When good companies do bad things: Examining illegal corporate behavior

November 18 2009

A study led by Michigan State University's Yuri Mishina suggests that the more successful a company becomes, the more likely it is to engage in illegal activity. Credit: Michigan State University

The more prominent and financially successful a corporation becomes, the more likely it is to break the law, according to a new study led by a Michigan State University scholar that challenges previous research.

MSU's Yuri Mishina and colleagues argue that unrealistically high pressure on thriving companies increases the likelihood of illegal behavior, as the firms are faced with continuously maintaining or improving their performance. Previous research suggested that high-performing firms are less likely to feel the strains that can trigger illegal activities such as fraud, false claims and environmental and anticompetitive violations.

The MSU-led study, which will appear in a forthcoming issue of the *Academy of Management* Journal, analyzed 194 large public manufacturing firms in the United States between 1990 and 1999.

"We found that high-performing companies tended not to be able to sustain that high level of performance over time," said Mishina, assistant professor of management and lead researcher on the project. "At the same time, high performing and highly prominent companies tend to be the ones that are punished most severely for not meeting performance expectations. And so it becomes a choice: Do I cut corners to try to meet these high performance goals and maybe get caught, or do I accept the results of not meeting my performance goals and be punished for sure."

The pressure comes from both internal and external sources, Mishina said. Internal pressure includes company officials' perception of how they're faring against the competition, while external pressure is driven by heightened investor expectations brought about by strong market performance.

The researchers say three factors potentially fuel illegal behavior: loss aversion, or the tendency to prefer avoiding losses above all else; hubris, in which managers come to believe they cannot fail; and the house-money effect, or the concept that people perceive themselves to be gambling with the "house's money" rather than their own capital.

Mishina said companies are most apt to engage in illegal activity once they become prominent and feel significant public pressure to maintain or improve performance. The findings also suggest it's the prospect of poor performance in the future - not the past - that compels firms to break the law.

Thus, regulators should try to monitor the activities of both high- and low-performing firms to detect illegal corporate behavior and consider a firm's prominence and performance relative to industry peers to determine which firms should receive closer attention, the researchers say.

Mishina also said analysts, investors and company directors need to be careful about how they evaluate firm performance and the pressure they place on management to constantly improve performance.

"Obviously people want their companies to perform well, both from a revenue and profitability standpoint as well as increasing stock prices," Mishina said. "But this implies we are in some ways missing the idea of what performance should be. Would it be better to think about maybe five-year growth or 10-year growth? Should performance be based on profitability and stock prices or should it be some sort of long-term viability measure that includes creating jobs, stimulating the economy and other factors?

"By focusing completely on fairly short-term financials we're ignoring a lot of other things," he added. "And the emphasis on this performance seems to be what's driving this type of illegal behavior."

More information: The study is called "Why Good Firms Do Bad Things: The Effects of High Aspirations, High Expectations and Prominence on the Incidence of Corporate Illegality." It was co-authored by Bernadine Dykes at the University of Delaware, Emily Block at Notre Dame and Timothy Pollock at Penn State.

Source: Michigan State University (news : web)