasons why profit-seeking firms may seek to root out corruption inside their organization and work for a less corrupt global business environment. The first involves cases where the costs of corruption are mostly absorbed by the firm in lost profits, and the firm has leverage over individual deals. The second, requires a collective change in behavior by most firms in the market. Here a narrow interest in firm profitability is unlikely to be sufficient to motivate action. Managers and boards need to accept ethical obligations that go beyond both private morality and their responsibility to stockholders.

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<sup>60</sup> Rose-Ackerman, Susan, 2002. "'Grand' corruption and the ethics of global business," *Journal of Banking & Finance*, Elsevier, vol. 26(9), pages 1889-1918, September.

<sup>61</sup> Id.

To Rose-Ackerman, *“Acceptance of these obligations may indeed be good public relations, but the fundamental arguments for abiding by these principles are neither profit maximization nor individual scruples but depend on an understanding of the role of the corporation in the modern world.”*

In this paper I tried to compile what has been written about Reputational Penalties and its importance in the optimal penalty theory. Since legal fines and penalties does not seem enough to deter companies to pay bribes, it is important to observe if reputational penalties can be considered significant for a company to comply with anti-bribery and anti-corruption laws. With the rise of anti-corruption laws and international efforts like the OECD Anti-Bribery Convention, and the increase of FCPA enforcements, this might be a factor that can hurt a company’s reputation, bringing market losses and adding to the deterrence effect of the law. More empirical studies need to be performed considering the market losses after recent FCPA enforcements to better understand the current anti-corruption efforts and market consequences for companies that do not comply.