

# THE FORMATION AND DETERRENCE OF ROGUE BUSINESS GROUPS

I develop an analysis of rogue behavior in business settings by analogy with gangs as these are more widely understood. Apparently irrational behavior in rogue settings can signal possession of skills of particular value to a group. Gangs form around traits that are useful to a subgroup, giving a gap between the characteristics of gang members and mainstream society or the parent organization. The comparison suggests that business gangs deserve no more sympathy than other gangs. Some policy responses for firms are investigated. One policy, offering amnesties to whistleblowers, requires caution as it can result in incentives for temporary membership of the gang.

**Key words:** Organization; Governance; Enron



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## INTRODUCTION

In this paper, I explore behavior within dysfunctional groups, which is “either illegal or morally unacceptable to the larger community” (Jones 1991), in terms of the exercise of human capital skills of value to the group. Such behavior is often seen as ultimately inexplicable (Levitt and Venkatesh 2000a and 2000b), or as the result of individual cognitive failure (Banaji, Bazerman & Chugh (2003). In a business setting, we are often surprised at seeing corporate officers being whisked off to prison as unusually respectable looking criminals: they cannot really be rotten-to-the-core wrongdoers, surely? Sometimes the business violations are of less-well-defined norms, as in conflicts of interests associated with the 2008 credit crunch or the Enron case (Moore, Tetlock & Bazerman, 2006; Fusaro & Miller, 2002). Straight forward deterrence analysis (Becker 1968) struggles to explain the persistence of dysfunctional groups because much behavior arises when deterrence appears to be very strong.

I explore an analogy between gangs and business dysfunctional groups as an exercise in developing a conceptual metaphor (Brown 2003, p.31) that draws attention to the indirect rational purpose behind dysfunctional behavior. A remarkable similarity can be seen between street gangs and the teams found at the center of recent failures in governance and ethics in business settings. To keep things manageable, I explore a metaphor based on the formation of street gangs, the members of which exhibit apparently irrational behaviors (Gilbert 2006; Venkatesh 2008), and then make comparisons with Enron-type cases. Team solidarity is not always a good thing: in a business setting, it would have been better for everyone if senior Enron employees had all been unredeemed individualists.

I argue that an increase in the fruitfulness of conceptual-

izing the formation of such groups is obtained by taking a more interdisciplinary approach, and integrating a little sociology, behavioral psychology, and new institutional economics (Williamson 2002; Alexander and Cohen 1996).

A truly fascinating aspect of rogue groups concerns individuals persisting with antisocial behavior in group settings when it is clear that the expected direct personal payoffs from such things are negative. Enron executives must have expected detection and intervention by criminal-justice authorities, which in due course happened exactly as one would have predicted, and yet something drove them to continue with their apparent folly. This observation is as problematic for general deterrence models (Becker 1968), because rogue behavior clearly continues in spite of apparently *overwhelming* deterrence variables. Psychology-based explanations of the toleration of bad behavior, such as the “slippery slopes” allowing gradual growth of toleration found in Gino & Bazerman’s (2009, p.710) experiments, do not lose linkages to deterrence theory: in any particular *frame*, some individuals are deterred. The implications of the analysis for a sensible approach to whistle blowing are discussed at the end of the paper.

## GANGS AND DYSFUNCTION IN BUSINESS

There are costs and benefits of individuals’ trading in skills (human capital) that can determine the nature and size of any dysfunctional group. The apparently irrational ignoring of immediate deterrence variables may reflect the signaling of behavior linked to human capital. The recent specialist literature

(e.g., Levitt & Venkatesh 2000a & 2000b; Venkatesh 2008; Milhaupt & West 2000; Gambetti 1994; Sobel & Osobu 2006) tends to examine the organization of human resources within American drugs gangs and intra-gang leadership tournaments. I wish to show how formation of gangs can reflect signaling of investment in and possession of skills that, in particular, indicate a willingness to put the gang first. An analogy can then be made with members of business gangs, such as those practicing “cutting edge accountancy” (Coffee 2001) and pressing the limits of fraud at Enron headquarters, all of whom were, in a sense, *excessively* team as they ignored outside society. The key skills of value to the rogue business group could for example include an ability to manipulate information, possibly breaching a duty of fiduciary duty toward shareholders and employees, for the benefit of the subgroup by adopting tactics such as speaking the literal truth in a misleading way so as to breach a duty of candor. The following exchange reflects a rogue culture that the author observed recently within a public organization:

Q. “Are you paid for editing the XYZ journal for which we hire a full time editor to free you to carry out other duties?”

A. “Except to say you are mistaken, I have no comment to make.”

Assuming there is a substitute hired at public expense, A. appears to say there is nothing wrong, but in fact has said no such thing and merely refers to Q’s knowledge. Q may be satisfied by such an answer if he is a member of a more trusting wider society. Rogue groups in otherwise legitimate organizations may place unusual weight on abilities such as avoiding candor without apparently lying. Gang-specific human capital could take many forms including recklessness, ability to misrepresent, and bullying, but really these are just examples and the exact form of particularly valuable traits is an empirical question to be investigated in particular cases. The point is that rogue groups will typically value skills differently from wider society.

The *size* of a gang or rogue group is an issue. Gangs would grow without any limits if it were not for management problems that increase with size. In particular, costs of supervision may tempt a member to enjoy gang benefits, but also to make use of opportunities outside of the gang, such as those involving defecting to other gangs (business rivals) or whistle blowing to the criminal justice authorities. Venkatesh’s (2008) record of time spent with gangs shows bosses quelling the tendencies of foot soldiers to act outside of the gang. The interaction between outside and within-gang opportunities has implications for laws protecting whistle blowers. Increased outside opportunities for gang members after they reform may be problematic in tempting temporary gang membership followed by eventual disloyalty. Gang leaders may then be more selective in admitting members giving rise to a tougher gang. The possibility of unintended consequences following from interventions is worrying in the context of business gangs because it implies that the Enron problem may well not have

been entirely chilled by action against Enron former employees, but may well surface periodically elsewhere.

Gangs have some characteristics that seem to defy the normal limits on rational behavior. Examples of apparently irrational behavior for street gangs encompass such things as continuing to beat up a victim after the robbery is complete, or rushing recklessly at another gang to provoke a fight under poor odds of winning, or participating in binge drinking to a state of near death. Given the apparent irrationality of gang behavior, some commentators see it as reflecting unthinking socialization into a group, often reinforced by media culture. One finds analyses that identify a process of slipping into dysfunctional behavior rather than impetus for those processes (Gino & Bazerman, 2009).

Rogue business groups raise similar questions. Why would accountants push the limits knowing the underlying legal position indicated precisely the form of action eventually taken against Enron executives? Deterrence clearly failed. It is as though they picked a fight by rushing through the doors of a club in the heartland of a more powerful gang known as mainstream society. It is this sort of observation that leads criminologists, e.g. Akers (2000), to be skeptical of deterrence theories (Becker, 1968)

These observations are puzzling, but may be answered by the possibility that at least some of the behavior may be indirectly rational. In their analysis of aristocratic elites, Allen and Reed (2006) show that the rules of dueling evolved during the eighteenth century to provide a low-cost screening device assisting the emergence of a class of individuals possessed of high integrity upon whom reliance could be placed in forming a type of (monarchical) civil service. The rules of dueling screened for honesty, bravery and preservation of reputation. Obedience to a *group* norm emphasizing honor and bravery, under rules very carefully designed so as not to favor the skilled fighter, screened out those having character faults making them. Within the aristocratic group, behavior that would seem dangerous to outsiders contributed to identifying.

In a dysfunctional business team, the emphasis is on team cohesion. The whistle blower in the case of Enron was an accountant who saw that it was not in her interest to continue team participation (Fusaro and Miller 2002). For some time advisors, and auditors had resisted any incentives to betray Enron as financial reward depended on the continued existence of a firm many knew was not sound (Coffee 2001; Moore, Tetlock, Tanlu & Bazerman 2006). Deterrence of rogue behavior is not straightforward: people typically start to detach themselves long after a group has begun to show poor underlying performance relative to normal business.

### **ROGUE HUMAN CAPITAL INVESTMENTS**

In a rogue-business setting, a pattern of adjusting skills, i.e. human capital investments, to highly localized objectives occurs, and recklessness may well be involved. Accountants in rogue firms make money within the organization by knowingly

distorting revenues and costs to the disadvantage of outsiders. They behave recklessly in the face of widely understood criminal sanctions. Penalties are often eventually applied by mainstream society just exactly as an informed observer would have predicted. Recklessness need not be at the heart of rogue business behavior though, as often the separation of the firm from widely held values creates an intra-organizational perception of being “above the law.” Where localized values trump those of wider society, we observe the cultivation of individual character traits that other members of the group can always rely on in putting group interests ahead of loyalty to mainstream society. Such cultivation is a form of human capital investment by the individual concerned.

Visible disregard of mainstream society is often a signal of loyalty to a separated group. Deschenes and Esbensen (1997) found gang members to be more impulsive, engaged in reckless behavior, and committed to their gang peers, compared with their allegiances to schools and parents. In a behavioral study following seminal work (Kahneman & Tversky 1979; Machlin 2004), Foreman-Peck and Moore (2010) found that individuals engaged in violent youth gangs showed marked preferences for risk taking, judged in terms of behavior such as hyperbolic discounting<sup>1</sup>. In some settings, individuals may learn risk taking, or it may be that risk takers are drawn to the groups. The signaling of putting the group first is an important feature of many dysfunctional groups, even in cases where recklessness may not be the obvious kernel of the group behavior.

### FORMATION OF A ROGUE BUSINESS GROUP

Individuals in the general population are born with different levels of relevant skills (human capital), measured against the whole spectrum of groups identifiable within society.<sup>2</sup> The skills may include the individual’s ability to contribute to a business group’s results through such behavior as shady accounting, non-candid representation, and so on, depending on exactly the type of group. An individual’s initial endowment of group-relevant human capital is best regarded as observable and augmentable by the individual, at a cost, by investing in acquiring relevant skills. In rogue-business settings we see individuals pushing the limits between sharp practice and illegality, and signaling with such things a culture of long hours on the job spent with the rogue group, and in extra-work socializing often of a group-focused type.

Individuals will be accepted as group members, or not, depending on whether they have a minimum level of required

**1 Normal discounting applies compound interest rates as time moves forward. Hyperbolic discounting applies ever higher interest rates, going beyond compounding, the further one is into the future, and is thought to be consistent with prospect theory, which weighs losses heavily compared with numerically equivalent gains and implies that an individual prefers a gamble to an equivalent certain payoff.**

**2 This section is a less technical version of the analysis in Dnes and Garoupa, 2010.**

human capital, typically set by a leader. It does no harm to think of the leader as an individual endowed at birth with a particularly high level of the required human capital: the worst, most reckless, individual (or whatever the exact characteristic is). For simplicity we rule out investment in skills ever resulting in a member overtaking the leader. The individual can act loyally, or enjoy benefits from membership but eventually betray the group.

The returns from a group’s activities tend to increase with its size. Members benefit from sharing in the total gains made by the group, but typically have different abilities to appropriate gains for the group and receive unequal shares of the proceeds. The leader can be regarded as the claimant of any residual gains after paying the members’ shares.

The leader needs to limit the size of the group bearing in mind loss of working power from reducing size and the difficulty of policing betrayal it grows larger. In practice, the group is defined by stating the level of skills (human capital) required to join. If a would-be member is born with relevant skills equal to or higher than the level set by the leader there is no need for investment and the person simply joins. If an individual is born with less than that level, but is not too far away from it, then he or she may well invest in increasing the required characteristics, providing it is cost effective to do so. Then there are individuals too far away from the cut off point, for whom investment is never cost effective, and who therefore remain in mainstream society. In trying to control rogue business groups, we need to concentrate on making investment unproductive for the middle group, either by setting penalties, or increasing benefits from legitimate activities.

The existence of a middle group, which starts below the level of relevant human capital, but invests to increase the level, implies there will be a separation between the characteristics of the gang members and the rest of the population. This gap is commonly observed: decent businesses do not ordinarily falsify returns. The gap reflects a separating equilibrium in the population: for some people it is way too costly to acquire the relevant skills, and they go into the mainstream, but, for others, investing in the skills necessary to signal commitment to the group is less costly, and so they are able to join. However, the gap may change over time as the costs and benefits of investment in gang-relevant skills change, a result that is consistent with so-called slippery-slope analysis (Gino & Bazerman 2009).

The leader needs to consider several effects when deciding whether to add members to the group. First, reducing the membership by increasing the required human capital implies more loss per member of the residual claimed by the leader (since members will be of higher quality and therefore will want more of the proceeds at the expense of the leader). Second, the reduction in membership implies fewer, albeit higher quality, foot soldiers to work for the group. Some disadvantage from expansion is needed to give a reasonably defined gang. One obvious cost is that of betrayal, which is much harder to police in a larger group. A little thought sug-

gests that increasing the required minimum level of human capital would be liked by the leader as it is a mechanism likely to increase commitment and deter betrayal – although just keeping numbers down will help that too.

Suppose the authorities (or the firm), wanted to increase betrayal within the group, and effectively offered an amnesty by increasing opportunities outside the group. There are three effects to consider. More individuals will be willing, ex ante, to invest in joining the group because outside opportunities after they cease gang activities will have increased. However, the leader is worse-off since the chances of betrayal have increased. Therefore, the leader will increase the required human capital to try and offset the higher likelihood of betrayal. On one hand, the leader will increase the level of required human capital, but on the other more individuals may still be willing to join. Therefore, increasing outside opportunities for gang members might have the counter-productive effect of inducing more individuals to join a gang.

We need to be careful about making membership of a dysfunctional business group more attractive, i.e. less temporarily worrying to would-be members, by increasing the value of outside activities that can be pursued after retirement from dysfunctional activities.

## DISCUSSION

The likelihood of betrayal limits the inclusion of more members in a dysfunctional group. Investment in required skills is rational from an individual member's viewpoint, and increasing the required investment is important from the leader's viewpoint as a mechanism to deter betrayal.

In Enron-type rogue business settings, groups show similar behavioral traits to those evident in street gangs. The issue of betrayal has a very important implication because at the heart of improving ethical behavior in business is a focus on aligning team members' investments in human capital with what is useful in mainstream society: Better by far to see them training as tax accountants than as off-balance-sheet experts in earning's enhancement.

Consider the encouragement of whistle blowing. Increasing the welcome from mainstream society to defector from a rogue business group is equivalent to extending an amnesty to a gang member who gives himself up. A key issue is the timing of whistle blowing: ideally this needs to happen as early as possible. Allowing long-time benefits to accrue to membership and then giving a way out may encourage the persistence of the group and even additional recruitment into it.

Managers who are keen to prevent formation of rogue groups could create incentives for earlier whistle blowing,

to increase the benefits in normal relative to rogue periods of the whistle blower's life. Also, it could be useful to have a cut-off point, after which whistle blowing does not lead to decoupling of the whistle blower from the group in relation to possible sanctions. This cut off could be achieved by a policy requiring an assessment of whether the information supplied by the whistle blower made a material difference in revealing the rogue group. Public policy could also step up legal penalties for harassing whistleblowers.

Removing leaders is an approach to dealing with a known rogue group and has salience given the gaps likely to exist in the human-capital distribution associated with the rogue group. If, as was assumed for analytical purposes earlier in this paper, the leader of a rogue group is well separated from the rest of the membership, removal will decapitate the group and leave it rudderless. We need to worry much less about remaining members, who may then be unable to function as before.

Penalties can be used to deter membership of a rogue group. It is a matter of tailoring penalties to the characteristics of the individuals concerned. Relatively modest penalties can deter membership for those who remain relatively closer to the human capital characteristics of the surrounding society. A misguided egalitarian approach, often favored by human-resources departments in firms, would miss this point. Using ex-post penalties for being part of the rogue group could salvage otherwise useful employees.

It is important to recognize the many influences on individuals who end up in rogue business settings. Some types of behavior, such as outright contemplation of illegal activities for dysfunctional business groups, can have a rational purpose in enhancing and signaling the level of human capital owned by a group member. The individual is interested in revealing skills as the benefits of membership are participation in group outputs. Apparently irrational behavior has a strategic purpose for an individual deciding whether join a group.

Public and business policy can usefully focus on the two groups forming the dysfunctional group. The first has invested in developing relevant human capital, and the second was endowed with a high level of it. Both groups are deterred if the gains from belonging to the gang are reduced, either by sufficient increases in the expected value of punishment, or by careful manipulation of the benefits from betrayal (whistle blowing). It is essential to recognize that increases in the benefits of moving into mainstream society will tend to reduce gang membership, but can also induce changes in recruitment leading to gang members being particularly nasty examples of the genus. It seems that early defection is desirable and whistle blowers need real protection.

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**თაღლითური ბიზნეს-დაჯგუფებების ფორმირება  
და მათი შეკავების კაღები**

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