The Yale Law Journal

Volume 90, Number 1, November 1980

The Place of Enterprise Liability in the Control of Corporate Conduct

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One does not have to believe that corporations are to blame for society's problems, or think ill of the persons who (in the popular but overstated expression) "run them," to be concerned about corporate accountability. Public focus is justified, if only by the increasing importance of corporations in our lives. More and more, it is they,¹ and perhaps an increasingly concentrated group of them,² who produce, pollute, distribute, invest, swindle, and farm. And to whom else do we look to plumb—and market—the mysteries of the human cell?³ In this setting, the success of the law as a social instrument—detering, rehabilitating, securing effective compensation for victims, educating citizens between right and wrong⁴—turns upon its capacity to deal with the corporation as a basic unit of communal activity.

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1. Between 1960 and 1976 the number of corporations increased from 10.2% to 14.4% of all forms of business enterprise. The corporate share of business receipts rose from 77.5% to 87.1% in the same period. *See* U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 553, table 913 (1979).

2. It is not entirely clear whether the increasing prominence of corporations has been accompanied by an increasing concentration. In 1978, firms comprising the first and second highest quintiles of the top 500 industrial corporations captured 0.6% and 0.5% more, respectively, of all sales accounted for by the top 500 than they had in 1960; the lower three quintiles declined proportionately over the same period. *See id.* at 571, table 949. However, this mild concentration may be less significant considering that over the same period the second 500 largest industrial corporations increased their sales receipts at a faster rate than did the top 500. *See id.*

3. *See* Bylinsky, *DNA Can Build Companies, Too*, FORTUNE, June 16, 1980, at 144; Rifkin, *DNA: Have the Corporations Already Grabbed Control of New Life Forms?* MOTHER JONES, Feb./Mar. 1977, at 23.

4. For a discussion of this last and perhaps most neglected function of law, see E. ZIMRING & J. HAWKINS, *DETERRENCE* 77-83 (1973).

Indeed, we do well to think of "corporation" today in something akin to its original sense, as comprising not merely business corporations, but the whole range of giant corporate bureaucracies⁵ that have become the peoples of a modern society:⁶ co-operatives,⁷ unions, pension funds, university systems, hospitals, charities, and governmental agencies. Such mischief as these nonbusiness institutions threaten is neither more confined, nor more controllable, because it is not motivated by profit.⁸ A mismanaged pension fund can sadden as many lives as a mismanaged assembly line. Government bureaus, motivated by various "policy" reasons, have committed any number of acts that were not nice,⁹ and some that were illegal.¹⁰ And in the

5. Anthony Downs provides a useful definition of bureaucracies as organizations (1) large enough that, in general, the highest ranking members know less than half of all the other members; (2) a majority of whose members are employed by the organization on a full-time basis; (3) whose personnel policies are based in some measure upon employee performance in organizational roles, rather than upon, say, social class or family connections; and (4) most of whose output "is not directly or indirectly evaluated in any markets external to the organization by means of voluntary *quid pro quo* transactions." A. DOWNS, *INSIDE BUREAUCRACY* 24-25 (1967). On the basis of the fourth criterion, Downs excludes the for-profit corporation, such as General Motors, from the class of bureaucracies that he studies. *Id.* at 25. By contrast, the present article inclines to regroup them together. Although I grant Downs's view that the social function of an organization exerts strong influence on its internal structure and behavior, *id.* at 2, which suggests separate consideration, nonetheless many of the insights of bureaucratic theorists like Downs seem apposite to for-profit enterprises.

6. See D. BELL, *THE COMING OF POST-INDUSTRIAL SOCIETY* 301 (1973) (unit of social decision is, increasingly, group not individual); P. DRUCKER, *CONCEPT OF THE CORPORATION* at ix (rev. ed. 1972) (American society is society of large institutions).

7. See *The Billion-Dollar Farm Co-Ops Nobody Knows*, *BUSINESS WEEK*, Feb. 7, 1977, at 54 (in first half of 1970s, total revenues of farm co-ops ballooned from \$25 billion to \$57 billion, giving them a third of total farm market).

8. On the contrary, whatever the shortcomings of the enterprise liability techniques in achieving adequate discipline of for-profit corporations—defects that are examined at pp. 14-16 *infra*—the availability of profit threats at least provides us with a handle on them. There are special difficulties in controlling the agencies and not-for-profit corporations, precisely because the profit threats are unavailable. See, e.g., Miller, *Municipalities Trail Industry in Cleanup of Water Pollution*, *Wall St. J.*, Oct. 13, 1976, at 1, col. 6 (municipal corporations much slower than business corporations to abide by water quality rules); cf. Wilson & Rachal, *Can the Government Regulate Itself?* 46 *PUBLIC INTEREST* 3 (1977) (suggesting that public agencies can regulate private organizations more easily than they can regulate other public agencies).

9. Consider, for instance, the so-called Tuskegee Study, begun in the 1930s. Some 400 poor black men, diagnosed as having syphilis, were studied for about 30 years by the United States Public Health Service. The subjects were examined periodically to determine the nature and course of their disease but were not treated, even after 1945 when penicillin had become available as a safe and recognized cure. An estimated 107 subjects died from the disease's effects. See G. ANNAS, L. GLANTZ, & B. KATZ, *INFORMED CONSENT TO HUMAN EXPERIMENTATION* 259 (1977).

10. See *FBI Counterintelligence Programs: Hearing Before the Civil Rights and Constitutional Rights Subcomm. of the House Comm. on the Judiciary*, 93d Cong., 2d Sess. 25-26 (1975) (colloquy among Congressman Robert Drinan, Deputy Attorney General Laurence Silberman, and Henry Petersen, Assistant Attorney General, Criminal Division) (discussing alleged criminal acts by FBI against supposed black extremists).

name of Science, things have been done that Greed would shrink from.¹¹

What these considerations contend for, and what this article undertakes to introduce, is a new "field" of law: the legal control of corporate behavior. Such an undertaking involves two commitments. It requires questioning the separate legal treatment that each of the various classes of "corporate" organization, broadly understood, has traditionally received, and it requires giving sustained attention to the features that they possess in common and that may merit their treatment as a class distinct from other classes of social actors—from ordinary persons, in particular.

The fact that the control of corporate behavior has enjoyed so little distinct attention, either in the legal literature or in the codes, has roots in legal history. As early as the twelfth century, various types of corporate bodies had been recognized, including guilds, trading companies, hospitals, universities, and municipalities.¹² Yet, at least as far as wrongdoing was concerned, the law was rarely pressed to consider whether the rules being developed to deal with ordinary human bodies might be inappropriate or ineffective to deal with those that were corporate.¹³ Some of the reasons for disregarding the corporation as a separate phenomenon were doctrinal. There were, for example, conceptual misgivings about whether a *persona ficta* could be liable for wrongdoing, particularly those requiring mental states as an element.¹⁴ Other impediments were more practical. The size and structure of the early corporations were so unprepossessing that when a wrong was done, it was ordinarily not difficult to reach within the corporation to locate a responsible member or agent—a "culprit"

11. See *Hyman v. Jewish Chronic Disease Hosp.*, 21 A.D.2d 495, 497-98, 251 N.Y.S.2d 818, 820-21 (1964), *rev'd*, 15 N.Y.2d 317, 206 N.E.2d 338, 258 N.Y.S.2d 397 (1965) (project financed by government and charity to inject foreign cancer cells into unknowing human patients).

12. For an authoritative survey of the development of early forms of corporations, see J. DAVIS, *CORPORATIONS* (1961).

13. See *id.* at 116 (King's tallages, fines, and amercements on municipal corporations collected from townsmen directly); cf. C. STONE, *WHERE THE LAW ENDS* 8-18 (1975) (discussing slow emergence of corporate liability in early law).

14. See, e.g., Anonymous, 88 Eng. Rep. 1518, 1518 (K.B. 1701) ("[a] corporation is not indictable, but the particular members of it are"); *Sutton's Hospital Case*, 77 Eng. Rep. 937, 973 (K.B. 1613) (dictum) (corporation cannot commit treason nor be outlawed). The nonliability of the corporation itself was variously rested on doubts about the corporation's amenability to process, see F. HALLIS, *CORPORATE PERSONALITY* at xlv n.1 (1930); on the fiction theory, under which the corporation, as a *persona ficta*, was metaphysically incapable of wrongdoing, particularly if *mens rea* was required, see Mueller, *Mens Rea and the Corporation*, 19 U. PITTS. L. REV. 21, 22-23 (1957); and on questions of agency concerning the authorizability of intentional wrongful acts, see F. HALLIS, *supra*, at xlv-xlvi.

—and apply the sanctions of the law, quite sensibly, to him or her.¹⁵

The industrial revolution gave corporations a prominence, size, and complexity that put an end to their low legal visibility. But only in a few ways were corporations recognized as special sorts of actors demanding the attention of specially adapted laws. The exceptions were almost entirely reserved for areas of “internal” corporate relationships, such as those between shareholder and manager, guild and tradesman, and citizen and borough.¹⁶ In those areas, the problems that arose were by their very nature peculiarly corporate: How many directors or trustees did a corporation need to have? How were they to be selected and removed? To resolve issues of this sort, for which there were no ready solutions, even by analogy from other areas of law, the law was pressed to compose special bodies of corporate laws. But so far as the corporation was performing acts that affected the outside world—polluting the environment, producing harmful goods, committing ordinary crimes—there already existed general rules of torts, crimes, and so on, designed for the control of “persons.” The simplest solution—although not necessarily the best—was to fit the various corporations into those existing frameworks. Nothing was required except to ignore, one by one, the earlier qualms about whether the corporation (“that invisible, intangible, and artificial being,” Chief Justice Marshall had called it¹⁷) could be regarded as a person, too—a wrongdoer in its own right.

Basically, it is this twofold heritage that I am calling into question. First, because the predominant response to corporations was to fit them uncritically into the preexisting bodies of general law, the distinct features they may possess as a class have been denied the concentrated attention given to recognized “fields” such as partnership, persons, and pleading. Even in contexts where the seriousness of corporate-connected problems has been recognized, there has been an inclination to view them merely as problems of “big business,” as though their remedy might be of no different quality than we would reserve for human beings who just happened to be especially powerful.¹⁸

15. Indeed, whatever strength the doctrines mentioned above, *see* note 14 *supra*, may have had in theory, it is open to question whether the courts, if pressed, would have regarded them as real stumbling blocks. *See* C. STONE, *supra* note 13, at 2; Pollock, *Has the Common Law Received the Fiction Theory of Corporations?* 27 LAW Q. REV. 219, 232-35 (1911).

16. The internal rules of early corporations were not wholly independent of public law. *See, e.g.,* J. DAVIS, *supra* note 12, at 177-81 (internal relations of trade guilds established largely autonomously in earliest stages but were gradually affected by public acts, such as Parliament's regulation of guild membership criteria in response to plague conditions).

17. *Bank of the United States v. Deveaux*, 9 U.S. (5 Cranch) 61, 86 (1809).

18. *See* C. STONE, *supra* note 12, at 27-29 (discussing historical failure of law to treat distinct problems of corporations).

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Second, in those limited contexts where the various types of bureaucratic organization have been singled out from the bodies of general law for special treatment, each type is ordinarily treated separately. The business organizations—stock, nonstock, utility, and so on—are fitted into one or more frameworks, and each of the nonprofits—the charities and the various categories of public agency—into others. Some of the reasons for separate treatment seem valid; others are less convincing.¹⁹ In fact, the differences among the different types of bureaucratic organization are most obvious only at the surfaces between each institution and the outside world. The one takes a stance for profits; the other assumes the dress of teaching or curing. The one relies for nourishment upon voluntary exchanges in the market; the other, upon the various devices that open the public's or a patron's purse. Yet the deeper we probe the various organizations' bureaucratic innards, the more we are able to locate organic similarities that are as striking as the surface contrasts.²⁰ All are schooled in the techniques of modern management and possess common structures to divide and disseminate authority and information.²¹ Each is a vehicle for livelihood, prestige, intrigue, self-fulfillment, aggression, and play.²² These common elements suggest that much of the harm done by the various types of organization may stem not so much from the goals that they hold apart²³ as from the bureaucratic features that they hold

19. For example, profit sanctions may seem more appropriate for controlling business corporations, while various bureaucratic and procedural controls seem to be the inevitable response to non-profit organizations. But neither connection is self-evident. Business corporations are not animated strictly by profits, *see* p. 21 *infra*, and so may be susceptible to the bureaucratic and procedural techniques associated with the regulation of public agencies. Conversely, even though not-for-profit institutions possess no "profit stream," they are not, of course, insensitive to financial penalties, such as the cutting off of public funds.

20. Dissimilarities remain, of course: "[e]very organization's social functions strongly influence its internal structure." A. DOWNS, *supra* note 5, at 2. The classic treatment of this theme appears in A. CHANDLER, *STRATEGY AND STRUCTURE* (1962).

21. *See generally* A. ETZIONI, *MODERN ORGANIZATIONS* (1964) (reviewing common elements of diverse organizations); J. THOMPSON, *ORGANIZATIONS IN ACTION* (1967) (same).

22. Daniel Bell, in particular, has emphasized the extent to which large occupational organizations—business corporations, universities, government agencies, and hospitals—have been gaining preeminence not only as employers and producers, but also as arenas for the fulfillment of personal and group needs no longer adequately satisfied by the weakening traditional institutions of society—the small town, the church, and the family. *See* D. BELL, *supra* note 6, at 287-89.

23. The notion of an organizational goal is thoughtfully examined in A. ETZIONI, *supra* note 21, at 6-19. Other commentators prefer to replace the concept of a goal, in the sense of a value that influences an organization's decisionmaking, with that of a mix of several constraints that the organization would like to satisfy, such as good reputation, high profits, and law abidance. The optimization of such a set of conditions might be viewed as a complex goal. *See* R. CYERT & J. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* 26-34, 43 (1963); Simon, *On the Concept of Organizational Goal*, 9 *AD. SCI. Q.* 1, 2-9 (1964).

in common, features that we would do well, in designing legal control measures, to take into account.

It is to account for this possible link between bureaucratic structure and bureaucratic harm that we must be prepared to group the various organizations together and to examine their delicts, not as mere incidents of tort or crime, but as primarily and distinctly organizational phenomena. By considering the control of bureaucratic organizations as the focus of interest, and the existing rules and principles as variables subject to amendment, we can identify and deal with a significant set of questions that might otherwise lie obscure. Are our present institutional arrangements appropriate for the regulation of corporate conduct, or are we dealing with a new breed of social actor that requires specially adapted techniques of discipline beyond those presently provided? What alternative control devices are available? And which alternatives may be most appropriate to which sort of bureaucratic organization, and at what social and economic costs? Can we identify the sorts of social undertaking that are most safely entrusted to a particular form of organization? And so far as society possesses some discretion over the total population and the "mix" of bureaucratic organizations—by manipulation of the tax laws, for example—what population profile should be fostered if our aim is a cost-effective reduction in the incidence of delicts?²⁴

In the space of a single article, we can attempt no expedition so heroic as to map this entire region. With this in mind, I plan to retain a principal focus on the business corporation and on the special set of rules that have evolved for its constraint. Thus, when we come to the question of agent liability, for example, I will trust the reader to know that, as the law now stands, civil servants enjoy immunities from suit that their counterparts in business organizations can well envy. Similarly, I assume an awareness that special liability rules prevail for charities, governmental agencies, and cooperatives, and that the role played by the shareholder's derivative suit in the large business corporation is entrusted to the attorney general in the case of charities.

This restriction of focus is not inconsistent with my broader intention to seek a method of analysis for questioning the prevailing distinctions among types of institution and bodies of rule. The first step towards the larger goal is to ferret out the basic sets of variables, both

24. Of course, the decision as to what sorts of bureaucratic organizations to foster depends upon estimates of their relative abilities to realize positive social goals such as legitimacy and efficiency, as well as upon our ability to keep them within minimally acceptable standards of behavior.

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of organization and of control technique, many of which can be reached as well from one angle as from another. The aim throughout is to identify the many possible variations, their implications, and their legitimating warrants, particularly those that may be generalizable from one context to the other.

I. The "Black Box" vs. Interventionism

The law has not been blind to the increased corporate presence and to its significance. Many of the most important reforms of the past century have been, at least in part, attempts to make some accounting. I have already referred to the conceptual misgivings in early law about whether a corporation itself could bear liability for wrongdoing,²⁵ misgivings that have virtually disappeared.²⁶ In a similar evolution, the rules of agency, which once impeded any shift in liabilities "upwards" onto the corporate master, have made it increasingly possible to pass the burden along.²⁷ The withering of assorted doctrines that traditionally shielded enterprises from liability, such as the fellow servant rule²⁸ and privity,²⁹ has accompanied the growth of strict liability rules.³⁰ New bodies of law have taken shape, and new in-

25. See note 14 *supra*. The practical significance of these doctrines could not have been great, however, in view of the limited social role the early corporations played and the relative ease with which individual culprits could ordinarily be located.

26. Vestiges that still crop up from time to time include, in some jurisdictions, the immunity of a corporation itself from indictment for manslaughter. See *State v. Pacific Powder Co.*, 226 Or. 502, 505-08, 360 P.2d 530, 531-32 (1961); *Commonwealth v. Peoples Natural Gas Co.*, 102 Pitt. Legal J. 348, 350 (Allegheny County Ct. 1954).

27. There remains, however, the "universally accepted" limitation on vicarious liability that requires that the employee have "act[ed] in behalf of the corporation within the scope of his office or employment." W. LAFAVE & A. SCOTT, *HANDBOOK ON CRIMINAL LAW* 234 (1972); see *MODEL PENAL CODE* § 2.07(1)(2) (1962). Nonetheless, a corporation may be liable even if the delinquent employee acts contrary to express corporate directions. See Note, *Corporate Criminal Liability for Acts in Violation of Company Policy*, 50 GEO. L.J. 547, 554-58 (1962) (vicarious liability for statutory crimes). As a precondition of non-strict corporate criminal liability, some jurisdictions require that the employee's acts have been "authorized, solicited, requested, commanded, or recklessly tolerated by the board of directors or by a high managerial agent acting within the scope of his employment and in behalf of the corporation." N.Y. Penal Law § 20.20 (McKinney 1967); *MODEL PENAL CODE* § 2.07(1)(c) (1962).

As to punitive damages, the state courts remain divided on whether they are allowable against corporations at all, and often limit recovery to circumstances in which managerial participation can be proved. See C. McCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* 283-84 (1935). This limitation is apparently the federal rule as well. See *Lake Shore & Mich. S. Ry. v. Prentice*, 147 U.S. 101 (1893).

28. See L. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 422 (1973).

29. See, e.g., Bohlen, *Liability of Manufacturers to Persons Other Than Their Immediate Vendees*, 45 LAW Q. REV. 343 (1929) (examining exceptions to privity requirement).

30. Of course, strict liability was not born of industrialization; in fact, it emerged prior to negligence. See Wigmore, *Responsibility for Tortious Acts: Its History*, 7 HARV. L. REV. 315 (1894). On the other hand, early strict liability rested on "the essentially

stitutions, preeminently the regulatory agencies, have emerged to administer them.³¹

That one can identify so many developments connected with the bridling of corporate conduct testifies to the richness of the law's devices. But running through the whole control system are, at bottom, only two fundamental techniques. The first is "enterprise liability"; the second, its rival, is what I shall call "interventionism." The framework of this article is built around the clarification and comparison of the two approaches, with recommendations that would revise the present balance struck between them.

Both enterprise liability and the various interventionist techniques assume as their starting point a societal decision to shift the burdens of certain activities towards an enterprise and away from hazarded "outsiders." Their modes of implementation, however, diverge. To adopt "enterprise liability" is to combine rules of liability and agency in such a way that accountability is sought by threatening corporate profits. In circumstances of ordinary civil liability, the exaction equals the damage. In other circumstances, we assess, on top of the damages, a punitive surcharge in the form of a fine or exemplary damage award. But in either case, the liability generated is *enterprise liability* because the outside world remains indifferent to how the enterprise participants—its investors and managers, in particular—adapt to the law's threats and distribute among themselves the law-driven losses that occur. As far as the outside world is concerned, the enterprise's interior relationships remain a "black box."

The distinguishing mark of the interventionist techniques is that the enforcement agencies disdain the "black box" prerogatives of the enterprise's interior. Where the enterprise-liability measures threaten to dun the company for a money judgment at its doorstep, the interventionist measures breach the threshold to impose direct and selective constraints on how the investors and managers work out various internal relationships.

To put enterprise liability and its interventionist alternatives into a finer perspective, it serves to consider the business enterprise not

superstitious and irrational spirit which pervaded the jural doings of primitive society." *Id.* at 316. It is the movement toward strict liability at the turn of this century that reflects the influence of industrialization and a society peopled with corporate actors, see L. FRIEDMAN, *supra* note 28, at 417-27, although the full range of considerations that support it are too extensive and rich to reduce to any single historical or social "cause." See generally Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151 (1973) (examining justifications for strict liability); Shavell, *Strict Liability and Negligence Compared*, 9 J. LEGAL STUD. 1 (1980) (discussing various aspects of strict liability and negligence).

31. See M. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* 16-19 (1955).

as an indivisible unit, but as an equilibrium of relationships established among the suppliers of capital (the investors), the suppliers of labor (the agents), and “the corporation,” the latter of which I shall consider, for these purposes, a separate party—the jural entity that holds the contracts, can be sued, and so forth.³² Moreover, for purposes of this article, I shall assume that the outcome of the relationships established among the parties is optimal from their own perspective.³³ This enables us to disregard the traditional questions of shareholders’ rights and focus more sharply on a less well explored inquiry, which concerns the external effects of the internal arrangements. In what ways can the outcome of the equilibria established by the parties

32. Obviously, the separateness is somewhat artificial, inasmuch as the agents’ and investors’ welfares are functions of the corporation’s. On the other hand, deeming the corporation an independent entity has a certain analytic value, because managers, through the force both of fiduciary rules and of psychological factors, *see* Rohrllich & Rohrllich, *Psychological Foundations for the Fiduciary Concept in Corporation Law*, 38 COLUM. L. REV. 432, 444-47 (1938), may be impelled to maximize “the corporation’s” welfare even at sacrifice of their own and of any particular investor group’s welfare. Moreover, the complexity of the legal system makes it unlikely that statements about “the corporation” can be reduced to a set of statements about its agents and investors without losing meaning. *See* Hart, *Definition and Theory in Jurisprudence*, 70 LAW Q. REV. 37, 38-39, 49-56 (1954).

33. This view of optimal relationships is far from unanimous. A strong indictment of the current legal system’s ability to protect investors appears in Cary, *Corporate Law and Federalism: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). In Professor Cary’s view, the states, left free to design their own corporations laws, have engaged in “a race for the bottom.” Each jurisdiction hopes, by dangling before corporate management an increasingly lax set of rules, to lure as many companies as possible into its own corporate homestate. For the winning states, the returns are measured perhaps in prestige and certainly in added tax revenues and an increase in corporate-related professional business. In Cary’s view, a sort of “Gresham’s Law” has taken control, the bad corporations codes driving out the good. *Id.* at 672. The only way to correct the situation (federal chartering being politically unacceptable) is for the federal government to legislate “minimum standards”—legal floors on how low the states can go in determining various features of internal corporate governance—at least for the largest companies with the greatest national impact. *Id.* at 671-72, 705.

Ralph Winter takes the opposing position and emphasizes that state corporations codes are only one of the constraints on managers either becoming inefficient or benefiting at shareholders’ expense. *See* Winter, *State Law, Shareholder Protection, and the Theory of the Corporation* 6 J. LEGAL STUD. 251, 262-73 (1977). Managers must enable the firm’s products and services to compete in the market; at some point, “misconduct” will render them uncompetitive. *Id.* at 264. Perhaps most important, the suppliers of capital (the sophisticated institutional buyers who establish investment trends, if not the small individual investors) are aware that some states give managers a freer hand than others do. Their scrutiny alone must constitute a significant guard against management simply shuttling the company about with impunity, dragging capital from one state that is lax to another that is more so. *Id.* at 257. Accordingly, Winter argues that the gradual liberalization in state law is a reflection, not of the fact that one side—management—has dominated the other, but of the fact that private parties have been optimizing private arrangements. *Id.* at 256-58. There is much to be said on both sides of this debate; I believe that Winter is largely correct, but in any event, proceeding with Winter’s model will put shareholder issues aside and give us a cleaner set of premises to work with in concentrating on the externalities effects.

have adverse impacts upon, or be less than ideal for, third parties—the corporation's neighbors, suppliers, customers, and the public-at-large?

To understand the implications of enterprise liability for the answer to this question, and to comprehend the character and justification of its interventionist alternatives, we have to keep clear which of several closely related clusters of relationships that the parties establish is under review.

Cluster 1 involves the variables associated with the functioning core of the enterprise, the basic bureaucratic and production variables. Here, enterprise liability means that once the outside world has established the price that the enterprise must pay for its liabilities, the investors and agents are free, subject only to market constraints, to devise and implement the most cost-effective organizational responses. They may alter production factors, intensify monitoring and discipline of subordinates, create a new corporate office, or do nothing at all.

Cluster 2 concerns some of the compensation variables negotiated between the corporation and its agents, notably the provisions that they make for indemnification. Here, enterprise liability means allowing the corporation and its agents freedom to reallocate among themselves the ultimate risks of judgments that the law may impose on one or the other of them.

Cluster 3 involves the relationships between the corporation and its investors. The most significant of these for our purposes is the investors' ability, through limited liability, to insulate their own wealth from exposure to judgments secured against the corporation should the firm lack the wherewithal to satisfy them.

The question of enterprise liability and its interventionist alternatives can now be stated more exactly. The issue in designing strategies for the control of unwanted corporate conduct is whether, and in what ways, the state—meaning the federal government, if necessary—³⁴ should intervene in any of these three clusters to override the resolutions that the enterprise's participants will arrive at in the absence of that intervention.

In Cluster 1, interventions will consist of the government's usurping the enterprise's autonomy over traditional "managerial" features. The usurpations may range from requiring particular bureaucratic arrangements, such as the institution of internal information-gathering and reporting procedures, to holding individual agents directly an-

34. If it is desirable to alter the course of corporation code development in favor of third parties, then, for the reasons set forth by Cary, *supra* note 33, federal action presumably would be required.

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swerable to the state for some range of their performance. Cluster 1 interventions thus displace the enterprise from full authority to define its servants' tasks and to monitor and discipline their conduct.³⁵ In Cluster 2, interventions will consist of altering the indemnification equilibrium: the state will restrict employee indemnification in some circumstances in which the enterprise participants would prefer it, and facilitate employer indemnification in some circumstances in which the enterprise participants, left to their own, would preclude it. In Cluster 3, interventions will consist of altering the rules regarding limited liability, particularly when the judgment that the firm has been unable to satisfy arises from a criminal fine or punitive damage award.

II. Cluster 1: Constraints on Autonomy over "Managerial" Variables

Any organization's performance, including how much disfavored conduct it causes, is affected by its selection of bureaucratic structure³⁶ and various input and output variables. The dominant question in this section concerns the circumstances under which the state should influence those choices only indirectly, intimidating the enterprise participants by means of a contingent charge against enterprise profits, and when it should intervene with a hand that is more active and direct.³⁷

To survey and understand the options, it is necessary to introduce at this point, with apologies, some special terminology. The central concept is what I shall call Harm-Based Liability Rules (HBLRs).³⁸

35. In terms of historical development, individual agents were held answerable to the state before corporations were. Cf. note 14 *supra* (early immunity of corporations due to law's unwillingness to apply doctrines of individual liability to them). Cluster 1 interventions in a sense reverse that historical movement, re-emphasizing the notion of individual agent liability.

36. For example, those threatened by toxic wastes discharge are affected by the offices that the corporation establishes to monitor emissions, the credentials of persons selected to fill those posts, the place of the office in the formal and informal corporate structure, the resources made available to the office, and the powers with which the office is endowed. Cf. P. DRUCKER, *supra* note 6, at 209-29 (discussing society's interest in corporation's organization); A. CHANDLER, *supra* note 20, at 14-16 (internal structure of firm reflects external strategies). More recent studies that seek to use bureaucratic variables to inform microeconomic theory include H. LEIBENSTEIN, *BEYOND ECONOMIC MAN* (1976), and O. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975).

37. Ordinarily, where the law has required certain bureaucratic structures—predominantly in the corporation codes and in the securities laws—the concern has been almost exclusively with defining and protecting the interests of investors, rather than those of third parties. See note 141 *infra*.

38. Outside of the injunction literature, the role of harm as a prerequisite for liability for civil wrongs has commanded little attention. Recent work on this question appears

HBLRs are "based" on harm in two senses. First, the operation of the rule is triggered by harm; that is, the law stays its hand until the harm is done. Second, the harm done is the measure of the injurer's liability. HBLRs can select as their target either the enterprise itself—a technique I shall denote Enterprise HBLRs—or, in some circumstances, an agent in the first instance³⁹—Agent HBLRs.

It is a fair, if rough, summary of the law to state that with respect to ordinary harm-causing activity, where society seeks principally to compensate victims⁴⁰ and to bring the incidence of harm into line with the activity's market-measured costs and benefits,⁴¹ the Enterprise HBLR has come to prevail.⁴² Such rules represent liability in my "black box" sense. Indeed, even when the liability rule makes possible the targeting of an agent in the first instance, the laws of agency, such as respondeat superior⁴³ and indemnification,⁴⁴ have evolved in such a way that the corporate treasury tends ultimately to bear the brunt of the judgment. In practice, then, Agent HBLRs ordinarily collapse into Enterprise HBLRs.⁴⁵

to have been done only in Wittman, *Prior Regulation versus Post Liability: The Choice Between Input and Output Monitoring*, 6 J. LEGAL STUD. 193 (1977) and S. Shavell, *Harm as a Prerequisite for Liability* (1979) (unpublished manuscript, Harvard University). The attention is more traditional in the criminal law literature. See G. FLETCHER, *RETHINKING CRIMINAL LAW* 238-40, 277-78, 402-05, 476 (1978); Robinson, *A Theory of Justification: Societal Harm as a Prerequisite for Criminal Liability*, 23 U.C.L.A. L. REV. 266, 266-71 (1975).

39. I use "first instance" in the sense that plaintiff expects to receive compensation from the agent. In some circumstances, of course, the employee may pass the loss onto the employer through indemnification. See pp. 47-56 *infra*.

40. The shifting of losses from the victim to others, ordinarily justified on intuitive moral bases, can be defended independently on economically informed social welfare grounds. See, e.g., G. CALABRESI, *THE COSTS OF ACCIDENTS* 39-40 (1970) (concentration of losses on few may involve larger net welfare decline). Under this approach, the distinction suggested in the text between compensation and the maximization of welfare through behavior modification becomes less clear.

41. At least where "accidents" are concerned (itself a complex determination), there is support for making the price of an activity reflect all the costs of its performance, including the costs of harms that the activity causes. The consumers' willingness to pay this price will set the appropriate output level. Passing on the costs will also create incentives to discover less harmful ways of providing the same goods or services. See generally G. CALABRESI, *supra* note 40, at 68-94.

42. See Klemme, *The Enterprise Liability Theory of Torts*, 47 U. COLO. L. REV. 153, 175 & nn.74-76 (1973).

43. In its earliest appearance, the doctrine of respondeat superior created "a merely subsidiary liability of the superior, which can only be enforced against him when it is proved or patent that the inferior can not pay for his own misdeed." 2 F. POLLOCK & F. MAITLAND, *THE HISTORY OF ENGLISH LAW* 533 (2d ed. 1905). The doctrine has evolved to subject corporate masters to considerably further-reaching liability today. See W. SEAVEY, *HANDBOOK OF THE LAW OF AGENCY* § 89, at 155 (1964) (in nineteenth century, respondeat superior limited to negligent acts of servants; doctrine now includes trespass, assault, and other non-negligent torts).

44. See p. 46 *infra*.

45. See Klemme, *supra* note 42, at 184. Strictly speaking, where employee indemnifi-

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The widespread emergence of “enterprise liability” in these circumstances is relatively uncontroversial. From a moral perspective, it may seem fairer to make the enterprise bear the burden in preference either to the outsider who has been harmed⁴⁶ or to the particular agents⁴⁷ whose acts were most closely linked with the injury, but which were performed under the direction, and for the benefit, of the corporation.⁴⁸ To the extent that compensation is the law’s goal, the enterprise ordinarily provides a superior fund and instrument of risk spreading.⁴⁹ To the extent that the goal is “general deterrence”—seeking not to eliminate a particular activity or outcome altogether, but to constrict it consonant with market-valued benefits and burdens—entrusting the investors and managers to put their own house in order finds support in familiar arguments for market superiority. Those tied to the enterprise’s economic well-being are presumed to have the motivation and expertise to devise and implement the most cost-effective arrangements for avoiding legal penalties, just as they are presumed most capable of avoiding market penalties. Firms that fail to shape up will suffer competitive disadvantage and, rightly, decline.⁵⁰

Reliance on Enterprise HBLRs, whether driven by the tort system

cation exists and judgment is given against the agent, the plaintiff will recover only what it can extract from the defendant. The enterprise would indemnify the agent only the amount that the agent had been able to pay out. RESTATEMENT (SECOND) OF AGENCY § 439, Comment g, at 332-33 (1957). For this reason a plaintiff would ordinarily prefer to press his claim against the enterprise initially. Cf. *Civil Liability of Government Officials*, LAW & CONTEMP. PROB. Winter 1978, at 1, 108-09 (remarks of Richard Epstein) (similar problem in indemnifying municipal corporate employees).

46. Often, in circumstances where the enterprise has harmed *B*, the “cause” can be traced to both actors’ conduct, particularly so the less either party seeks or permits the harm. It is evident that in many cases, the judgment as to which party “caused” the harm tracks—and even obscures—judgments about what risks may fairly be borne and about how expectations should be satisfied. See Klemme, *supra* note 42, at 215-27.

47. There is likely to be considerable support for having the enterprise alone bear the brunt of liability, both because of the pressures of organizational life under which the employee operates, see W. LAFAVE & A. SCOTT, *supra* note 27, at 232; R. PERKINS, CRIMINAL LAW 641 (2d ed. 1969), and because of the appearances that the wrong will have been done for the benefit of, and perhaps under the direction of, the (wealthy) corporation, not the (poor) agents. An instance of the use of this logic in a somewhat different context is Assistant United States Attorney General Henry Petersen’s explanation of the decision not to prosecute any agents in the FBI “COINTELPRO” program for activities that might well have been illegal. See *FBI Counterintelligence Programs: Hearing Before the Civil Rights and Constitutional Rights Subcomm. of the House Comm. on the Judiciary*, 93d Cong., 2d Sess. 26 (1975).

48. The agent, of course, is also likely to participate, through compensation, in the gains from wrongdoing. Cf. Geis, *White Collar Crime: The Heavy Electrical Equipment Antitrust Cases of 1961*, in CRIMINAL BEHAVIOR SYSTEMS 139, 146 (M. Clinard & R. Quinney eds. 1967) (benefits to agents one factor considered in sentencing defendant executives in heavy electrical equipment industry price-fixing cases).

49. See G. CALABRESI, *supra* note 40, at 46-47 (discussing many diverse and possibly conflicting notions involved in concept of “risk spreading”).

50. See *id.* at 69-70.

or by some surrogate such as a "tax" on pollution emissions that is scaled to the damages,⁵¹ is called into question when we fear they will fail to modify enterprise behavior stringently enough to satisfy collective preferences. Such a concern may arise for a number of reasons. Some detriments are not judicially cognizable,⁵² whereas other losses, such as loss of life or vision, probably are not satisfactorily compensable.⁵³ Some behavior, such as murder, is viewed as so objectionable⁵⁴ that we do not wish to provide an actor the option of doing it merely on the condition that he purchase the damages.⁵⁵ There may be a collective aversion to certain events, such as the explosion of a nuclear plant, that make us willing to expend more to avert them than we would suffer in damages were they to occur.⁵⁶

51. See Rose-Ackerman, *Effluent Charges: A Critique*, 6 CANADIAN J. ECON. 512 (1973) (criticizing effluent charges, which constitute "tax" system, as method of controlling pollution).

52. See, e.g., *Fuentes v. Perez*, 66 Cal. App. 3d 163, 136 Cal. Rptr. 275 (1977) (no recovery for emotional distress absent physical injury and without intentional and unreasonable infliction of distress). But see *Molien v. Kaiser Foundation Hospitals*, 27 Cal. 3d 916, 616 P.2d 813, 167 Cal. Rptr. 831 (1980) (enlarging concept of judicially cognizable distress damages beyond rule of *Fuentes*).

53. See G. CALABRESI, *supra* note 40, at 97-100.

54. Some activities—price-fixing, for example—are probably not "highly immoral" in ordinary parlance. Yet such activities so lack redeeming social value and can be restrained with so little reduction in beneficial activities that the impact of the penalties we are prepared to attach to them exceeds the judicially cognizable "damages" that they are likely to cause. As to these activities, as with conduct deemed immoral, we are likely to be relatively insensitive to efficiency constraints in setting penalty levels. See p. 25 *infra*.

55. For example, it is unlikely that we wish to confer upon a company the choice of engaging in "oppressive child labor" under the Fair Labor Standards Act, 29 U.S.C. § 212(c) (1976), depending upon its wealth and willingness to pay the \$1,000 civil penalty, *id.* § 216(e).

Calabresi and Melamed argue that the thief (who "could have" negotiated with his victim) not only causes harm equivalent to the value of the items stolen but also "undermines rules and distinctions of significance beyond the specific case." Therefore, "we must add to each case [of theft] an undefinable kicker which represents society's need to keep all property rules from being changed at will into liability rules." Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1126-27 (1972).

56. Under conditions of uncertainty, individuals may forego a mathematically expected return to accept a lesser sum as a certainty: a certain bird in the hand for an expected but uncertain two in the bush. This aversion to risk is measured by the *risk premium*—what the risk averter will give up—defined as the difference between the outcome that is expected mathematically and the certain offer he accepts instead. If we transfer these concepts into the model of collective choice (putting the entire society in the position of the gambler), I am suggesting that there are some highly distasteful outcomes towards which society is collectively risk averse. In these cases society is willing to forego a certain amount of mathematically expected social product—to expend in this sense a certain "collective risk premium"—to avoid them. I cannot verify that such calculations are consciously expressed in the political process, but one can find suggestions of them through an ex post inspection of social choices. For example, Britain declined in 1971 to spend an estimated £1,000 per life to make drug containers safe for children; yet British building codes have been changed at a cost of £20,000 per life, and protections

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Even when the threatened assessments are adequate expressions of society's preferences that the disfavored events not occur, additional measures may be required if it appears that the enterprise may fail to modify its behavior appropriately. Such a failure may stem from the enterprise being economically "irrational": it may subjectively underappreciate the risks,⁵⁷ it may be a risk preferrer,⁵⁸ it may employ too high a discount rate,⁵⁹ or the managers may be maximizing something other than share value.⁶⁰ On the other hand, the enterprise may under-restrict its objectionable behavior for reasons that are quite consistent

in Britain against nuclear hazards imply a cost per life saved of some £40,000. *Nuclear Safety: Pricing a Life*, THE ECONOMIST, Mar. 22, 1980, at 92, cols. 1-3. Differing risk aversions to catastrophes of various sorts, not irrationality or inconsistency, may explain these discrepancies.

By themselves, the high aversions to risks of catastrophe do not compel abandonment of the Enterprise HBLRs, if we are prepared to define "damages" comprehensively enough. For example, we might include in the harm-based liability of the operator of a nuclear facility not only the injuries that the facility may cause, as ordinarily measured, but also an additional element designed to account for people's desires not to be injured *in that way*. This solution, however, entails the difficulties of quantifying the aversions *ex post*. Moreover, the aversion to nuclear catastrophe is felt as a generalized demoralization throughout society; it might be inappropriate to give the parties who were actually injured the right to collect on top of their own damages—as a windfall—the measure of the entire society's aversion.

57. Cf. Shavell, *An Analysis of Causation and the Scope of Liability in the Law of Torts*, 9 J. LEGAL STUD. 463, 490-91 (1980) (some accidents occur because injurer's subjective estimate of probability of accident, used in making its decisions, may be less than probability society would assign to accident).

58. Of course, the term risk preference is a crude characterization, since the firm will probably respond differently to the same mathematical risk, depending upon other elements of the risk's character. See Friedman & Savage, *The Utility Analysis of Choices Involving Risk*, 56 J. POL. ECON. 279 (1948).

59. The question of possible deviance between public and private rates of discount, and its implications, ordinarily arises in the context of financing major social undertakings. The text, however, raises the question in a setting in which it has not been examined, where our concern is not with general investment policies, but extends to the control of aberrant firms. See p. 23 *infra*. Such firms may employ a relatively high discount rate (undervalue long-term gains) not only because the managers miscalculate, but also because the managers may design strategies to realize short-term gains that they plan to capture from the company for their personal benefit. A theory of corporate control must account for the firm that, biased to prefer short-term over long-term gains, employs a discount rate higher than the public rate, thereby understating the social preference for making present expenditures to avoid future liability claims. The significance of this phenomenon can be illustrated by a simple example. Consider a metal smelter engaged in a cost-benefit analysis of its liability for blood poisoning. If the firm installs no safety device, it can expect to suffer a damage award of \$10,000,000 ten years from the present; the liability can be eliminated, however, by present expenditures of \$2,000,000. If the enterprise is operating subject to an 18% discount rate, the *present* value of the expected liability is only \$1,900,000, less than the cost of the device; the firm would not, rationally, avoid the damages. But if the society, by contrast, deems itself subject to a 7% discount rate, then the present value of the \$10,000,000 damages is over \$5,000,000, and the installation of the \$2,000,000 device clearly warranted by collective preferences. Hence, under these conditions, the HBLR techniques, uncorrected, would fail to yield the socially preferred outcome.

60. See p. 21 *infra*.

with economic rationality. It may simply calculate that it does not really face the theoretically correct price that the HBLR signal is transmitting, whether because of various legal doctrines⁶¹ and costs of proof⁶² that impede the imposition of liabilities, or because of bars to judgment such as limited liability and bankruptcy.

Because the HBLR signal may, for these and similar reasons,⁶³ fail to produce the collectively desirable response, society may wish to "correct" the HBLR signal, if not so strongly as to eliminate all the undesirable outcomes that the HBLR techniques will allow, then at least to restrict their occurrence.⁶⁴ It is when the law undertakes to make these corrections that its posture towards "black box" enterprise liability becomes ambivalent, and the theoretical bases for choice, uncertain.

On the one hand, society's correction can take the form of enacting liability rules that are harm-based in the first sense outlined above, in that harm triggers their imposition, but are detached from harm in the second sense, in that harm is removed as the measure of liability.

61. Such doctrines include, for example, proximate cause, see *New York Cent. R.R. v. Grimstad*, 264 F. 334 (2d Cir. 1920), consent to harm, see *Mink v. University of Chicago*, 460 F. Supp. 713 (N.D. Ill. 1978), and intervening cause, see *Henderson v. Dade Coal Co.*, 100 Ga. 568, 28 S.E. 251 (1897).

62. See Blum, *Jury System is Found Guilty of Shortcomings in Some Complex Cases*, Wall St. J., June 9, 1980, at 1, col. 1; *Separate Jury Trial Claim Poses 200-fold Nightmare*, Wash. Legal Times, June 2, 1980, at 1, col. 2.

63. Generally, these reasons stem from characteristics of the legal system, including the inability of the system of damages to restrict wrongdoing to the collectively desirable extent, see p. 14 *supra*, and characteristics of firm reaction in the face of legal threats, see pp. 15-16 *supra*.

64. The direct and perhaps ideal solution in these cases would be to alter other rules and retain the HBLR approach. For instance, my criticisms of the HBLR framework are based, in part, on the availability of limited liability as a bar to judgment. Yet, as I myself propose, see pp. 74-76 *infra*, these rules could be changed. The courts could expand the concept of compensable injury to include certain instances of mental distress for which no recovery may presently be had. Cf. note 52 *supra* (citing cases that approach mental distress damages differently). Elements of a cause of action could be made easier to prove. But while such changes in the rules, retaining the HBLR framework, might be optimal, some of the ideal reforms are practically foreclosed by problems of proving what one ideally wants to know, by legislative inertia, and even by constitutional bars, see pp. 44-45 *infra*. Hence, the justification for the corrective penalties and various "interventions" proposed in the text may have to rest, ultimately, on a "second best" basis. See Lipsey & Lancaster, *The General Theory of Second Best*, 24 ECON. STUD. 11 (1956) (explicating theory). Under the theory of the second best, when certain elements that comprise the ideal solution are practically foreclosed, there is no reason to suppose that the ideal solution is yielded by fulfilling the remaining nonforeclosed elements. Here, some ideal reforms of the HBLR framework being unrealizable, a "second-best" solution—special corrections such as the bureaucratic intervention proposed below, see pp. 36-38 *infra*—may be preferred. See Markovits, *A Basic Structure for Microeconomic Policy Analysis in our Worse-than-Second-Best World: A Proposal and Related Critique of the Chicago Approach to the Study of Law and Economics*, 1975 WIS. L. REV. 950, 968-76 (discussing how failure of one condition forces consideration of second-best possibilities).

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In other words, the law retains harm as a prerequisite of liability, but threatens, should it occur, to impose a money burden in excess of the damage that the actor has caused. I will designate this technique as penalty liability in the HBLR mode, or HBLR(P).⁶⁵ In circumstances in which the enterprise is the target of the rule—Enterprise HBLR(P)—it is clear that enterprise liability in our sense has not been abandoned. Society's distaste for certain outcomes, inadequately accounted for by the basic HBLRs, is expressed by superimposing a new, punitive set of liability rules that leave the underlying strategy unchanged. The law still threatens to levy a charge against corporate funds and is indifferent to how the enterprise participants avoid and distribute it.

The actual substitution of strategies—interventionism for enterprise liability—begins with the employment of penalties aimed at the agent. Because this second type of corrective action makes agents directly answerable to the state, the law displaces the enterprise from some of the autonomy it enjoyed under the Enterprise HBLR regimes—the power to direct, monitor, and “penalize” its agents itself.

A third set of corrective strategies operates by detaching the law from harm as the trigger of liability. I shall call such rules “Standards.” Instead of giving the actor the option of causing the harm and then, if caught, paying the damages or the penalty, Standards are employed to prevent some harms from occurring in the first place.⁶⁶ Standards—whether they are embodied in general legislation or specially tailored in injunctions—are always interventionist in our sense, inasmuch as they substitute collective judgments for market-guided managerial judgments, not only as to the “supply” of the harm (in common with

65. I am employing “penalty” in a broad sense to include any charge over and above the legally cognizable market-measured damages that the liability bearer would incur. These damages may be imposed not only through a civil judgment but also through a tax or criminal fine set to reflect the injury caused. Thus, in some cases “penalty,” as I use it, retains its connotation of moral distaste, as when a traditional criminal fine is employed. In other cases, however, such as the fines imposed for overweight trucks, the penalty expresses a desire to correct the supply of harm and to see that it is compensated, without making any strong moral judgment about the act. That is, we sometimes want the actor to be particularly sober before he performs a certain act, but not necessarily to abandon doing it if, for example, the market warrants its completion. Indeed, at one time, the Internal Revenue Service recognized this distinction. Motor carriers could deduct fines levied for violation of state weight and length requirements as ordinary and necessary business expenses. [1950] 5 STAND. FED. TAX REP. (CCH) ¶ 6134. The Service subsequently changed its mind, finding that the fines were in the nature of penalties, not, as it had supposed, in the nature of tolls. 1951-1 C.B. 15-16. The Supreme Court supported this decision, *see* *Tank Truck Rentals, Inc. v. Commissioner*, 356 U.S. 303 (1958), and it was eventually codified, *see* Tax Reform Act of 1969 § 902(a), I.R.C. § 162(f).

66. For a discussion of ex ante regulations as opposed to ex post liability, see Wittman, *supra* note 38, at 205-09.

the penalty-mode HBLRs), but also as to the means most appropriate to restrict the harm. Building code standards, for example, often dictate the installation of fire sprinkler systems rather than allow the owners to balance the costs of alternative fire prevention measures against the risks of fire, including the risks of all the various harm-based recovery modes.⁶⁷

As with HBLRs, violation of a Standard may in some circumstances trigger liability against the enterprise or against an agent.⁶⁸ But in other circumstances, Standards are designed to operate outside contingent liability altogether, functioning as conditions of doing business—of shipping goods in commerce,⁶⁹ or of receiving a government license⁷⁰ or contract.⁷¹ The distinction between these two uses of Standards—as penalty or as precondition—although blurred in particular application,⁷² has practical effects on the range of responses available to the corporation and is therefore significant in theory. Where Standards are attached to penalties, the law retains some degree of sensitivity to market-measured costs and benefits; the target can risk violating the Standard and paying the penalty if the market warrant for doing so is strong. Where standards are more or less ab-

67. Those recovery modes include liability aimed at either the enterprise or the officer, and from either a general deterrence or penalty posture.

68. For a survey of federal law authorizing criminal penalties against both agents and enterprises for violations of Standards promulgated by any one of a number of federal agencies, see SUBCOMM. ON CRIME OF THE HOUSE COMM. ON THE JUDICIARY, 96TH CONG., 2D SESS., CORPORATE CRIME 45-52 (Comm. Print 1980).

69. See, e.g., Establishment Registration and Device Listing for Manufacturers of Devices, 21 C.F.R. §§ 807.3-.97 (1980) (FDA regulations).

70. See, e.g., Reporting of Defects and Noncompliance, 10 C.F.R. §§ 21.1-.61 (1980) (Nuclear Regulatory Commission regulations concerning nuclear power plants); 21 C.F.R. §§ 601.10(a), .20(a) (1980) (FDA licensing requirements).

71. See 4 GOV'T CONT. REP. (CCH) ¶ 34,847 (specifying standard quality control techniques required of firms contracting with Defense Department). There are situations, too, in which Standards are employed to reinforce HBLRs. For example, violation of a statutory duty is sometimes evidence of negligence per se. See W. PROSSER, HANDBOOK OF THE LAW OF TORTS 190-95 (4th ed. 1971). Conceivably, violation of a Standard could be used to raise the penalty otherwise applicable to an HBLR(P). Section 2201 of the proposed federal criminal code represents a related approach, providing that where a misdemeanor (often violation of a Standard) results in loss of life, the maximum permissible penalty rises from \$100,000 to \$1,000,000. See *Reform of the Federal Criminal Laws: Hearings on S. 1722 and S. 1723 Before the Senate Comm. on the Judiciary*, 96th Cong., 1st Sess. 11,090, 11,250 (1979).

72. The distinction between Standards attached to liability rules and those that function as conditions can be viewed as one merely of style and degree insofar as an actor is free to disregard the "condition" and gamble on nondetection. Yet there is some range of cases in which the character of the Standard and the high level and likelihood of penalty—particularly if exacted on a per-day-of-violation basis and backed up by the prospect of injunction, see, e.g., N.Y. CIV. SERV. LAW §§ 210.2(g), 211 (McKinney 1973) (per-day fines for and injunctions against strikes by public employees); N.Y. JUD. LAW § 751.2(a) (McKinney Supp. 1979) (per diem fines against public employee organizations for strikes in violation of court order)—make the requirements, realistically, something more than contingent liabilities.

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solute conditions,⁷³ this option is removed, rendering errors in societal judgment less remediable.⁷⁴ The important point is that in either case, the burden that the Standard imposes on the actor may, like an HBLR in the penalty mode, impose costs on the enterprise that are in excess of the expected damages. Hence, Standards should be viewed as an alternative way of keeping the supply of disfavored outcomes beneath the level that the nonpenalty HBLR measures would permit.

A metal smelter whose air emissions threaten those who live in its vicinity with blood poisoning will serve to illustrate these various control alternatives. The Enterprise HBLR would threaten the enterprise with all judicially cognizable damages traceable to its activities.⁷⁵ An Enterprise HBLR(P) would confront the enterprise with an additional "penalty" over and above the legally cognizable damages. Agent liability would operate by singling out some key employee for liability, the plant manager, for example; the amount of the liability would be measured by the cognizable damages in the case of an Agent HBLR, and would be subject to a punitive overlay in the case of an Agent HBLR(P). A Standard in these circumstances might mandate the installation of a certain grade of air emission control device, or require the hiring of a health officer. Failure to install or maintain the device, or hire the officer, could trigger liability either against the enterprise or against a selected agent, or could result, for example, in disqualification from government contracts.

The question that began this section can now be further refined. Suppose that we are collectively unwilling to accept the supply of certain outcomes that nonpenalty HBLRs will permit. Within the expenditures we are prepared to make to achieve further reduction, what considerations make one or the other of these devices the most effective technique? I will begin by examining the enterprise liability approach—Enterprise HBLR(P)—and then proceed to consider its interventionist alternatives—agent liability in the HBLR penalty mode and then the various types of Standards.

A. *Enterprise Liability in the HBLR Penalty Mode*

In our metal-smelter illustration, the Enterprise HBLR(P) approach would entail no legal action until the poisoning or damages had

73. By "more or less absolute conditions," I mean conditions such as those described in note 72 *supra* whose violation is almost certain to bring punishment.

74. Cf. Ellickson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines on Land Use Controls*, 40 U. CHI. L. REV. 681, 706-08 (1973) (penalties preferable to injunctions in area of land use controls because they preserve market-sensitive measures of value).

75. Whether the liability rule is based on strict liability or negligence is unimportant in this context.

reached some recognized level,⁷⁶ at which time a penalty would be exacted over and above the prospects of all ordinary damage liabilities that might be imposed on the enterprise.⁷⁷ There are several steps that the enterprise can take to reduce its risk of liability, including a substitution of inputs, an increase in monitoring, and a reduction of output. Each alternative represents a cost that we are assuming to be greater than the cost the enterprise would incur if responding only to the spectre of HBLR damages. I will use C to designate the incremental costs assignable to the avoidance of the penalty "correction." We will assume, first, that the penalty liability rule is clear;⁷⁸ second, that the upper boundary of C is a limit L, the cost of installing a technologically feasible control device—that is, smaller expenditures will reduce the risks, but the device, at a cost of L, will virtually eliminate them; and third, that L is within the range of the "premium" that society is prepared to expend to eliminate the outcome.⁷⁹

It is readily apparent that the Enterprise HBLR(P) technique gives the enterprise a choice of risks. By taking its chances that it will not cause the harm or, at least, that it will not be convicted, the firm will face an upside possibility of L as a gain by saving itself the cost of the device. The downside risks are a function of the level of the penalty that the potential defendant can expect if convicted, P, and the probability of being subjected to it, *f*. Employing the simplifying assumptions of classic economic rationality—that the enterprise seeks to maximize share values, that it has access to and rationally processes all relevant information, and that it is risk neutral—the firm will be "persuaded" to install the device (if not to find a better alternative) when the net expected present value of *Pf* rises to the level L.

76. There is no universally recognized test for determining when "poisoning" and "damaging" have occurred. The difficulty of resolving the question, as suggested by *Mink v. University of Chicago*, 460 F. Supp. 713 (N.D. Ill. 1978) (increased susceptibility to vaginal cancer of daughters of women who took certain drugs not actionable harm, but merely greater risk for which daughters could not themselves recover), may well lead us to substitute Standards for HBLRs in some circumstances.

77. See note 64 *supra* (discussing correction of HBLR as second-best solution). Generally, the state would collect this penalty, but the plaintiff in a civil damage action could also collect the appropriate penalty "correction" amount, as is done in treble damage actions under the antitrust laws. On the relative merits of public versus private fine enforcement, see Becker & Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1 (1974). But our definition of "penalty" and the discussion in text is unaffected by the choice of who best collects it.

78. The concept of "understanding a rule" is complex and can mask considerations important to the present inquiry. For example, whether a firm finds its equal employment obligations "clear" may reflect its prior decision to bear the increased risks of violating them, rather than pay the costs of understanding them better. We will relax this assumption that the rule is clearly understandable at pp. 25-26 *infra*.

79. See note 56 *supra* (discussing society's risk premiums).

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The best that can be said for this technique—and it is a strong warrant—is that the penalty approach leaves each enterprise maximum flexibility to work out the best harm-avoiding solution. For example, in contrast with a highly intrusive interventionist technique, such as a Standard that mandated installation of a specific device for all smelters, the HBLR(P) approach allows readier accounting for deviations among plants: if some preferable solution exists or emerges, each plant will be free to implement it.

Misgivings over this penalty approach begin with some of the same doubts that undermine faith in the nonpenalty Enterprise HBLR: the fear that the enterprise may not respond in the manner implied by the classic rationality assumptions. Over some interval (presumably when profits are sufficient to retain the managers in power),⁸⁰ the managers may trade off the maximization of share values for the maximization of some competing value, such as prestige, expansion, or sales.⁸¹ If the enterprise employs an abnormally high discount rate or is a strong risk preferrer,⁸² the P_f combination that will sway the “rational” firm to install the device— P_{f_r} —will be inadequate. There is the further possibility that, whatever those nominally in control of the enterprise are seeking to maximize, their actual control, particularly in a huge and complex modern bureaucracy, will erode. The

80. See J. GALBRAITH, *THE NEW INDUSTRIAL STATE* 115 (1967) (when earnings above certain minimum, management has little to fear from stockholders); cf. W. BAUMOL, *ECONOMIC THEORY AND OPERATIONS ANALYSIS* 383-85 (4th ed. 1977) (management seeks to maximize sales while also maximizing profits, which is independent and principal concern of shareholders).

81. Prestige, expansion, market share, sales, and other values are not antithetical to profits. On the contrary, the realization of these supposedly non-profit-maximizing values are in general assisted by profits, and thus the question of conflict and trade-off occurs, if at all, only within relatively restricted boundaries. Cf. note 23 *supra* (organizational decision-making better described as choice subject to multiple constraints, rather than pursuit of “a goal”).

82. It is not clear under what set of assumptions the enterprise would prefer risks. Shavell suggests that shareholders as a group are likely to be “a risk neutral principal,” and employs an example that assumes a risk-averse manager. Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.* 55, 66 (1979). But whatever assumptions one makes regarding the relative risk postures of the shareholders and agents, one cannot clearly infer the risk posture of the corporation, which can be viewed as possessing a somewhat distinct life and somewhat distinct incentives. See p. 9 *supra*. By virtue of limited liability, shareholders are buffered from the full impact of the corporation's liability, but if no liability-creating incidents occur, they will reap the benefits of skimping on safety measures. As to executives, lawsuits against the corporation almost inevitably leave executive tenure and salary untouched. Indeed, executive compensation is often designed to increase if company earnings rise but not to fall beneath some assured base should the company sustain losses. How the enterprise likes risk is going to be a complex product, therefore, of the relative risk preferences of investors and managers, the balance of control between them, and their likings and capacities for various means of extracting wealth.

reasons for such erosion range from subgoal pursuit—a particular division may pursue some target not wholly congruent with ostensible company goals⁸³—to outright opportunism of various agents and sub-agents—individual agents may seek to maximize their own welfare in ways inconsistent with the welfare of the enterprise.⁸⁴ In addition, however “rational” the firm may be in its outlook, it may be incompetent in its calculations. Or the firm may be quite competent yet deliberately eschew the global rationality of the textbooks for what Simon calls “bounded rationality,”⁸⁵ in which the manager will accept a solution that meets certain minimal aspirations, in preference to bearing the added costs of searching for the unique optimal solution.

It is true that we lack empirical evidence that such phenomena produce widespread deviations from classical profit-maximizing behavior. Nor can we be certain that, to the extent such deviations exist, each operates to make the enterprise less rather than more sensitive⁸⁶ to the law’s threats, although the former seems more likely.⁸⁷

83. See H. LEIBENSTEIN, *supra* note 36, at 161-65; O. WILLIAMSON, *supra* note 36, at 118-26; Simon, *Rational Decision Making in Business Organizations*, 69 AM. ECON. REV. 493, 500-01 (1979).

84. At the extreme, an agent who appreciates the risks of a certain course of conduct and who owns shares might underprotect the corporate interest in the hope of capturing short-term personal gains. By foregoing the present costs of avoiding future harms, the present value of his shares will benefit; he may be able to sell before the stock market comprehends and discounts for the prospects of legal liability. Other sources of control loss are reflected less in blatantly calculated self-interest than in the inherent complexities of bureaucratic management, such as the difficulty of communicating information. See R. CYERT & J. MARCH, *supra* note 23, at 26-38; C. STONE, *supra* note 13, at 43-46; Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1136-41 (1977).

85. See Simon, *supra* note 83, at 495, 501.

86. Even if we abandon the simplifying assumption that the enterprise is risk neutral, we cannot say with confidence that it is more likely to be a preferrer than an avoider of law-transmitted risks. For example, that a company is oriented more towards prestige than towards profits does not make the law’s threats ineffective. A company that will sacrifice profits for prestige may be more sensitive to the law’s threats than one that is purely profit-oriented, if it weighs the prestige loss that accompanies the prosecution more heavily than the lost profits. Even the possibility of an abnormally high discount rate, see note 59 *supra*, has ambiguous implications depending upon the anticipated sequence of private benefits from ignoring the liability rule and of private costs from paying liability claims. It is possible that high social benefits associated with not violating some law will not begin to flow until some relatively distant future, in which case the firm would be (from society’s perspective) overly cautious.

87. One can draw this implication from bounded rationality, for example. If a firm is going to sacrifice the processing of some information, it may have incentives to underconsider (from a social point of view) factors that bear on its legal liabilities. This decision to ignore may be quite rational because giving full consideration to the risks of legal liability has the peculiar character of increasing those risks. First, with the rise of computer technology, consideration of legal liability will help create a trail of evidence whose eradication will require concerted action that may involve several levels of bureaucratic authority. Second, the imposition of punitive damages and criminal penalties on the corporation may depend upon actual or constructive knowledge by top management.

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In all these matters, both the classical economists who follow in the mold of Marshall, and the "behavioral theory of the firm" proponents such as Simon, Cyert, and March, rest much of their cases on hunches and plausibilities.⁸⁸ Yet it is important to bear in mind that our own heuristic interests—the design of legal strategies—are narrower than those of the macroeconomists, and we cannot pass over so lightly the potential for nonrational firm activity. For the macroeconomists' task of describing the whole economy, it is more reasonable to disregard deviations among particular firms on the assumption that firms that are deviant will fall by the wayside. From that perspective, variations from the classical assumptions, particularly short-term variations, are as likely as not to cancel out in portraying the long-run activity of the total economy.⁸⁹ But because our concern is with establishing liabilities to restrain incidents of misconduct by individual firms, it is best to presume both that there exists a certain amount of "irrationality," and that it tends to desensitize firms to the law's profit threats. To do so is prudent even if these presumptions characterize only the atypical firm, or the typical firm only in its moments of temporary or small-scale internal deviance from "ordinary" firm behavior. Just as the laws that constrain natural persons have to be written not only with the average but also with the atypical person in mind—not the ordinary reasonable man, but the killer, the robber⁹⁰—so the corporate penalties must account for the one highly irrational metal smelter, insensitive to profit, that can produce toxic emissions causing enormous amounts of uncompensated and perhaps noncompensable losses.

This prudent presumption that we are dealing with enterprises that deviate from "pure" profit-maximization in the direction of insensi-

Such knowledge becomes more probable the more exhaustively the risks of any course of conduct are considered. Indeed, evidence that the firm rationally mulled over its prospects of ordinary civil liability may be seized upon by a jury as an element warranting punitive damages in a civil suit, and as support for premeditation or a comparable element in a criminal prosecution. See, e.g., Harris, *Why the Pinto Jury Felt Ford Deserved \$125 Million Penalty*, Wall St. J., Feb. 14, 1978, at 1, col. 4 (jury awarded punitive damages in design defect case partly because of evidence that defendant balanced production savings against safety factors from different designs).

88. For a survey of some of the empirical attempts see Simon, *supra* note 83, at 501. For reviews of behavioralists' positions, see A. HIRSHMAN, EXIT, VOICE, AND LOYALTY 5-15 (1970); H. LEIBENSTEIN, *supra* note 36, at 42-44.

89. Cf. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 213-14 (1950) (economic system can be studied as a whole even though individual firms drop out or fail).

90. Our deterrence strategies must account for persons of far less than average sensitivity to threats, and probably become increasingly ineffective at any level of punishment as we encounter actors who do not behave according to the law's presumption of self-interest. See W. BERNIS, FOR CAPITAL PUNISHMENT 128-30 (1979).

tivity towards the law's threats does not of itself eliminate enterprise liability as an appropriate strategy. If we lack confidence that Pf_c will be an adequate intimidation, the most obvious response is to increase the threat of the law to ever higher levels. Two variables can be employed for this task, separately or in combination. First, the probability of punishment, f , can be increased within the limits of budget constraints on enforcement expenditures. Second, the level of penalty, P , can be raised.⁹¹

Other things being equal, escalating the penalty would seem preferable: whereas increasing the rate of conviction entails increasing demands on the public budget, P appears susceptible to unrestricted manipulation.⁹² This notion, however, is misleading. Several significant factors constrain our escalating P to an unlimited in terrorem level.⁹³ First, the defendant's wealth puts a ceiling on the values we can assign to P . The enterprise cannot be forced to pay out in penalty more than it has,⁹⁴ and in the case of the business corporation, what it "has" can be restricted through limited liability as well as bankruptcy.⁹⁵ Second, the enforcement costs rise with the level of P . The higher the penalty, the more the enterprise will impede detection by covering up, and the more it will resist conviction if charged.⁹⁶ Both

91. See Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 177, 183-84 (1968); Polinsky & Shavell, *The Optimal Trade-Off Between the Probability and Magnitude of Fines*, 69 AM. ECON. REV. 880, 880 (1979); Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 528 (1970). Generally, the authorized P is a variable to be fixed by the sentencer, at his discretion, within a certain range; as used in the text, P refers to the level of penalty that the defendant can expect the sentencer to set. The sentencer's discretion will, of course, affect some of the problems associated with P that are discussed in the text.

92. There is, nevertheless, literature emphasizing the value of the frequency of conviction (and its temporal proximity to the offense) that goes back at least to Beccaria. It is supported in contemporary literature by Block & Lind, *Crime and Punishment Reconsidered*, 4 J. LEGAL STUD. 241 (1975), who argue that while there is no penalty severe enough to deter every crime, there is a probability of punishment, less than one, that will deter all crimes. *Id.* at 246-47.

93. The text emphasizes the economic and moral constraints on penalty escalation, but we also should consider the constraints implicitly suggested in the psychology and sociology literature. See W. BAGEHOT, *PHYSICS AND POLITICS* 44-84 (1948) (conflict tends to intensify loyalty of group members to their respective groups); L. COSER, *THE FUNCTIONS OF SOCIAL CONFLICT* 33-38 (1956) (same). Conceivably the intensification of challenges to the corporation, particularly when they are viewed as silly or outrageous by the corporate employees, will have a perverse effect on law compliance, creating a "siege mentality" that unites the employees against the government in the determination to get away with whatever they can.

94. See Block & Lind, *supra* note 92, at 242-44.

95. Strictly speaking, corporations cannot be "discharged" in bankruptcy. See 11 U.S.C. § 727(a)(1) (Supp. III 1979). A bankruptcy discharge would, however, apply to any of the investors' debts arising out of liabilities to the corporations' creditors that were not immunized by limited liability.

96. See Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61, 69-71, 99 (1971).

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reactions operate to increase the toll on enforcement budget resources. Third, there are target efficiency⁹⁷ constraints. We do not want to impose on the enterprise marginal costs that exceed the marginal benefit of compliance.⁹⁸ The question of efficiency constraints poses the most difficult problems. The benefits of avoiding some undesirable conduct are so high and unambiguous, and the costs imposed on the enterprise so merited and containable, that we hardly consider excess caution an issue. For example, the penalties we attach to deliberate price fixing are probably independent of target efficiency constraints. In such instances, however, the conduct we want to restrict can be defined and prohibited with virtually no toll on beneficial activity—that is, price fixing can be eliminated without any social loss. But because liability rules cannot commonly be framed in a way that so precisely severs the deliberate from the unintended, and the unwanted from the beneficial, the desirability of liability rules is ordinarily less certain.

On the one hand, laws that are too vague may be ignored⁹⁹ or may even prove constitutionally infirm.¹⁰⁰ On the other hand, they may have a chilling effect on the enterprise whose managers, uncertain of a prohibition's bounds, are so intimidated that they avoid behavior that would prove, if they chose to litigate the issue, lawful.¹⁰¹ Moreover, even if the law's commands can be rightly understood, the higher the threatened penalties, the greater the risk of compelling the firm to make expenditures disproportionate to the benefits that society seeks. The risks of overdeterrence are heightened when there is no certain

97. I use the term target efficiency to denote efficiencies in the production of goods and services, as distinct from efficiencies in law enforcement and administration.

98. By benefits I mean, of course, external benefits, not merely benefits to the enterprise. This efficiency concern operates not only to restrain the levels of penalty, but to affect the choice of liability rules as well. See *United States v. United States Gypsum Co.*, 438 U.S. 422, 441 & n.17 (1978) (concern about not deterring "salutary and procompetitive conduct" under Sherman Act renders strict liability judicially disfavored absent clear legislative authorization.)

99. See C. STONE, *supra* note 13, at 41. In some circumstances, efforts to provide superior bright line rules will sacrifice achievement of the underlying values that the law seeks to advance. See, e.g., Ackerman & Sawyer, *The Uncertain Search for Environmental Policy: Scientific Factfinding and Rational Decisionmaking Along the Delaware River*, 120 U. PA. L. REV. 419, 436-49 (1972) (use of dissolved oxygen as readily available and accepted measure of environmental degradation shown to correlate poorly with advancement of clean river goals).

100. See, e.g., *Lanzetta v. New Jersey*, 306 U.S. 451, 457-58 (1939) (vague, indefinite, and uncertain terms in state criminal statute violate due process).

101. Moreover, just as uncertainty as to the law's reach can, through its chilling effect, produce unwanted results, so too can certainty. The creation of a set of legal bright lines may vitiate responsible corporate self-control, for the businessman will then feel less compunction about extending his behavior to the very limits of what the rule allows. See C. STONE, *supra* note 13, at 100-03.

expense, such as the installation of known technology, that will avoid the liability with certainty.¹⁰² At what price can management guarantee that its workers will not die in coal mines, or drivers of its cars in accidents from failed brakes? Moreover, in the context of a large enterprise, where problems of opportunism exist,¹⁰³ many outcomes that are within the "deliberate" control of an individual are less intelligibly "deliberate" as matters of corporate conduct, there being no level of commitment by the enterprise's managers that can insure compliance at all levels of the organization.

As a consequence, much corporate misconduct will be relatively inelastic to changes in expected penalty levels,¹⁰⁴ over a moderate range of penalty. And as we escalate penalty levels into a range where they should modify behavior effectively, we are increasingly likely to conflict with efficiency considerations.

Finally, there are moral constraints¹⁰⁵ on the escalation of *P*. Some of these have found formal recognition in independent legal and perhaps even constitutional barriers, such as those that constrain the imposition of fines for offenses not requiring intent.¹⁰⁶ For moral reasons, too, we are restricted from trading off an increasingly higher *P* for a reduced *f* in an effort to achieve the same level of deterrence at a reduced cost. To do so entails punishing a few miscreants severely in order to serve as an example to all, a strategy that conflicts with fundamental precepts of equality.¹⁰⁷

102. That is, we are relaxing here the second initial assumption—that the cost of compliance, *C*, has a clear limit, *L*. See p. 20 *supra*.

103. Opportunism must be understood in this context to include laziness—maximizing leisure at investor expense—see Anderson, *Conflicts of Interests: Efficiency, Fairness and Corporate Structure*, 25 U.C.L.A. L. REV. 738, 776 n.111 (1978), a form of self-benefit that may increase hazards to third parties as well as to investors.

104. For a discussion of the implications of an inelastic supply of offenses for the level and probability of punishment, see Wittman, *supra* note 38, at 198.

105. Obviously, there are "moral" justifications for the efficiency constraints discussed in the text, justifications that derive from the positive welfare effects of efficient production and distribution. What I deem in the text "moral constraints" stem from sentiments that resist reduction to efficiency terms, whether they are viewed as deontological limits on utility-maximization, or otherwise.

106. See *Morissette v. United States*, 342 U.S. 246, 256 (1952) (relatively small penalty one of several conditions that criminal statute not requiring intent must meet in order to satisfy due process clause); cf. MODEL PENAL CODE § 205(2) (1962) (strict liability offenses never more than "violation," which is less than petty misdemeanor and does not constitute "crime").

107. See Wittman, *supra* note 38, at 201 (ex post inequitable to make convicted criminal "pay price" for unconvicted criminals through high penalty to compensate for low probability of conviction). John Rawls suggests a case rejecting similar punishment policy—"telishment"—without introducing nonutilitarian premises. Rawls, *Two Concepts of Rules*, 64 PHIL. REV. 3 (1955).

We may also prefer to restrict the level of *P*, for any particular crime, in order to hold in reserve a yet higher level as a discriminating mechanism. See Stigler, *supra* note 91,

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Moreover, many of the prevailing moral constraints that affect the imposition of penalties in law are even stricter in the corporations context because of an inevitable vicariousness. Corporate penalties often impose losses in circumstances when no one appears blameworthy, least of all the investors, employees, consumers, and dependent communities, who will bear the brunt of the burden.¹⁰⁸ True, we allow some of these same innocents to suffer (the investors, for example, through a decline in share values) when corporate agents wrongfully break a contract or commit a tort, notwithstanding the unlikelihood that they could have monitored and halted the misconduct. But it seems one thing to make a blameless investor help absorb ordinary damages, which amounts to compensating an equally blameless injured party from corporate funds, and quite another thing to reduce his investment further by imposing a penalty. It may be for such reasons that courts and prosecutors, even when armed by the legislature with increased penalties for crimes as deliberate and socially unredeemable as price-fixing, appear little inclined to exact the sanctions to the fullest.¹⁰⁹

None of these observations proves that correcting the general deterrence regime via Enterprise HBLR(P)s is necessarily inferior to its alternatives, which we have yet to examine. There is some support for the view that, even when we have allowed for the various constraints, the expected level of penalty for many offenses can be raised to a point high enough that most enterprises will behave correctly most of the time.¹¹⁰ As I have already indicated, trying to remain within this framework has the additional virtue of flexibility, in that the firms most ready to comply are free to work out the most cost-

at 527-28. For example, we may not wish to apply the death penalty for airline hijacking because, by holding the higher penalty in reserve for murder, we may be able to dissuade the hijacker from carrying out more onerous acts.

108. See, e.g., G. WILLIAMS, CRIMINAL LAW § 283, at 865 (2d ed. 1961) (criticizing corporate criminal liability because "punishment does not fall upon those who are really responsible").

109. See M. CLINARD, ILLEGAL CORPORATE BEHAVIOR 147-48 (1979); Posner, *A Statistical Study of Antitrust Enforcement*, 13 J.L. & ECON. 365, 388-95 (1970). Posner reports that, although the maximum penalty for violations of the Sherman Act was raised tenfold (from \$5,000 to \$50,000 in 1955), the average fine actually assessed during the period 1960-1969 increased only four-fold over that of the period 1890-1954. *Id.* at 390. From 1967 to 1970, in cases in which sentencing occurred under the federal antitrust laws, the Department of Justice recommended the maximum fine (then only \$50,000) only 27 percent of the time. See K. ELZINGA & W. BREIT, THE ANTITRUST PENALTIES: A STUDY IN LAW AND ECONOMICS 61 (1976).

110. K. ELZINGA & W. BREIT, *supra* note 109, at 115; Note, *Increasing Community Control Over Corporate Crime—A Problem in the Law of Sanctions*, 71 YALE L.J. 280, 294-95, 302 (1961).

effective solutions. A significant number of the most undesired outcomes will be eliminated with minimum social cost.

The infirmity of enterprise-oriented HBLRs concerns that group of firms, impossible to identify in advance, whose behavior in the face of realistically achievable penalty levels will remain inadequately modified. To bring such firms to heel, our best hope will be to bring f , the probability of conviction, closer and closer to 1. But many of the measures we might employ to increase f , such as shifting burdens of proof against defendants, are subject to their own moral, if not legal, restrictions;¹¹¹ and the measures that are allowable, such as increased policing and prosecution, obviously entail greater and greater enforcement costs. Hence, even if the alternatives to Enterprise HBLRs—agent penalties and interventions via Standards—entail their own peculiar costs, it does not necessarily follow that those alternative techniques are less efficient means of achieving the best balance of caution and unwanted outcomes.

B. *Agent Liability*

Where enterprise liability appears deficient, some of the slack can be taken up through penalty HBLRs that target agents directly: what I have denominated Agent HBLR(P)s.¹¹² Certainly, the appeal of direct agent liability is widespread and obvious.¹¹³ A close examination, however, reveals that its case for displacing or even sharing duty with enterprise liability is not as persuasive as some of the literature suggests.

To begin with, we should note that the issue is not one of shifting from a system that leaves agents untouched to one that affects them.

111. See, e.g., *In re Winship*, 397 U.S. 358 (1969) (statute that reduced standard of proof from "beyond a reasonable doubt" to "by a preponderance of the evidence" violated due process). Civil penalties may soften or circumvent the impact of traditional restrictions on criminal fines. See *United States v. Ward*, 100 S. Ct. 2636, 2640-44 (1980) (imposition of civil penalty under Federal Water Pollution Control Act does not trigger Fifth Amendment protection against self-incrimination presumably available to corporate officer in instance of criminal proceeding).

112. Our concern here is not with ordinary civil liabilities of agents, which are ordinarily shifted without objection to the enterprise, see pp. 12-13 *supra*, but with the application of some penalty increment. Furthermore, we consider here only agent penalty liability for a violation of a harm-based rule; the special case of agent liability for violation of a Standard is discussed at pp. 43-44 *infra*.

113. Traditionally, support for agent liability has been drawn from notions of blameworthiness, deterrence, and distributive justice. See Mueller, *supra* note 14, at 45; Comment, *Is Corporate Criminal Liability Really Necessary?* 29 Sw. L.J. 908, 919-24 (1976). But see *New York Cent. & Hudson River R.R. v. United States*, 212 U.S. 481, 496 (1909) (corporate criminal liability only means of effectively controlling and correcting abuses); K. ELZINGA & W. BREIT, *supra* note 109, at 132-33 (managerial fines unfavorably compared to fines against corporations).

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Under the rules aimed at the enterprise, the enterprise presumably will deal as it sees fit with the employee whose conduct risks or has actually caused its liability. These sanctions available to the enterprise may range from ostracism and "passing over" in the matter of promotions and raises, to dismissal, or even the institution of an employer's indemnity action.¹¹⁴ Indeed, the employer and the employment environment have a strong and immediate influence on employees, whereas the state, for all its nominal authority, is distant and abstract. As a consequence, one might well prefer to sanction the whole enterprise and thus induce it to reform its internal environment in the most appropriate manner.¹¹⁵

We may also suppose that it is ordinarily less costly to identify and convict whatever enterprise was responsible than to go further and fix responsibility on one of the enterprise's agents.¹¹⁶ If so, one would expect increases in enforcement expenses to yield a higher rate of conviction, at any margin, if the enterprise rather than the agent is the target. Thus, to the extent that the enterprise can be presumed to respond rationally to *its* penalties, it would seem preferable, within the range that constraints on the escalation of enterprise penalties permit, for the law to aim its penalties at the enterprise and entrust the enterprise to discipline its agents.

Nevertheless, there are reasons to make the agent answerable directly to the state in its own forum, rather than indirectly through the agency of the enterprise.¹¹⁷ Most obviously, the agent's misconduct may have been so egregious as to demand a penalty, such as imprison-

114. See pp. 56-60 *infra*; cf. S. 1722, 96th Cong., 1st Sess. § 2202(a)(4) (1979) (amount of fine imposed on defendant organization should take into account "any measure taken by the organization to discipline its employees or agents responsible for the offense").

115. Indeed, it is a commonplace that one of the principal features, and perhaps virtues, of a bureaucracy is that it makes individuals subordinate to and substitutable in a dominant institutional structure. The influences of bureaucratic structure and peer group pressure are particularly likely to dilute the force of more distant and contingent legal rules as such rules become increasingly "technical," that is, morally neutral. See MODEL PENAL CODE § 2.07, Comment, at 148-49 (Tent. Draft No. 4, 1955); C. STONE, *supra* note 13, at 67-69; Cressey, *Culture Conflict, Differential Association, and Normative Conflict*, in CRIME AND CULTURE: ESSAYS IN HONOR OF THORSTEN SELLIN 43-47 (M. Wolfgang ed. 1968). This is a strong argument for probationary terms that alter bureaucratic features as a remedy for corporate wrongdoing. See Note, *Structural Crime and Institutional Rehabilitation: A New Approach to Corporate Sentencing*, 89 YALE L.J. 353, 370 (1979).

116. See *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1006 (9th Cir. 1972), *cert. denied*, 409 U.S. 1125 (1973) (corporate liability for antitrust violation justified in part because of difficulty of identifying responsible agents). The task becomes more difficult as institutions become larger and more complex. See K. ELZINGA & W. BREIT, *supra* note 109, at 38-39.

117. In addition, if the potential fine exceeds the cost of collecting it, the state will prefer to punish the agent directly.

ment, that is beyond the power of the enterprise to mete out. But less clear-cut situations occur when the agent's misconduct would concededly merit no more severe a penalty than a fine. The question then arises whether, supposing the enterprise to be capable of exacting from the wrongdoer a "penalty"—through dismissal, an indemnity action, or whatever—exactly equivalent in monetary value to the fine that the state would exact, any reason remains for the state to undertake the added costs of identifying and convicting the responsible agent itself.

At least in some of the more serious cases meriting legal fines, public prosecution of agents is arguably appropriate. In this view, even though imprisonment is not demanded, the law may yet have a retributive, even denunciatory role to play, one that requires the ceremonial trappings of public prosecution for symbolic and educative purposes. In many such cases, moreover, we are likely to be skeptical that the enterprise, having been prosecuted, will in turn proceed to identify the wrongdoing employee and impose the appropriate sanction. The enterprise's own notions of what constitutes blameworthy conduct may be too lenient to suit the collective preferences of society. In addition, we may suspect the integrity of the enterprise's internal sanctioning process, which is, after all, largely in the hands of high-level managers who have their own welfare to protect. The managers may tend either to find a scapegoat or to accord light treatment to a true culprit in exchange for his not implicating them.¹¹⁸

Thus, when we are dealing with the most reprehensible agent conduct, the case for agent penalties is clear, and the only real question is whether to rely on them exclusively, or to employ them in tandem with the enterprise-liability sanctions. This decision would seem to turn on pragmatic considerations, such as whether the availability of the enterprise as a target will distract public and prosecutorial attention from the individual in circumstances where the individual is the preferable target.¹¹⁹

118. For an instance of "light treatment," see note 209 *infra* (executive fired for role in foreign bribery scheme later hired as consultant). The aim of S. 1722, 96th Cong., 1st Sess. § 2202(a)(4) (1979) (amount of corporate fine should account for corporation's own disciplinary action against employees responsible for offense), is evidently to induce more intensive private sector discipline.

119. See G. WILLIAMS, *supra* note 108, § 283, at 865; cf. Lee, *Corporate Criminal Liability*, 28 COLUM. L. REV. 1, 187 (1928) (traditional sanctions affect innocent shareholders); Note, *supra* note 110, at 292-93 (traditional sanctions do not reach important policy-makers). The availability of both enterprise and individual targets may lead to unjust conviction of corporations. The prosecutors may indict both the enterprise and individuals with the intention of dropping charges against the defendant executives in exchange for a guilty plea by the corporation. See 1 NATIONAL COMM'N ON REFORM OF FEDERAL CRIMINAL LAWS, WORKING PAPERS 180, 199 (1970).

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The most important point, however, is that the bulk of harm-causing corporate conduct does not typically have, at its root, a particular agent so clearly "to blame" that he or she merits either imprisonment or a monetary fine extracted in a public ceremony. A bribe, for example, can be traced to a particular hand and mind; not so a new car with flawed brakes. In a large organization, the division of bureaucratic functions makes it difficult to ascribe individual responsibility for the brake design even when we are using "responsibility" in its moral sense.¹²⁰ To establish the legal responsibility of an agent is even more costly and problematic, especially in criminal actions where the burden of proof and various due process constraints impede prosecution. Indeed, there may be circumstances in which we find it appropriate to judge that a wrongful act has occurred, but to ascribe it—both in morals and in law—to the corporation rather than to any agent. Such an attribution has appeal when, for example, the society wishes to denounce the conduct and rehabilitate¹²¹ the actor, but the source of the wrongdoing seems to lie in bureaucratic shortcomings—flaws in the organization's formal and informal authority structure, or in its information pathways—rather than in the deliberate act of any particular employee.¹²² In these circumstances, it may be more intelligible, and make better policy, to focus the sanction on the enterprise.¹²³

As we move away from highly blameworthy individual misconduct, then, towards situations in which agent culpability is not so readily apparent and in which weighing an activity's costs and benefits at different margins¹²⁴ overrides the law's interest in retribution, the

120. The agents themselves may not be able correctly to describe their own responsibility, often carrying out "series of apparently rational actions without any ideas of the ends they serve." C. MILLS, *THE SOCIOLOGICAL IMAGINATION* 168 (1961).

121. Rehabilitation would occur through corporate probation. See Stone, *Proposed Model Code for Corporate Rehabilitation*, reprinted in *Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce*, 94th Cong., 2d Sess. 297-301 (1976); Note, *supra* note 115, at 364-75 (advocating corporate probation as technique to rehabilitate corporation).

122. See French, *The Corporation as a Moral Person*, 16 AM. PHIL. Q. 207 (1979) (attributing moral characteristics to corporations for reasons given in text). But see Ladd, *Morality and the Ideal of Rationality in Formal Organizations*, 54 MONIST 488 (1970) (nature of formal organizations makes it unintelligible to ascribe moral responsibility to them). The law can be regarded as subscribing to some view of institutional blameworthiness in situations in which the corporation is held liable for a non-strict-liability offense without proof of specific intent of a particular employee. See *United States v. Hilton Hotels Corp.*, 467 F.2d 1000, 1005-06 (9th Cir. 1972), *cert. denied*, 409 U.S. 1125 (1973).

123. One such policy reason flows from the likelihood that the public knows the corporation, but probably not the agents, by name. See G. WILLIAMS, *supra* note 108, § 283, at 863. The adverse corporate publicity will have a deterrent effect and may enable the public to protect itself against dangerous enterprises.

124. The cost-benefit analysis justifications seem appropriate to "crimes" ordinarily labeled "regulatory" or "public welfare" offenses in the literature, and where the con-

case for pursuing agents rather than the enterprise becomes increasingly unsure. If, for example, the law imposes its penalty on the manager of our hypothetical smelting plant, the same constraints that inhibit the escalation of enterprise penalties—defendant wealth, efficiency, morality, and so forth—limit even more stringently the sanctions against the agent.

Thus, although proposals recur to legislate severe penalties for conduct such as failure to supervise,¹²⁵ it is far from clear that such reforms are either prudent or workable. To criminalize behavior that is essentially beyond the actor's control undermines the moral basis of the entire criminal justice system.¹²⁶ Even at this high price, we are likely to realize only a marginal diminution in misconduct, for the more the conduct is unpremeditated, or is a joint product of many agents' acts over which the targeted agent has limited control, the more inelastic its "supply" will be to changes in expected penalty levels. The likely results are a rate of conviction of those prosecuted, and a level of punishment of those convicted,¹²⁷ that are far lower for

siderations that dominate liability rules merge with those of accident law. *See generally* Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423 (1963); Sayre, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933). The Polinsky and Shavell analysis seems particularly appropriate for offenses of this sort, as evidenced by their principal illustration, parking violations, an offense that carries little moral freight. *See* Polinsky & Shavell, *supra* note 91, at 886-87.

125. *See, e.g.*, S. 1, 94th Cong., 1st Sess. § 403(c) (1975) (supervisor criminally liable for organization's offense if "reckless failure to supervise" permitted or contributed to its commission). This section has not been carried forward in the bills currently pending before Congress. *See* S. 1722, 96th Cong., 1st Sess. (1979). *But see* H.R. 4975, 96th Cong., 1st Sess. (1979) (penalizing person having management authority in business entity who, discovering serious danger, fails to inform appropriate federal agencies and warn affected employees).

126. *See* H. PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* 359 (1968) ("If we make criminal that which people regard as acceptable, either nullification occurs or, more subtly, people's attitude toward the meaning of criminality undergoes a change."); White, *Making Sense of the Criminal Law*, 50 COLO. L. REV. 1, 21 (1978) (finding criminal responsibility without regard to fault both unfair and senseless as "crazy obliteration of distinctions that are essential resources for our collective life").

127. Comparisons among levels of punishment are complicated, since fines and imprisonment are not the only alternatives. In the 1974 Paper Label Case, *United States v. Blankenheim*, No. 74-182 (N.D. Cal. Nov. 1, 1974), Judge Charles Renfrew, reluctant to imprison five executives convicted of price-fixing, but concerned that the fines he imposed would not adequately deter other potential price-fixers, required each executive to make several speeches to business, civic, or other groups about the case and his participation in it, and to submit to the court a written report on his experiences in doing so. Renfrew, *The Paper Label Sentences: An Evaluation*, 86 YALE L.J. 590, 592-94 (1977). *But see* *The Paper Label Sentences: Critiques*, 86 YALE L.J. 619 (1977). The critiques point out three factors seemingly ignored by Judge Renfrew: the deterrent value of incarceration, *see id.* at 619-25 (critique by Baker & Reeves); the impropriety of courts usurping a legislative function, *see id.* at 626-29 (critique by Dershowitz); and the risks of inequity inherent in such creative sentences, *see id.* at 630-35 (critique by Liman).

Another punishment alternative is to empower sentencing judges to disqualify organi-

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the same offense than the enterprise would be likely to bear.¹²⁸

Even if we presume that the penalty that the agent can realistically expect in these circumstances is less, per enforcement dollar, than the penalty that the enterprise can expect for the same conduct, we cannot conclude that the dedication of enforcement resources to the pursuit of agents would be less effective a deterrent at any margin than the pursuit of enterprises. To make a comparison of the responsiveness of unwanted conduct to increments in enterprise-targeted and agent-targeted enforcement programs, we would have to place the penalties in a broader context. What burdens do the respective penalties impose on agent and on enterprise, considering all the direct and indirect, monetary and nonmonetary implications?¹²⁹ What does each party stand to gain if the conduct is not detected?¹³⁰ What are

zation executives from exercising functions giving rise to violations. A few statutes do provide for such disqualifications. See 12 U.S.C. § 1829 (1976) (disqualifying persons convicted of certain offenses from holding positions in banks whose deposits are insured by Federal Deposit Insurance Corporation); 29 U.S.C. § 504(a) (1976) (disqualifying union officers convicted of certain offenses from holding office in labor organizations). Of course, in areas of activity requiring licenses, discipline may include suspension of the right to engage in an activity. See 15 U.S.C. § 78o(b)(4) (1976) (Securities and Exchange Commission empowered to censure, deny, suspend, or revoke license of broker-dealer "in the public interest"); 46 U.S.C. § 471 (1976) (Federal Maritime Board empowered to suspend license of officer in charge of steamer in certain circumstances).

128. The likelihood of leniency toward individuals may be inferred from the treatment accorded executives convicted of antitrust violations, usually price fixing. See Baker & Reeves, *The Paper Label Sentences: Critiques*, 86 YALE L.J. 619, 623 n.17 (1977) (none received prison sentences during period 1962-68; fewer than twelve received sentences exceeding 30 days during period 1969-77). Similar leniency appears in a study of various types of illegal corporate behavior from 1890 to 1976, when

of the 56 federally convicted executives of all 683 corporations, 62.5 percent received probation, 21.4 percent had their sentences suspended, and 26.6 percent were incarcerated The average prison sentence for all those convicted, whether or not they went to prison and regardless of the offense, averaged 2.8 days. There were 10 officers who had their sentences suspended The average for all [16] imprisoned executives was 37.1 days; excluding the two six-month sentences the remaining 14 averaged 16.7 days

M. CLINARD, *supra* note 109, at 209.

129. Obviously, the fine represents a welfare loss not adequately expressed in the amount of the judgment—that is, presumably those involved would not be indifferent as between paying \$X in a fine and losing \$X in an uninsured accident. But even accounting for these effects, it is difficult to generalize as to which enforcement emphasis—counter-agent or counter-enterprise—is likely to result in the greatest degree of deterrence per enforcement dollar. The criminal process is humiliating to the agent, and may reduce his future earning power, but it also has a demoralizing effect on the organization, perhaps one not readily expressed in dollars as loss of economic "good will." The comparisons are further complicated by the fact that, especially when the enterprise is targeted, the criminal conviction may provide collateral assistance to civil plaintiffs seeking recoveries far in excess of the fine (in treble-damage antitrust actions, for example).

130. Again, we are not concerned solely with monetary benefits; conduct in violation of the law, particularly where the rules seem technical, may itself produce a welfare gain for the violator, just as gambling does for the gambler, independent of outcome. See C. STONE, *supra* note 13, at 68-69.

their respective risk preferences,¹³¹ and their respective capacities to modify the unwanted outcomes? There is simply no way we can begin to answer these questions in the abstract, or even, with a high degree of confidence, in any concrete situation.

Despite our ignorance on these points, some conclusions are possible. As we advance into the area of unpremeditated and morally neutral conduct, whichever way we decide to distribute the liability in the first instance, the parties will tend to continue the disfavored conduct at a level that is relatively independent of the original distribution of liabilities.¹³² To illustrate, suppose that society opts to correct the emission level of our hypothetical plant by threatening a \$10,000 penalty upon the plant manager. The manager's reaction will be self-protective. He may divert corporate resources to make as certain as possible that no potentially harmful discharge occurs—shutting down operations for repeated cleanings, or ordering additional monitoring—and he can be expected to demand an increase in compensation to cover the risks of liability that remain irreducible after whatever resource diversion he can arrange.¹³³ These demands will, in turn, set in motion a reaction by the enterprise that will depend upon several factors, including the costs of inducing the agent to maintain, at personal risk, the level of activity that maximizes the enterprise's welfare. To the extent that the enterprise, considering its

131. It has been argued that managers will be less inclined than shareholders to take risks "since if the gamble is successful, most of the benefit will go to shareholders, while if it fails, the manager may lose his job." Anderson, *supra* note 103, at 785 n.143. Their relative likings for risk, however, would seem to depend upon many variables about which it is difficult to generalize. See note 82 *supra*.

132. This position is perhaps implied by the Coase Theorem, see Coase, *The Problem of Social Costs*, 3 J.L. & Econ. 1 (1960). There is, however, one twist. Where we are concerned with ordinary unintentional and unblameworthy accidents, we may be inclined to place the loss, in the first instance, on the "cheapest cost avoider." See G. CALABRESI, *supra* note 40, at 135-50. But where our aim shifts to the deterrence of highly undesirable conduct, we may wish to place the initial penalty on what we might call the most expensive cost avoider, so as to increase the inefficiency of noncompliance. Suppose, for example, that the easiest way to avoid conviction is to bribe enforcers, and that the most effective briber—the party that carries out the bribe most cheaply, with the least visible trail of evidence—is a particular agent. All else being equal, we would incline to place the fine on the enterprise because it is the least efficient—more cumbersome—arranger of the conviction-avoiding bribe. The irony is that this result seems to present a case, perhaps an important class of cases, in which social costs may be minimized by maximizing an individual's private costs.

133. Cf. Mashaw, *Civil Liability of Government Officers: Property Rights and Official Accountability*, LAW & CONTEMP. PROB., Winter 1978, at 8, 26-28 (examining efficiency implications of public official liability). In addition to inducing excess caution, there is also the prospect that intense agent liability will yield a perverse substitution of factors. High quality, relatively risk-averse managers may be replaced by less risk-averse but less qualified personnel in the very jobs where we least want such a change to occur.

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independent incentives, finds the agent's risk-taking attractive, it will be tempted to pay him to take the additional risks and to monitor his performance to make certain that he is taking the risks he is being paid to take.¹³⁴ In either case, the enterprise will be called to account.¹³⁵

I do not wish to suggest that the supply of harm will be exactly the same, irrespective of the initial distribution of risk. The equivalence would seem to hold in the limiting case where the plant manager and the enterprise (1) have equal capacity to appreciate the risks, (2) are equally averse to the \$10,000 risk at existing margins, and (3) have equal control over outcomes. Any variance between manager and enterprise, respecting any of these three factors, however, would reinforce a particular preference for the initial placement of the loss. For example, the plant manager may not appreciate the hazards as accurately as does the enterprise, with its staff resources, or he may be relatively risk-preferring, or he may have only partial control over the relevant outcomes. In each case, the \$10,000 fine would be less effective a deterrent if we direct it towards the agent rather than towards the enterprise.

Although such reasoning suggests a theoretical preference for placing the liabilities on one party rather than on the other,¹³⁶ the significance of the initial choice is narrowed still further by the likelihood that the parties will attempt through indemnification (or some approximation) to re-establish their preferred outcome. In order to make society's selection stick, it may be necessary to limit indemnification, an effort that involves a special, complex set of problems reserved for discussion later.¹³⁷ At this point, I observe simply that, although a case can be made that some constraints on indemnification are clearly desirable, there are limits on how effectively we can enforce them. Holding agents liable is subject to more of the infirmities of enterprise liability than one first imagines and, outside the region of the most blameworthy wrongdoing, tends to permit a similar level of harm.

134. The enterprise can be expected to bear those expenditures until the marginal cost to it reaches its marginal benefits. Whether the incremental \$10,000 penalty falls on the enterprise in the first instance or upon the agent should have little effect on the amount of risk-taking.

135. See Baxter, *Enterprise Liability, Public and Private*, LAW & CONTEMP. PROB., Winter 1978, at 45, 47.

136. In addition to the concerns about efficiency emphasized in the text, the initial placement of the penalty may reflect considerations of distributive justice, moral education, and other factors.

137. See pp. 45-65 *infra*.

C. *Intervention by Standards*

I have suggested that while there is a valuable place in the law for both enterprise liability and agent liability, neither technique is adequate to produce the desired behavior-modifying corrections in all circumstances. There is, however, another set of strategies through which we can achieve those aims: Standards. As I have already indicated, Standards are distinguished from the various HBLRs by the way in which they constrict managerial autonomy. With HBLRs, the actor is left free to permit the harm on the condition that it pay the damages or a penalty; the supply of unwanted conduct is affected by altering financial rewards. By contrast, Standards transmit collective judgments not only through liabilities that affect financial prospects if harm occurs, but also by prescribing the means by which the harm is to be avoided.

Standards are of various sorts. The example employed earlier, mandating a fire sprinkler system in building codes,¹³⁸ illustrates what I call a *factor constraint*: it removes from the enterprise participant full autonomy over product and process variables. In the illustration of the smelter, a factor constraint could take the form of mandating that the plant use only ore with a specified low sulfur content. A second group of Standards, *performance constraints*, specify minimum acceptable levels of product and service performance.¹³⁹ This could involve, for example, restricting emissions of particulates to a level less than N per hour, but leaving the firm free to achieve the required level by whatever technique it prefers, an option foreclosed by the factor constraints.¹⁴⁰ A third group consists of *information constraints*:¹⁴¹ the smelter could be forced to disclose certain hazards associated with its operations.

Finally, there has been a recent trend towards what I call *bureaucratic constraints*.¹⁴² The harbingers are appearing so unobtrusively

138. See p. 18 *supra*.

139. See, e.g., Occupational Safety and Health Standards, 29 C.F.R. § 1910.1001 (1979) (establishing maximum permissible levels of exposure to asbestos fibers).

140. See Ackerman & Hassler, *Beyond the New Deal: Coal and the Clean Air Act*, 89 YALE L.J. 1466, 1521-28 (1980) (criticizing factor constraint—required coal scrubbing—and suggesting performance constraint—emission limitation—in EPA's regulation concerning sulfur dioxide emission from new coal-burning power plants).

141. See, e.g., Guide Concerning Fuel Economy Advertising for New Automobiles, 16 C.F.R. §§ 259.1-2 (1980) (FTC regulations).

142. Constraining bureaucratic variables is a technique not unknown to the law. That a corporation has a board of directors, for example, is not the outcome of unrestrained manager-investor negotiations, but a requirement of corporation codes. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1978); ABA-ALI MODEL BUS. CORP. ACT § 35 (1979). It is also through law that certain of the agent's functions are established. See, e.g., DEL. CODE ANN. tit. 8, § 170(a) (1974) (directors authorized to declare dividends); ABA-ALI MODEL BUS. CORP. ACT § 45 (1979) (same).

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and in such unrelated areas that few people, probably not even their draftsmen, have yet recognized that, taken together, they constitute a new and significant species of corporate control device. For example, in recent years we have seen significant intrusions on companies' internal information networks to assure that data of a certain sort are gathered by the organization and delivered to specified desks for action.¹⁴³ Corporations have been required by law to establish new posts¹⁴⁴ and to endow existing jobs with powers and obligations specified by the outside world.¹⁴⁵ In several areas, constraints are imminent as to who may, and may not,¹⁴⁶ hold certain corporate jobs. In

It is important to recognize, however, that existing bureaucratic constraints are typically subject to three significant limitations. First, they affect the highest echelons of the firm's bureaucracy only—directors and various classes of “controlling persons”—rather than day-to-day managers, much less subordinate agents. Second, even the corporate officers affected are restrained in only a few of their functions, which ordinarily constitute a small fraction of their total work. *See, e.g.*, DEL. CODE ANN. tit. 8, § 152 (Supp. 1978) (requiring directors to value property received in exchange for company's stock); ABA-ALI MODEL BUS. CORP. ACT § 19 (1979) (same). Third, the limitations focus almost exclusively on the interests of investors, rather than on those of third parties—the corporation's neighbors and fellow citizens.

Because of the significant effect of interior bureaucratic arrangements on noninvestors, *see note 36 supra*, whose transaction costs of negotiating a favorable rearrangement are higher than the negotiating costs for investors, one might expect the law to be readier to constrain the corporate bureaucracy in the interest of noninvestors, and to leave investor concerns to market forces.

143. *See, e.g.*, AT & T Discrimination Settlement, 8 LABOR REL. REP. (BNA) (431 Fair Empl. Prac. Man.) 73, 95-96 (1973 consent decree between AT & T and EEOC including several informational requirements); 10 C.F.R. § 21.21(a) (1980) (Nuclear Regulatory Commission regulation requiring subject firms to adopt procedures to inform responsible officers of failings or defects in construction or operation of facilities or activities); Current Good Manufacturing Practice for Finished Pharmaceuticals, 21 C.F.R. §§ 211.1-208 (1980) (FDA regulation requiring pharmaceutical firms to establish procedures to bring certain FDA regulatory activities to attention of executives).

144. *See* AT & T Discrimination Settlement, 8 LABOR REL. REP. (BNA) (431 Fair Empl. Prac. Man.) 73, 87 (AT & T consent decree requiring each major subdivision to establish “Equal Employment Opportunity Coordinator” to assist in preparation of local affirmative action programs, to receive and investigate employee complaints, and to report to Assistant Vice President-Personnel if corrective action necessary); 10 C.F.R. § 73.50(a)(3) (1980) (Nuclear Regulatory Commission regulation requiring licensee to establish security organization that “shall establish, maintain, and follow written security procedures”).

145. Most of the experience with imposing new obligations on pre-existing officers has involved furtherance of investor interests under the securities laws. *See Comment, Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 GEO. L.J. 737, 744-46 (1976). The establishment of new duties for executives in furtherance of noninvestor interests, however, did occur in the AT & T Discrimination Settlement, 8 LABOR REL. REP. (BNA) (431 Fair Empl. Prac. Man.) 73, 86-88. Another example is the Nuclear Regulatory Commission requirement that directors and responsible officers of subject companies report to the NRC any information concerning certain failures, hazards, or defects. 10 C.F.R. § 21.21(b)(1)-(4) (1980).

146. *See, e.g.*, 21 C.F.R. § 211.25 (1980) (FDA requires broad qualifications for personnel engaged in manufacture of drug products); *cf.* 10 C.F.R. § 73.30(d) (1980) (Nuclear Regulatory Commission licensee required to submit plan for selection and qualifications of escorts for nuclear materials).

other areas, the managerial level at which decisions of a certain character must be made is no longer a matter solely for managerial discretion.¹⁴⁷ There are even suggestions that the government is prepared to intrude in the selection process by which key corporate slots are filled.¹⁴⁸

These bureaucratic constraints, it should be observed, are particularly germane to a theory of controlling large organizations. Factor, performance, and information standards all play significant roles in the control of modern corporations. But they apply indiscriminately to all social actors, rather than to large-scale organizations in particular. That is, a ban on cyclamates in soft drinks is as intelligibly applied to a sole proprietor, who bottles soft drinks commercially in his garage, as to a 10,000 employee conglomerate. By contrast, bureaucratic standards, such as those that mandate reporting obligations between vice-president and president, are, as control devices, inherently corporate.

Obviously, the predominant attraction of all four types of Standards is the hope that they will prevent outcomes that are underdeterred by the various HBLRs. Conversely, the principal risk of Standards, relative to HBLRs, is that they will overdeter. Most corporate-caused harm, especially if unpremeditated, is likely to be the product of many variables. Whenever the law opts to single out a particular variable and dictate some resolution of it without regard to enterprise preferences, we are meddling in a process about which we on the outside ordinarily know considerably less than do the enterprise managers.¹⁴⁹ The remedy may impose on the firm costs in excess of the expected social harm that constituted the original justification for the intervention.¹⁵⁰ Industrial development and innovation may be stultified.¹⁵¹ And the "protection" may prove, in the end, illusory. There

147. See pp. 44-45 *infra* (discussing FCC requirement that radio stations screen recordings to eliminate songs advocating drug use).

148. One federal case suggests the appropriateness of a court-ordered, even court-appointed, "probation officer" to take over critical functions of a company in the interest of noninvestors. See *United States v. Atlantic Richfield Co.*, 465 F.2d 58 (7th Cir. 1972) (district court's probation order, which required oil spill containment program, remanded to make conditions less onerous). For a discussion of this case and of the possibility of corporate probation, see Comment, 3 U. BALT. L. REV. 294 (1974).

149. Even in circumstances where the state may be presumed to have better information-gathering and assessment resources than corporate managers—the area of health and epidemiology, for example, see Cohen, Book Review, 62 VA. L. REV. 259, 267 (1976) (reviewing C. STONE, *supra* note 13)—it may be preferable for the government to publicize the risks before it mandates solutions.

150. See Ellickson, *supra* note 74, at 687 (imposition of Standards may prohibit conduct even though actor willing to pay external costs of such conduct).

151. See Vagts, Book Review, 49 S. CAL. L. REV. 635, 638-39 (1976) (reviewing C. STONE, *supra* note 13) (speculating whether federal regulation would inhibit industrial innovation).

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is always the risk that the formal arrangements mandated by the law will be subverted by the organization's informal procedures and standards, factors that are more difficult, perhaps impossible, for the outside world to bring under control.¹⁵² Indeed, the more strategically the externally imposed adjustment threatens the firm's way of doing things, the more likely it is to induce a counter-attack of bureaucratic hindrance.¹⁵³

Because the risks of overdeterrence and outright waste are significant, Standards probably ought to be reserved for two situations. In the first, the Standard is preventative and is imposed across an entire industry; in the second, the Standard is remedial and is reserved for a selected firm in response to a particular incident or pattern of wrongdoing.

In the preventative situation, it seems prudent to displace managerial judgment with a Standard only when there is some strong combination of the following characteristics:

(1) there are features of the hazard that render the HBLR strategies, with their after-the-fact solutions, inferior to a more directly preventative approach; such qualities might include a deep societal aversion to the harm, the inadequacy of monetary compensation, and anticipated problems of litigation and proof;¹⁵⁴

(2) the government, because of its ready access to the relevant data, or through publicly funded laboratories, for example, is able to as-

152. See DeMott, *Reweaving the Corporate Veil: Management Structure and the Control of Corporate Information*, LAW & CONTEMP. PROB., Summer 1977, at 182 (pessimistic conclusions about implementation of corporate restructuring proposals based on analysis of operation of Emergency Loan Guarantee Board and its relationship to improper payments by Lockheed Aircraft Corporation). Similar reservations are expressed in Cohen, *supra* note 149, at 263-70, and in Stone, *Law and the Culture of the Corporation*, BUS. & SOC'Y REV., Fall 1975, at 5.

153. This conclusion is somewhat speculative, because there is little experience in the for-profit sector with mandatory bureaucratic constraints on behalf of third parties. Interventions on behalf of investors—the appointment of a receiver or special counsel, for example—are likely to enjoy more success than interventions on behalf of other groups affected by corporate action, because the former enjoy the support of a strong and traditional constituency. See Stone, *supra* note 152, at 6, 13-14. Nevertheless, there have been some studies of the processes by which organizations generally resist incursions comparable to the imposition of bureaucratic constraints. A classic study, based on the resistance of British coal mines to technological changes in production methods, is Trist & Banforth, *Some Social and Psychological Consequences of the Longwall Method of Coal-getting*, 4 HUMAN REL. 3 (1951), discussed in D. KATZ & R. KAHN, *THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS* 435-42 (1966). Of closer legal interest is Note, *The Wyatt Case: Implementation of a Judicial Decree Ordering Institutional Change*, 84 YALE L.J. 1338, 1347-78 (1975) (discussing use of structural injunction in Alabama state mental hospitals). See also J. THOMPSON, *supra* note 21, at 19-23 (proclivity of large organizations to "buffer" themselves from environmental forces).

154. See p. 14 *supra*.

sess the positive and negative impacts of the Standard at least as well as the enterprises can;¹⁵⁵

(3) the enterprises affected by the Standard are relevantly similar, so that the cost that a blanket stricture imposes by strait-jacketing innovative and compliant companies is outweighed by the benefit of controlling their more intransigent competitors;¹⁵⁶

(4) there is a strong relationship between the variable that the standard affects and the outcome to be avoided, such as exists, for example, between automobile brakes and automobile accidents;¹⁵⁷

(5) the cost of the constraint, considering its alternatives, is not likely to exceed what society is prepared to expend to avoid the harm.

On the other hand, in circumstances where Standards are being fashioned as part of a remedy in response to demonstrated misconduct by a particular corporation, the general presumption against preventative Standards could be somewhat relaxed:¹⁵⁸ (1) rather than anticipating the harm, the government will have stayed its hand until the occurrence of wrongdoing; (2) the presumption that the managers possess superior abilities in the design of avoidance measures will have been called into question by the harmful action itself; (3) the risks presented by blanket application of general rules are avoided; (4, 5) the relationship in the particular circumstances between variable and violation, and the cost of the constraint, can be examined and demonstrated. Thus, in many cases it may be appropriate for the relief—through corporate probation, for example¹⁵⁹—to require mandatory

155. See S. Shavell, *supra* note 38, at 3. This circumstance leaves open the important regulatory question whether the government should publish the superior information for the firms' benefit, to use as they choose. As a result, this information access criterion cannot by itself justify a mandatory Standard.

156. Cf. Wittman, *supra* note 38, at 199-200 (examining implications of nonuniformity among offenses rather than among offenders). Nonuniformity among offenders may constitute a reason to reserve mandatory Standards for remedial decrees. Nevertheless, industry-wide Standards on a nonremedial basis may be appropriate in circumstances when Standards actually command support among industry leaders, but when no single firm is prepared to suffer the competitive disadvantages of being the sole implementor.

157. See Wittman, *supra* note 38, at 198-99.

158. Mandatory Standards possess several virtues in such circumstances. First, firms that can find their own cost-effective manner to obey the law are left free to do so. Second, employees of firms that have failed repeatedly to work out their own compliance solutions may recognize the justice of the intrusions and accept them more willingly than they would otherwise. Third, the ordering of a special compliance program may serve the ends of the criminal law more effectively than do fines: they may rehabilitate the defendant corporation, serve retributive ends by shaming the organization more than would a fine, and deter violations by other companies to the extent that others regard the partial invasion of managerial autonomy as a vexatious form of punishment.

159. See note 121 *supra* (citing sources recommending corporate probation). In civil suits an injunction, rather than probation, would provide the mechanism for imposing mandatory standards.

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Standards, such as the addition of specific duties to existing corporate offices, or the addition of special compliance officers and committees.¹⁶⁰

Employed either as preventative or as remedy, Standards possess several advantages over harm-based liability rules. First, in some circumstances Standards offer the prospect of reducing the costs of monitoring and enforcement, from detection through conviction. To return to our smelter example, if we wait for an outbreak of blood poisoning to trigger a legal reaction, there will be significant proof problems in correlating a plaintiff's injury to different levels of pollution and in allocating responsibility among multiple sources.¹⁶¹ By contrast, when we focus the monitoring effort on a mandatory standard, the cost of detecting a violation obviously drops.¹⁶²

Bureaucratic Standards in particular may hold promise in reducing monitoring costs, especially when they are employed to reinforce internal law-compliance programs. In our smelter example, the clue that the emission standard has been violated may take the form of an increase of ten micrograms per cubic meter in the level of particulates in the air basin. An outside enforcement agency faces the costs of determining whether there has in fact been a violation (rather than a change in natural conditions, exacerbated by coincident, but lawful, discharges), and, if a violation is likely, the costs of ascertaining which of the many plants in the air basin was responsible. To reduce the costs of determining whether this standard—itself a performance standard—has been violated, it may be worthwhile to introduce bureaucratic standards that transfer some of the duties and costs of monitoring onto the firms themselves. We could provide, for example, that some designated company employee has to keep the monitoring devices under observation and personally verify compliance by signing the emission monitoring log. Although mandatory self-monitoring requirements, like all laws, provide incentives and opportunities for new forms of cheating, we may expect an outside agency to bear fewer costs if it serves merely to police various self-monitoring devices, records, and organizational plans, than if it undertakes all the

160. See notes 144-45 & 148 *supra* (citing commentary and examples).

161. Flexible, nontraditional modes of allocating responsibility may mitigate this problem, at least for plaintiffs. See *Sindell v. Abbott Laboratories*, 26 Cal. 3d 588, 610-13, 607 P.2d 924, 936-38, 163 Cal. Rptr. 132, 143-46 (1980) (plaintiff, unable to prove which of several defendant manufacturers produced drug that caused her injury, allowed to hold each liable on basis of market share, with burden on each defendant to rebut inference of causation).

162. For an examination of how variations in the costs of detecting *ex ante* offenses—violations of Standards—affect the ideal levels of both *ex ante* and *ex post* penalties, see Wittman, *supra* note 38, at 195-97.

monitoring from scratch and at arm's length. Commissioning enterprises to shoulder a greater share of the monitoring burden may not only prove more efficient in some circumstances, achieving the same level of behavior modification at reduced costs. It may also be viewed as apportioning those costs more equitably, laying a larger portion of them on those who cause harm rather than on the society at large.

Besides the possible benefits associated with monitoring costs, an advantage of Standards over HBLRs is that it is easier to raise the penalty that the liability target can reasonably expect to the level that is ideal for enforcement.¹⁶³ This result obtains, first, because the ideal penalty level will be lower for a Standards violation than for the consummated injury that the Standard was designed to prevent, at least as long as the correlation between meeting the Standard and avoiding the harm is not perfect. This can be illustrated by reference to our smelter example. Suppose that the health hazard to be avoided has a net expected present value of one million dollars. If installing the required device were an absolute guarantee that the harm would be avoided, we would be prepared to impose costs on the noncomplying firm of one million dollars. But in the more likely case, the harm will be the product of many factors, and no single Standard can do more than reduce the probability of its occurring, or, more accurately, reduce its net expected present value. If, for example, the device reduces the expected damages by a factor of ten, then the imposition of costs greater than one hundred thousand dollars would constitute overdeterrence. As a consequence, some of the constraints that retard our raising the expected level of penalty to the ideal level—limited liability and the added prosecutorial resources that the imposition of heavy penalties requires, for example—are less significant when it comes to enforcing the lower sanctions associated with Standards.

Second, when we shift to Standards, both the target-efficiency and the morality constraints are less obstructive. This feature is partly a result of the lower penalties. But it also follows from the fact that Standards tend to transmit clearer signals, and to affect matters that are more directly under management's control ("install a device D"), than do HBLRs ("don't be a cause of blood poisoning"). When an enterprise fails to comply with a clear Standard, its misconduct may

163. This result assumes the use of Standards coupled with contingent liability, rather than with what I call "more or less absolute conditions." See note 73 *supra*.

rightly appear more deliberate, and consequently more blameworthy, than would violation of a general harm-based liability rule.¹⁶⁴

Moreover, as we have seen, at the time of a collective decision to impose a penalty via an HBLR, we have little way of calculating how costly compliance may prove; that ignorance may lead to inefficiencies. By contrast, the costs of complying with Standards, while rarely certain, are likely to fall within more predictable limits, particularly if there has been broad opportunity for affected parties to be heard. Rather than force the enterprise to be a surety against harm, society effectively agrees, by mandating Standards, to share the added social costs of especially protective harm-avoidance measures. The firm subject to regulation pays its share not in cash, but through some alteration of the factors it employs or of its bureaucratic arrangements. Society contributes by absorbing the higher costs that will therefore be passed along, and perhaps by allowing the firm immunity from some harm-based penalty judgments if it abides by the Standard.¹⁶⁵ This approach, like any risk-spreading system, may be more efficient than placing the full burden on a single actor.

The various advantages of Standards are probably even more significant when we turn from those that apply to enterprises to those that operate directly upon agents. Agents can often avoid stiff penalties because of the difficulty of establishing individual accountability, both moral and legal, in a giant, complex institution. When an airplane falls apart in the air, who can we say was to blame? But when we require bureaucratic standards that make certain features of the agent's performance mandatory and visible to all, accountability can be improved in two ways. First, we can attach individual liability to non-performance of the required tasks. With lines of responsibility clarified, the costs of identifying and prosecuting violators will decline, and the penalty that the non-performing agent can realistically expect will be brought into line with the ideal level. Second, we should not forget that the control of organizational behavior depends importantly, perhaps ultimately, upon how people feel about themselves and their jobs. Clarifying what is expected of a person may make the agent *feel* responsible and may be effective in modifying

164. On the other hand, in those cases in which no harm resulted from the Standard violation, the trier might view such a merely "technical" misfeasance more leniently.

165. Whether or not abidance by a Standard is construed to provide the defendant with immunity from compensatory damage claims, we are probably prepared to withhold punitive and criminal judgments for acts done in compliance with a Standard. An analogous principle is that good-faith reliance on counsel may provide a defense to punitive damages. See *Fox v. Aced*, 49 Cal. 2d 381, 385-86, 317 P.2d 608, 610-11 (1957).

his performance, quite aside from the threat of suit. Both the legal and the social-psychological effects should translate into a lower incidence of violation, and the social costs may well prove moderate.¹⁶⁶

Before leaving the subject of Standards, two other special warrants for the use of Standards—of bureaucratic Standards, in particular—deserve some comment. One of the most important is to serve as an interim measure during a period when a preferable rule is being developed and put into place. The need springs from the inevitable delays between society's appreciation of an evolving danger and the promulgation of a specially tailored legislative or administrative response. These hiatuses present a law-making dilemma. On the one hand, the longer we temporize, the more damage can occur before an ideal rule is established. On the other hand, public outcry may prompt lawmakers to act even on the basis of inadequate data, producing rules that overdeter—that is, impose more costs than benefits—or are unjust. In some such situations, bureaucratic Standards can secure some measure of interim protection, at the same time advancing the collection of data appropriate to the alteration of the more traditional measures, such as ordinary liability rules.¹⁶⁷ Indeed, the very assurance that potential harm and its amelioration are under investigation allows rules to evolve that may prove far more realistic from a cost-benefit point of view.

Second, there are occasionally outcomes that we wish to restrict, but for which imposing HBLRs or even nonbureaucratic Standards may conflict with assorted policies other than efficiency. Consider, as an illustration of this use of bureaucratic Standard, the broadcasting of popular records whose lyrics promote illegal drug use. The Federal Communications Commission (FCC) has power over station licensing, but no apparent authority to prevent stations from playing particular records. Nor is it clear how much power Congress could give it in this area without encroaching on First Amendment values. Furthermore, questions of power aside, it would obviously be difficult to formulate and police workable standards as to which records were allowable and which were not, especially considering that the

166. For example, requirements that companies provide and publish the details of certain key individuals' duties, such as currently exist in nuclear utility regulation, see 10 C.F.R. § 73.50(a) (1979), are difficult to fault as stultifying, particularly when the corporation, not the government, supplies the details of organizational responsibility.

167. Some suggestion of this approach appears in the Toxic Substances Control Act, 15 U.S.C. §§ 2601-2629 (1976). Under the Act, the Administrator can order manufacturers to test suspect chemical substances, *id.* § 2603(a), to monitor their own compliance with certain required procedures, *id.* § 2605(a)(4), and to report their proposed quality control protocols, *id.* § 2605(b)(1). Should he find those protocols inadequate, the Administrator can order them revised. *Id.* § 2605(b)(2)(A).

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lyrics may play on sly insinuation rather than on blatant advocacy of drug use.¹⁶⁸

The solution that the FCC reached was a somewhat unorthodox bureaucratic Standard, but one that may prove generalizable to other circumstances. The decision as to which records were playable was left with the broadcasting companies, but the companies were required to establish internal bureaucratic procedures to insure that whenever a question arose as to whether a record promoted illegal drug use, not the disc jockeys alone, but "someone in a responsible position (i.e., a management level executive at the station)" would exercise review.¹⁶⁹ Advancement of equal employment goals presents comparable problems, and has yielded some comparable bureaucratic Standards, as the AT&T Anti-Bias Consent Decrees illustrate.¹⁷⁰

In summarizing Cluster 1, it seems to me that of all the prospective devices available to the law, those that warrant the most attention are Standards, and perhaps bureaucratic Standards in particular. Indeed, if we return our attention to the larger undertaking outlined in the introduction—the design of a general theory of corporate control—we see that Standards have an especially prominent role to play: their partial independence from profit threats makes them suitable for disciplining the vast population of organizations that lack the handle of profits or some close analogue. Nevertheless, because our experience with such measures is limited, and the risks significant, it may be appropriate initially to reserve their use to the few areas that meet the strongest combination of conditions set forth above,¹⁷¹ such as the production and handling of radioactive materials, pharmaceuticals, and toxic substances, and, in addition, to some instances of wrongdoing warranting special interventionist remedies.

III. Cluster 2: The Indemnification Equilibrium

The second cluster of relationships vital to a comprehensive understanding of enterprise liability involves the freedom of the firm and its agents to shift between themselves the risks of law-imposed losses.

168. See Note, *Drug Songs and the Federal Communications Commission*, 5 J.L. REF. 334, 337-38 (1972).

169. *In re Licensee Responsibility To Review Records Before Their Broadcast*, 28 F.C.C.2d 409, 409 (1971). See Memorandum Opinion and Order of April 16, 1971, 31 F.C.C.2d 377, 379-80 (1971), *aff'd sub nom. Yale Broadcasting Co. v. FCC*, 478 F.2d 594 (D.C. Cir.), *cert. denied*, 414 U.S. 914 (1973).

170. See 8 LAB. REL. REP. (BNA) (431 Fair Empl. Prac. Man.) 73, 86-88, 95-96 (AT & T discrimination settlement imposing new responsibilities on managers and establishing new reporting systems).

171. See pp. 39-40 *supra*.

Such shifting takes place in both directions. The agent may wish to arrange that if he suffers judgment for conduct undertaken "on account of the agency," he shall have *employee's indemnity* to recoup his losses from the firm.¹⁷² Conversely, the firm, wary of agent misconduct that may be imputed to it on a respondeat superior or other basis, may wish, through *employer's indemnity*, to shift the losses back onto the agent.¹⁷³

The product of these two recoveries—the balance of risks between agent and firm—I will call the *indemnification equilibrium*. In any enterprise, the equilibrium is established, depending on the particular risk, in part by status-based rules and in part by contract, within bounds of variation permitted by legal doctrine. If we trace these doctrinal constraints on indemnity through history, and regard them as evidence of the prevailing practices, a general trend clearly appears: the balance of risks has been shifting, for an ever-broadening range of injuries, away from the agent and towards the enterprise. Today, the agent can recoup his losses from the firm in circumstances in which, in earlier law, he would have failed,¹⁷⁴ and the firm will not recover from its agents in some cases in which, in earlier law, it would have succeeded.¹⁷⁵

It is not my purpose, in emphasizing externalities effects, to question the proposition that the equilibrium that evolves through the "bargaining" of investors and managers optimizes their own welfares. The investors, for their part, have reason to be wary of employer indemnification that is too liberal, not only because they will want to avoid the payments, but because anything that encourages their agents

172. See RESTATEMENT (SECOND) OF AGENCY §§ 438(b), 439(c)-(d) (1957).

173. See *id.* §§ 401-404; Steffen, *The Employer's "Indemnity" Action*, 25 U. CHI. L. REV. 465 (1958).

174. The posture of earlier doctrine is reflected in *New York Dock Co. v. McCollum*, 173 Misc. 106, 111, 16 N.Y.S.2d 844, 848-49 (Sup. Ct. 1939) (corporation not "legally obligated" to indemnify employee who has totally vindicated himself on merits unless vindication produced some definite benefit to corporation). The subsequent liberalization of indemnification law was aimed at clarifying the "right" of the employee to recover. See G. WASHINGTON & J. BISHOP, *INDEMNIFYING THE CORPORATE EXECUTIVE* 112-68 (1963); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1081-87 (1968).

175. Some of the developments that have eroded the employer's indemnity action, particularly in the corporate area, where suit is often triggered by shareholders rather than by management, include the requirement that shareholders instituting the action post security for expenses, see, e.g., CAL. CORP. CODE § 800(d) (West 1977); ABA-ALI MODEL BUS. CORP. ACT § 49 (1979); the liberalization of defenses based on an officer's "right to rely" on corporate records, reports, committees, and opinions of counsel, see, e.g., CAL. CORP. CODE § 309(b) (West 1977); ABA-ALI MODEL BUS. CORP. ACT § 35 (1979); and the possibility that the shareholders, or a disinterested majority or committee of the board, may terminate the action on relatively nonreviewable "business judgment" grounds, see note 222 *infra*.

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to regard misconduct lightly increases the risk of the enterprise's liability.¹⁷⁶ From the agents' perspective, the more vulnerable they feel to personal liability, the higher the compensation they will demand, and the more they will divert their time and other company resources into self-protection. By and large, the investors should be able to extract whatever degree of managerial diligence they are prepared to compensate. Moreover, indemnification, like insurance, involves a spreading of risks; it therefore follows, if we assume that the agent is more averse to risks than the enterprise (which is a spreader of risks), that there will be some range through which it will be more efficient for the investors to offer their agents, in lieu of salary, a betterment of their indemnification equilibrium. The betterment will comprise some combination of waivers of claims otherwise available to the investors and increases in claims available to employees. As to the outcome of this negotiation,¹⁷⁷ the outside world would seem to have no more interest in how the parties choose to compensate performance that is defective than in how they reward performance that is superior.¹⁷⁸ Our interest, however, principally concerns the externalities effects: the possibility that the outcome that the investors and managers arrive at may harm or be suboptimal for third parties or public policy.

A. *The Employee's Indemnity*

Although an agreement to indemnify agents against their ordinary negligence may constitute a marginal incentive to harm-causing behavior, and thus adversely affect third parties, attempts to restrict indemnification in such circumstances would quite likely create inef-

176. In some cases, however, penalties will be low enough and benefits of law violations high enough that enterprises will want agents to misbehave, a prospect discussed below. See pp. 52-53 *infra*.

177. In most cases investors do not, strictly speaking, bargain over terms with their agents, but purchase securities from other investors in a public market. If we assume, however, that the indemnification laws of the various leading states of incorporation are known to the investors—at least to investors whose trading influences market price most heavily—then it would seem that the indemnification provisions optimize the preferences of the investors and their agents *inter se*. Cf. Winter, *supra* note 33, at 257-58 (liberality of state corporation codes one factor in investors' decisions to purchase stock).

178. Perhaps ironically, present law makes employee indemnification less readily available when the underlying injury stemmed from negligence or misconduct to the corporation than when the injury was to third parties. See ABA-ALI MODEL BUS. CORP. ACT § 5(a)-(b) (1979) (where liability to corporation based on negligence or misconduct, indemnity allowed only if court finds that "in view of all circumstances of the case," employee "reasonably entitled" to indemnity despite liability; indemnity otherwise allowed if employee shows good faith and acts in or not opposed to corporation's interests).

iciencies.¹⁷⁹ Indeed, in the context of ordinary accidents, where the law aims principally to compensate victims and to spread unavoidable losses, indemnification shares the virtues of insurance, without any apparent sacrifice of public policy.¹⁸⁰

The policy objections come into play when indemnification takes the form of reimbursing agents for fines and penalties,¹⁸¹ a practice that amounts to little more than permitting the parties, by private agreement, to undo society's judgment as to the appropriate deterrence strategy. Recall that the key component of this strategy is Pf , the product of the level of penalty that a defendant can expect if convicted, P , and the likelihood of conviction, f , the latter itself a function of social enforcement costs. If the target of the law is an officer who, let us suppose, stands a fifty percent chance of being indemnified,¹⁸² then for him the expected penalty falls to one-half Pf . This outcome introduces unjustifiable distinctions between corporate employees and others. And if Pf is the ideal level for deterrence, then to reestablish that level, society has to make an adjustment that is suboptimal. For example, society could increase the enforcement resources enough to double the rate of detection and conviction, f . But note that these increased expenditures represent the amount that society would be willing to pay the parties not to indemnify,¹⁸³ which

179. Inefficiency would arise where the employee is more risk averse than the enterprise. See note 202 *infra* (discussing effect of different risk preferences on enterprise activities).

180. Unlike insurance, however, indemnification does not provide a superior compensation fund: indemnification only repays the agent what the plaintiff was able to extract from him, which would be limited by the defendant's wealth. Indeed, if there is a trade-off of indemnification for wages, as suggested above, see p. 47 *supra*, then the effect, in terms of compensating victims, may be perverse. An increased indemnification right will imply lower wealth for the agent, thereby reducing his ability to compensate.

181. By contrast, the right of the parties to arrange reimbursement of agents for legal expenses connected with unsuccessful defenses seems harder to fault, even though these expenses are often more substantial than the fines the agents are likely to receive, largely because the amounts so expended are not integral to the deterrence strategy. See Bishop, *New Problems in Indemnifying and Insuring Directors: Protection Against Liability Under the Federal Securities Laws*, 1972 DUKE L.J. 1153, 1164 (1972).

182. Indemnification will not be certain due to inevitable problems of interpretation, both of fact and of the controlling state code and the corporation's articles and by-laws.

183. Employee indemnification might also be opposed on distributive justice grounds in order to protect investors. This position proceeds on the view that the "consent" of investors to bear indemnification for grossly improper acts is too tenuous, considering the manner in which investors, in purchasing securities, "agree" to indemnification arrangements. See notes 33 & 177 *supra*. For instances when statutory policies were held to prohibit indemnification—although not of employees—see *Professional Beauty Supply, Inc. v. National Beauty Supply, Inc.*, 594 F.2d 1179, 1182-87 (8th Cir. 1979) (pro-rata contribution but not indemnification allowed among joint antitrust tortfeasors); *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1283-89 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970)

is, in turn, an index of the externality that the parties are imposing on society by their indemnification agreement.

It is true that even the most lenient states still require an agent seeking indemnification in such circumstances to demonstrate to the satisfaction either of the court or of "independent legal counsel"¹⁸⁴ that the actions were "in good faith," that they were undertaken in the interest of, or at least not opposed to the interest of, the corporation, and that, where a crime was involved, the agent had no reason to believe his conduct was unlawful.¹⁸⁵ But these conditions hardly set the policy conflicts to rest. Consider the case of an officer who has been convicted and fined for a federal offense that dispenses with or strongly reduces proof of intent or knowledge.¹⁸⁶ If the executive can be indemnified because he had no reason to believe his conduct was unlawful, the enterprise is permitted, under cloak of state law, to amend into the definition of the federal crime an element that Congress chose to omit: knowledge of wrongdoing. Indeed, by providing that conviction "shall not, of itself, create a presumption that the person did not act in good faith,"¹⁸⁷ such statutes introduce an element that is essentially irrelevant. That an agent who violated the Civil Rights Acts acted "in good faith" in furtherance of the corporate interest should not be a ground for undoing the public's judgment—evidenced through prosecutorial and judicial action—that he or she bear the fine. Nor should the directors or shareholders be allowed in effect to nullify the agent's penalty by a special vote,¹⁸⁸ for it was not on their behalf that the liabilities were established.

The potential for abuse is almost certainly larger than appears at first blush. We may suppose that if all indemnification agreements had to conform to the standard statutory form, and if payments had

(issuer's agreement to indemnify underwriter for securities law violation unenforceable because liability imposed on underwriter was designed primarily to deter negligence).

184. See, e.g., DEL. CODE ANN. tit. 8, § 145(d) (1974); ABA-ALI MODEL BUS. CORP. ACT § 5(d) (1979).

185. See, e.g., CAL. CORP. CODE § 317(b) (Supp. 1980); DEL. CODE ANN. tit. 8, § 145(a) (1974); N.Y. BUS. CORP. LAW § 724(a) (McKinney 1963); ABA-ALI MODEL BUS. CORP. ACT § 5(a) (1979). N.H. REV. STAT. ANN. § 294:4 (IX) (1977) appears to be even less restrictive, omitting the qualification.

186. See *United States v. Park*, 421 U.S. 658, 665 n.9 (1975) (president of warehouse company convicted of violating federal Food Drug and Cosmetic Act under jury instruction that he need not have committed wrong consciously, or participated personally, if jury found he occupied position of responsibility by virtue of his executive position).

187. CAL. CORP. CODE § 317(b) (Supp. 1980); DEL. CODE ANN. tit. 8, § 145(a) (1974); ABA-ALI MODEL BUS. CORP. ACT § 5(a) (1979).

188. But see N.C. GEN. STAT. § 55-20(a)(3) (1975) (apparently allowing indemnification even of criminal fine upon approval of majority of disinterested shares).

to be passed upon by the state courts, the opportunities for undermining public policy would be restricted.¹⁸⁹ But two considerations conspire to make these outcomes doubtful. First, under the approach of Delaware and the Model Business Corporation Act, the statutory conditions for paying indemnification are "nonexclusive."¹⁹⁰ This means that the parties can arrange their own more liberal terms, lodged discreetly in the employment contract, if they choose, rather than in the Articles or By-laws where they would be more visible.¹⁹¹ Second, it is not the sentencing judge to whom the officer must apply in order to secure an indemnity; rather, the officer's cause may be argued, *ex parte*, in the law offices of "independent legal counsel." "A lawyer," one commentator has observed, "no matter how ethical or rugged, may find it difficult to deny indemnification to directors who are responsible for his retainer."¹⁹² There are, furthermore, no assurances under federal or state law that every payment under an indemnification agreement will be reported to the court, prosecutor, or shareholders.¹⁹³

Even in the face of such possibilities for abuse, a case can be made against the federal government's intervening to restrict these private arrangements. Two lines of argument are possible. The first is, perhaps ironically, moral; the second is practical.

Viewed in its most favorable light, lenient indemnification can be seen not as a blatant attempt to flout public morals, but as something more nearly the opposite. In many instances, the wrongdoing executive's peers and lawyers probably consider themselves to be in a better position than "outsiders" to judge what, in the total ethical context,

189. Presumably, indemnification would be kept within the bounds of insurance: no coverage would be available for intentional wrongs. See 1 R. LONG, *LAW OF LIABILITY INSURANCE* §§ 1.26-27 (1969).

190. DEL. CODE ANN. tit. 8, § 145(f) (1975); ABA-ALI MODEL BUS. CORP. ACT § 5(f) (1979). However, "[n]o judicial precedent clearly indicates how far this provision allows corporations to make indemnification payments not permitted under the other subsections of the statute." Bishop, *Understanding D & O insurance policies*, HARV. BUS. REV., Mar.-Apr. 1978, at 20, 22. For criticism of these provisions, see Cheek, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255, 277 (1969); McAdams, *A Proposal to Amend the Indemnification Section (§ 5) of the Model Business Corporation Act*, 31 BUS. LAW. 2123, 2140-41 (1976).

191. For companies subject to SEC reporting requirements, however, SEC Form 10 requires a statement of the "general effect of any charter provision, by-law, contract, arrangement or statute under which indemnification is available." 2 FED. SEC. L. REP. (CCH) ¶ 23,106 (1975) (emphasis added). The New York Stock Exchange listing application requires no comparable information. *Id.*

192. McAdams, *supra* note 190, at 2138.

193. See, e.g., DEL. CODE ANN. tit. 8, § 145(d) (1975) (indemnification may be paid simply upon approval by majority vote of quorum of disinterested directors); ABA-ALI MODEL BUS. CORP. ACT § 5(d) (1979) (same).

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was truly wrongful. Loosely restricted indemnification agreements preserve, as an option, the power to correct for the law's having lodged responsibility where, according to prevailing business community sentiment, it was "immoral" (or "stupid") to have put it. It is possible, too, that lenient indemnification is part of a law-making dynamic that is too complex to permit easy condemnation. Lawmakers, prompted by public outcry to get tough on corporate crime, may implicitly rely on indemnification to correct penalties they do not really believe in. Professor Reisman has demonstrated in the context of anti-bribery crusades that such a mode of accommodating diverse interests, and leaving underlying practices unruffled, would hardly be unique.¹⁹⁴ But even if we assume that the final outcome is a body of practices that do not strongly deviate from what the prevailing moral climate is willing to allow, such byzantine law-making, in which the indemnification procedures of one state are counted on to temper the professed zeal of the federal government and sister states, is not easy to defend. It is better that lawmakers, prosecutors, and sentencing authorities act responsibly in deciding what is, and what is not, a delict for which the agent should be the final bearer of the risk. Once that decision is made, after due consideration of the factors examined in Cluster 1,¹⁹⁵ it is in principle senseless to stand by and allow the enterprise participants, by agreement among themselves, to deflect the collective judgment.¹⁹⁶

The availability of alternatives to indemnification presents a second set of complications. Simply stated, because there are other devices through which the enterprise can compensate agents for the risks of adverse judgments, government action to limit indemnification will increase pressure to readjust compensation in other ways. In light of the alternatives, can restrictions on indemnification be effective?

The closest substitute for indemnification is directors' and officers' liability insurance. The Model Business Corporation Act expressly empowers corporations to purchase such insurance for its agents "whether or not the corporation would have the power to indemnify" them under its already far-reaching indemnification provisions.¹⁹⁷ But while

194. See W. REISMAN, *FOLDED LIES* 15-36 (1979) (discussing existence of two different codes of behavior in society: official, normative code ("myth system") and unofficial, effective code ("operational code")).

195. See pp. 28-35 *supra*.

196. The current practice retains some sense insofar as the state's interests depend, not on extracting a penalty from the agent, so much as on the ceremony of publicly prosecuting and convicting him.

197. ABA-ALI MODEL BUS. CORP. ACT § 5(g); see CAL. CORP. CODE § 317(a)(i) (West 1977 & Supp. 1980) (same power); DEL. CODE ANN. tit. 8, § 145(g) (1974) (same).

this provision seems to invite perniciously broad coverage,¹⁹⁸ in operation little abuse is likely. First, it is not the practice of insurers to underwrite intentional wrongdoing or, probably, to underwrite criminal activity of any sort, intentional or not.¹⁹⁹ And even if the parties could purchase from the insurers a change of heart in regard to coverage, there is a fairly well established body of state insurance law, in contrast with the paucity of reported indemnification decisions, that would preclude enforcement on public policy grounds.²⁰⁰ In further contrast with indemnification, ambiguities about both the insurance agreement's language and the claimant's conduct will be reviewed by the insurer at arm's length, rather than by the claimant's peers, investors, or "independent counsel."²⁰¹

The other *ex ante* alternative to indemnification is to increase the agent's wages in compensation for his bearing the risks without recourse. But an increase in wage, although able to substitute for indemnification with little effect on the level of ordinary negligence, provides a less ready equivalent where the conduct is of a sort that may incur fines and punitive damages. In this latter range of cases, restricting indemnification is likely to curb misconduct rather than merely yield a substituted wage level. Comparison of two legally hazardous activities, both of which a firm might wish its agent to engage in, will illustrate this point.

In the first example, the company wishes its employee to drive a truckload of explosive materials, an activity that risks civil liability but is not illegal; in the second, it wants him to meet with competitors to fix prices, conduct that is subject to punitive sanctions. In the case of the driver whose risk is civil liability, precluding indemnification would do little to alter the conduct: the enterprise would provide additional compensation and then monitor the driver's activities to insure that he was attending to his risky but agreed-upon duties.²⁰²

198. See Letter from Wright Patman to Chairman of National Governors Conference (Jan. 28, 1971), reprinted in Bishop, *supra* note 181, at 1160 n.34 (Model Business Corporation Act insurance provisions undermine essential safeguards of federal and state law).

199. See Johnston, *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 Bus. Law. 1993, 2019-20 (1978) (discussing prevailing "dishonesty exclusion" clause in directors' and officers' insurance contracts).

200. See, e.g., *Sheeham v. Gorinsky*, 321 Mass. 200, 203, 72 N.E.2d 538, 541 (1947); *Messersmith v. American Fidelity Co.*, 232 N.Y. 161, 165, 133 N.E. 432, 433 (1921); 1 R. LONG, *supra* note 189, § 1.26, at 1-76, 1-78.

201. These further protections for public policy may explain why the SEC, while opposing indemnification for securities law penalties, has never taken a stand against insuring the same losses. Cf. Bishop, *supra* note 181, at 1165-66 (considering possible reasons for SEC's position).

202. If the driver is more risk averse than the enterprise, and if both are equally knowledgeable with respect to the risks and have equal control over outcomes, the ex

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By contrast, when the employee is asked to fix prices at the risk of punishment beyond damages, adjustments involving ex ante compensation and monitoring are more entangling. Even if the corporation and agent could agree on a wage appropriate to the agent's risk of nonindemnifiable liability—perhaps including a prison term—the corporation would find it virtually impossible to hold the agent to the task.²⁰³ The agreement presumably would be unwritten and unenforceable in law; in fact, the employee's performance could not be monitored without increasing the risks of criminal fines and punitive damages to the corporation and its superior agents.²⁰⁴ Consider the trail of evidence: "Memo to Jones: We note you failed to meet with competitors on Thursday, as agreed."²⁰⁵

None of these limits on the substitutability of wage increases for indemnification proves that there is no cost at which the enterprise, if determined, could purchase the unlawful behavior. But it is some comfort that the more such an enterprise is forced to expend for its intentional wrongdoing, the more it is suffering one of the competitive disadvantages that the criminal law seeks to impose: the expense becomes a sort of continuous fine.²⁰⁶ Hence, where penalizable conduct

ante payments (the wage increase) and monitoring will impose greater expenses than the firm would bear if it could pay through indemnification, ex post. In these circumstances, prohibiting indemnification will add some cost and, in conditions of competition, reduce shipments and, consequently, explosions. The firm's reduction of its activity would not necessarily be socially desirable, however, if the original decision to entrust accident reduction to general deterrence was correct. See McKean, *Should Corporate Managers' Liability for Third-Party Injuries Be Expanded?* in *THE ATTACK ON CORPORATE AMERICA* 86-91 (M. Johnson ed. 1978).

203. There may be incentives for the firm to make such an agreement, see K. ELZINGA & W. BREIT, *supra* note 109, at 133 (potentially huge rewards to be gained from anticompetitive behavior may induce firm to "bribe" its executives to violate laws), but it is less clear how one would be constructed. Any such agreement would probably be less express than implied by a mix of verbal and nonverbal signals in the context of a corporate "way of life." See J. FULLER, *THE GENTLEMEN CONSPIRATORS* 58-59 (1962) (emphasizing capacity of informal pressures and implied agreements to secure law violations); Bensman & Gerver, *Crime and Punishment in the Factory: The Function of Deviancy in Maintaining the Social System*, 28 AM. SOC. REV. 588, 593-95 (1963) (example of foreman as source of concealed pressure to commit wrongs).

204. A recent California case has even allowed an employee to sue in tort for being fired because of refusal to participate in an illegal scheme to fix retail gasoline prices. *Tameny v. Atlantic Richfield Co.*, 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980).

205. Of course, the corporation can check on the agent's performance in less incriminating fashion by monitoring output rather than by monitoring the means that the servant was employing. But where it is difficult to correlate individual efforts with team output, output monitoring would not be a satisfactory equivalent. For instance, at some margin the principal does not wish to compensate increased sales, which may come about for any number of reasons, but rather to compensate what it deems the most effective means of increasing profits: transmitting illegal payments.

206. The analogy is loose, of course: unlike a true fine, the proceeds go not to the state but to the wrongdoing agent in the form of extra compensation. Moreover, a true

is involved, it would not be fruitless to restrict employee indemnification, even in the face of the obvious *ex ante* alternatives.

The various *ex post* alternatives to indemnification, however, constitute an independent obstacle. When the officers have been made codefendants with the corporation, those in charge of the litigation may plead the company guilty in exchange for a *nolle prosequi* or charge reduction for the individuals.²⁰⁷ In a civil penalty suit, where there is joint liability, the company has large discretion to contribute the preponderant share of the judgment.²⁰⁸ Should these techniques for deflecting the penalty from the agent prove inadequate, the company may award a penalty-compensating bonus, or a deferred or retroactive raise. Even if the managers are forced publicly to fire the wrongdoer, it may be possible to return him to the payroll as a "consultant" when publicity has subsided.²⁰⁹

From one perspective, these *ex post* alternatives seem less pernicious than the *ex ante*, if only because the latter provide the agent with relatively certain advance assurances that reimbursement will be set in motion, perhaps as a requirement under the employee's contract.²¹⁰

fine may have greater impact on the firm than the wage increment because a fine is exacted as a lump sum in a public setting.

The outcome of the wage adjustment for legal risk-taking is difficult to determine because it depends on a number of complex factors. Obviously, if the risk being purchased is one that makes incarceration of the agent a real possibility, the wage equivalent will be difficult to establish and, in all events, costly. Furthermore, the enterprise has a wide range of non-monetary forms of compensation available to reward risk-takers without imposing equivalent costs on the enterprise. Such benefits include better opportunities for promotion, travel, relocation, and titles and other badges of prestige. On the other hand, even the corporation's non-monetary treasury must have a bottom and be subject to budgetary constraints. Non-monetary rewards are needed to induce lawful conduct as well as to purchase agent risk-taking and cannot be distributed too lavishly without diminishing their value. There is no such thing as a free corner office.

207. See note 119 *supra* (discussing practice).

208. In *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), the court found the company and three of its directors jointly and severally liable under a securities law for filing a defective registration statement in connection with an exchange offer. The company then informed the court that it had decided to pay the entire judgment and not to seek contribution from the directors. The SEC filed a brief opposing this resolution as contrary to public policy. Bishop, *supra* note 181, at 1162. The parties subsequently entered into a settlement by which each director contributed \$5,000 and the company the \$331,500 balance.

209. In the wake of the foreign bribery scandal involving Gulf Oil Company, it was discovered that the vice president in charge of the payments had "borrowed" \$26,000 from a pool of employee contributions that he had administered in order to pay Gulf \$25,000 to release him from any claims against him. Later, publicly fired from the company, he was retained to "consult" for eight months. See Robertson, *The Directors Woke Up Too Late at Gulf*, *FORTUNE*, June 1976, at 121, 209.

210. See ABA-ALI MODEL BUS. CORP. ACT § 5(c) (1979) (agent who successfully defends action entitled to indemnification for reasonable expenses); Bishop, *supra* note 174, at 1081-84 (discussing change in Delaware statute to provide for mandatory indemnification in certain circumstances).

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The availability of the ex post alternatives will always be more problematical, since the agent, forced to appeal for a discretionary judgment, is less able to predict its outcome. It is one thing for the board or top management to approve indemnification in the abstract, as part of a general package, and quite another to approve a payment after the fact, in a concrete case of delinquency, perhaps in the glare of publicity. After the fact, the wrongdoer's peers or superiors may decide to dissociate themselves from the actor and his deed.

On the other hand, the difficulties of policing the ex post payments are at least as severe as monitoring the ex ante arrangements, for the former offer no express provisions that can be discovered and challenged. Moreover, many covert ex post "indemnifications" will never come to light, and successful challenges to those that do—often in the form of derivative actions—are unlikely, given judicial reluctance to second-guess business judgments as to questions of job performance.²¹¹

Nevertheless, even if we are limited in how successfully we can ultimately restrict the various alternatives, the stakes are large. Indemnification and its surrogates have the power not only to undo the law's judgments against executives who have been caught; they also lend themselves to undermining prosecutorial efforts against others. In cases of corporate wrongdoing, the successful prosecution of top management often requires the testimony of lower- and middle-level managers; yet the willingness of those managers to turn state's evidence may be eroded by the promise that the company will take care of them, provided they demonstrate their loyalties. Indeed, the value of a prosecutor's grant of immunity is surely debased if the corporation, through indemnification, can dole out something resembling an immunity on its own.

For these reasons, federal law should, and could, do more to protect the integrity of its judgments. Indemnity, whether direct or indirect, should be restricted by specific rules in the circumstances of certain fines, penalties, exemplary damages under federal law, and perhaps even some ordinary civil liabilities under federal statutes whose policies are not fully realized by compensation of victims.²¹² Such

211. The Nuclear Regulatory Commission refused to make civil penalties for non-notification of hazards nonindemnifiable, in part because of "the serious practical difficulty in attempting to differentiate between a properly awarded salary increase or bonus and an improper reimbursement." 42 Fed. Reg. 28,892-93 & n.1 (1977).

212. *Cf. Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970) (policy against indemnification for securities law judgment designed to deter, not merely to compensate); *Hartford Accident & Indem. Co. v. Village of Hempstead*, 48 N.Y.2d 218, 228, 397 N.E.2d 737, 744, 422 N.Y.S.2d 47, 53-54 (1979) (New York public policy prohibits insurance coverage of punitive damages awarded against municipal police officers in civil rights action brought under 42 U.S.C. § 1983).

federal action could be accomplished either through legislation that preempted the state rules generally,²¹³ or by specific rules attached to designated penalties.²¹⁴ Courts should also be encouraged to include in their judgments, in appropriate circumstances, prohibitions on direct and indirect indemnification of their judgments. No such measures can foreclose every ruse a firm can devise to take care of its good soldiers. But we can do more at least to confound the efforts of those who would undermine strongly felt public policies.²¹⁵

B. *The Employer's Indemnity*

In many circumstances at common law, if the master suffers liability in consequence of his servant's conduct, the master acquires a right of indemnity against (or contribution from) the servant.²¹⁶ One can

213. Cary, *supra* note 33, at 702, suggests a "minimum federal standard" for state-authorized agent indemnification payments. He does not, however, make the distinction emphasized here between indemnifying agents for liabilities to third parties incurred in violation of strongly felt policies, where the case for restrictions seems strong, and indemnifying them for liabilities when investors alone are affected, where, under the approach of Winter, *supra* note 33, the arguments seem considerably weaker. S. 1722, 96th Cong., 1st Sess. § 2202(e) (1979) provides that "[i]f a fine is imposed on an agent . . . of an organization, the fine shall not be paid, directly or indirectly, out of the assets of the organization," which seems to propose such a pre-empting limitation. The accompanying report, however, although commenting on language of an earlier draft, indicates an intention to defer to existing state law, *see* S. REP. NO. 553, 96th Cong., 2d Sess. 977 (1980), which is by no means as restrictive as the proposal, *see* pp. 49-50 *supra*.

214. Congress has expressly prohibited indemnification in the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified at 15 U.S.C. § 78dd-2(b)(4) (Supp. III 1979)). Federal agencies presumably have authority to reach like results through administrative action. The Nuclear Regulatory Commission recently considered, but rejected by a 2-1 vote pending further findings, a provision that the penalty for executives who fail to transmit information on certain defects to the NRC, *see* 10 C.F.R. § 21.21(b)-(c) (1980), be made nonindemnifiable. 42 Fed. Reg. 28,892-93 (1977).

Presumably, too, a court could provide in its final judgment that attempts to indemnify against its sanctions would constitute contempt of court. A federal court has power to protect the integrity of its judgments even against acts by those not party to the judgment. *See* *United States v. Hall*, 472 F.2d 261, 264-68 (5th Cir. 1972). Such an approach could be a particularly effective way to avoid circumvention by the *ex post* devices, such as "bonuses." *See* p. 54 *supra*.

215. For example, federal law could require a corporation seeking to indemnify an agent to give prior notice to the trial court or administrative law judge and to the appropriate prosecuting authority. The court could have power to enjoin the payment if it appeared that, under the circumstances, the policies underlying the law would be defeated. There could also be requirements that all indemnifications, including amounts spent, be reported to the shareholders and that the role of "independent legal counsel" be more restricted, if not eliminated. *See* McAdams, *supra* note 190, at 2139-40 (proposing amendment to Model Business Corporation Act providing written notice of indemnification to shareholders and limiting role of independent counsel).

216. *See* RESTATEMENT (SECOND) OF AGENCY § 401, Comment d (1957) (principal may recover from agent for any liability arising out of agent's unauthorized negligence or other wrongful act). The grounds for indemnification should be compared with those

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imagine a master, apprehensive of liabilities beyond those that will yield him a common-law recovery against the servant, providing specially for a more extensive indemnity in the employment contract. In practice, however, there is little evidence that corporate masters favor exercise either of the common-law right or of special provisions in the contract. The greater the prospective liability that the employee's conduct could cause the company, the more the company would have to give up in compensation to persuade the agent to shoulder the risks personally. Moreover, the liabilities that agents can cause their corporations run so high today that it is unlikely that the company could, even if successful in suit, collect on many judgments. As a result, in the absence of an empirical survey of lawsuits or contracts, we can conjecture that monitoring, together with the implicit threat of disciplinary action and termination, dominates the employer's indemnity as the way for firms to protect themselves from their agent's foibles.

The over-arching question of this subsection, however, is not what arrangements generally prevail in the employer's indemnity area, but whether there is a basis for overriding any particular investor-manager preferences in order to advance third-party and public interests. The issue tends to arise in the following manner. A firm has been subjected to criminal and civil suits for price-fixing. Subsequently, a shareholder brings a derivative action seeking to force various of its agents—ordinarily directors and high-level managers—to indemnify the company for losses that the firm has suffered in fines, civil damages, and costs of suit. The plaintiff may allege either that the defendants actively participated in the offense²¹⁷ or that their failure to have discovered and terminated the wrongdoing constituted a breach of the fiduciary

for contribution, which are specified by various state statutes. See UNIFORM CONTRIBUTION AMONG TORTFEASORS ACT (Commissioners' Prefatory Note (1955 Revision)) (noting several different state statutes); W. PROSSER, *supra* note 71, § 50, at 307-10. At the federal level, in cases of joint violation of federal securities laws, contribution has been permitted because it promotes "the policy of deterrence behind the securities laws by discouraging corporations from assisting in [their] violation." *Rice v. McDonnell & Co.*, 442 F. Supp. 952, 954-55 (S.D.N.Y. 1977). This policy apparently supports contribution but not indemnification. See *Odette v. Shearson, Hammill & Co.*, 394 F. Supp. 946, 954-58 (S.D.N.Y. 1975) (indemnification for violation of securities laws with *scienter* requirement impermissible, but contribution on basis of third party's knowing use of defendant's false figures permissible).

217. Cf. Blake, *The Shareholder's Role in Antitrust Enforcement*, 110 U. PA. L. REV. 143, 157-58 (1961) (director's participation in antitrust violation may ease problems of proof for plaintiff); Forte, *Liabilities of Corporate Officers for Violation of Fiduciary Duties Concerning the Antitrust Laws*, 40 IND. L.J. 313, 319-21 (1965) (discussing malfeasance by director resulting in antitrust violation as basis for derivative suit).

duty to supervise and manage with due care.²¹⁸ Assuming no express indemnity provisions in the agents' contracts, the success of the suit will turn upon a whole matrix of fiduciary rules under the state law: whether the illegal contracts are judged *ultra vires* (and with what consequences);²¹⁹ whether, and in what measure, the business judgment rule will limit judicial scrutiny;²²⁰ whether defendants can successfully interpose their reliance on reports and opinions furnished them;²²¹ whether a group of disinterested directors or shareholders can foreclose or settle corporate claims;²²² and whether, in the calculations of losses, any ill-gotten gains that the firm received will offset the amounts suffered in penalties and damages.²²³ All these variables

218. See Forte, *supra* note 217, at 319-29 (discussing causes of action based on malfeasance and negligence). The duty of due care is typically described as "the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance." H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* § 234, at 455 (2d ed. 1970); see *id.* at 454-55 (quoting similar standards and citing cases).

219. The important questions in this regard are whether the *ultra vires* conduct constitutes negligence *per se*, compare *Adams v. Smith*, 275 Ala. 142, 145-47, 153 So. 2d 221, 223-25 (1963) (directors absolutely liable for *ultra vires* act) with *Litwin v. Allen*, 25 N.Y.S.2d 667, 699 (Sup. Ct. 1940) (directors not absolutely liable for *ultra vires* act if they acted honestly, diligently, and without violating statute), or whether it shifts the burden of proof. *Ultra vires* conduct may also be nonratifiable. See 13 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5964 (rev. perm. ed. 1980) (*ultra vires* acts one category of nonratifiable deeds).

220. The business judgment rule saves directors and officers from liability for virtually any decision provided it is in good faith and within their authority. See H. HENN, *supra* note 218, § 242. Some confusion has arisen, however, over when and how the rule applies. See Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 100-11 (1979) (discussing conflicting applications of rule).

221. See, e.g., CAL. CORP. CODE § 309(b), (c) (West 1977) (in performing duties, director entitled to rely on information provided by certain competent people); DEL. CODE ANN. tit. 8, § 141(e) (1974) (same); ABA-ALI MODEL BUS. CORP. ACT § 35 (1979) (same). See generally Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

222. The capacity of disinterested directors to foreclose litigation in their "business judgment" has been upheld repeatedly. See, e.g., *Swanson v. Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957); *Gall v. Exxon Corp.*, 418 F. Supp. 508, 514-15 (S.D.N.Y. 1976). But see *Maldonado v. Flynn*, 413 A.2d 1251, 1256-62 (Del. Ch. 1980) (independent committee of directors cannot secure dismissal of shareholder's suit on business grounds when suit seeks redress for breach of fiduciary duty); *Groel v. United Elec. Co.*, 70 N.J. Eq. 616, 622-24, 61 A. 1061, 1064-65 (Ch. 1905) (directors' decision that derivative suit would be unsuccessful inadequate to bar suit).

The general requirement that demand be made on the other shareholders as a condition precedent for the bringing of a derivative suit may be lifted in some circumstances, such as where the act complained of is deemed illegal, *ultra vires*, or otherwise "unratifiable." 13 W. FLETCHER, *supra* note 219, §§ 5964-65; see note 231 *infra* (discussing ratifiability). For a criticism of corporations' use of special litigation committees to preclude derivative actions, see Note, *The Business Judgment Rule in Derivative Suits Against Directors*, 65 CORNELL L. REV. 600, 617-29 (1980).

223. See *Smiles v. Elfred*, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.) (dismissing derivative action for insufficient allegation of damages to corporation; complaint left open possibility that corporation "may have gained more from the price-fixing conspiracy than the amounts of the fine paid and the expenditures . . . incurred").

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inevitably influence the quality and direction of managerial efforts to steer the corporation clear of acts that injure others. Hence the principal interventionist question: should this potential to benefit noncontracting interests be deliberately emphasized at some sacrifice of investor-manager preferences?²²⁴

Two disparate legal styles are indicated. If we adopt what I call the *true fiduciary style*, the answer is no.²²⁵ In this view, the plaintiff's case will be treated like any other charge of economic loss resulting from the defendant's breach of fiduciary duty.²²⁶ The matrix of fiduciary rules will be construed to shift the judgment onto the agent only if the agent's misconduct was so clumsy or egregious that, as a matter of interpreting the fiduciary relationship, it cannot be deemed within the performance bargained for.²²⁷ The outcome, in other words, will be consistent with enterprise liability as we have been using the term: the investors and managers will distribute losses solely according to their own benefit,²²⁸ without consideration of externalities.

In contrast with the true fiduciary style is the *interventionist style*. Under this alternative, the fiduciary variables are conscripted into nonfiduciary service. That is, the standard of care, the right to rely, and so forth, are subjected to special constraints aimed at diverting

224. As a subordinate interventionist question, one could consider whether there is any imbalance in bargaining power between corporation and agent that justifies intervention to prevent the enterprise from shifting onto the agent liabilities beyond those the agent should fairly bear. The need for such intervention on the agent's behalf seems highly doubtful.

225. At an extreme of this style, the court would uphold a by-law or other agreement by which the corporation agrees not to recover against an agent even when the loss he brings about constitutes a crime against the corporation.

226. I assume that the alleged breach of the fiduciary duty of care is not complicated by elements of self-dealing, which would introduce slightly different rules and considerations.

227. Just as the states have different corporations codes, so they have different fiduciary rules, which derive in some key elements from the respective codes and in some ways from variations in common law rules. Cf. *Geller v. Transamerica Corp.*, 53 F. Supp. 625, 629-30 & n.7 (D. Del. 1943), *aff'd per curiam*, 151 F.2d 534 (3d Cir. 1945) (application of Delaware conflicts rule to facts avoids problem of dealing with different fiduciary doctrines from different jurisdictions).

228. Should a derivative suit arise from a bribery scheme, for example, a court oriented to the true fiduciary style might consider the sum of the payments, the value of the business they purportedly secured, the probability that the business in question would have gone elsewhere if the payments had not been made, the expected penalties to the firm if the practices had been detected, and the cost to the firm of various monitoring systems that would have been capable of detecting them. Moreover, even if a defendant's business judgment was erroneous, the business judgment rule provides a strong presumption of liability. This presumption reflects the general sentiment of investors that the gains they would realize from higher standards of vigilance would be offset by higher compensation demands if courts imposed on agents a harsher liability rule. Cf. *Coffee*, *supra* note 84, at 1230-31 (relaxation of fiduciary standards for outside directors may encourage more careful examination of corporate affairs).

managerial efforts along lines that the investors and managers would not otherwise select, but that are imposed over their negotiations in order to advance external interests.

If we look at the cases, the true fiduciary style appears to prevail in most of the decisions;²²⁹ interventionist, public policy concerns seem to dominate others.²³⁰ But because the distinction between these two styles has not been clearly marked, many decisions appear hybrid. The court supports plaintiff's position, but is ambiguous whether the basis is public policy, as such, or whether the defendant's unlawful conduct was beyond the authority "bargained for" and therefore actionable under the "true fiduciary" rationale.²³¹

Without attempting any more definitive statement of where present law stands, other than to remark this ambivalence between the styles, let us return to the underlying policy question: Does it make sense

229. A good example is *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963). There, a shareholder sued derivatively to recover from officers and directors for losses, including fines and punitive damages, occasioned by price-fixing. Plaintiff alleged that defendants' failure to exercise the required review of company affairs was particularly inexcusable because the company had been operating subject to a consent decree based on settlement of prior price-fixing allegations. The Delaware court held for defendants, however, on the grounds that "directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong." *Id.* at 83, 188 A.2d at 130. In view of the size of the company, the court deemed it "not practicable for the Board to consider in detail specific problems of the various divisions." *Id.* at 82, 188 A.2d at 128. Other examples are *Smiles v. Elfred*, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.), and *Hornstein v. Paramount Pictures, Inc.*, 22 Misc. 2d 996, 37 N.Y.S.2d 404 (Sup. Ct. 1942), *aff'd mem.*, 266 A.D. 659, 41 N.Y.S.2d 210 (1943), *aff'd per curiam*, 292 N.Y. 468, 55 N.E.2d 740 (1944). In *Smiles*, a derivative action was dismissed for failure to plead actual damage to the corporation, even though the corporation's antitrust violation and fine represented obvious externality problems. In *Hornstein*, a derivative action to force officers to reimburse "payoffs" they had made to labor racketeers under the threat of crippling strikes was dismissed. Corporations, the court said, do not "owe a duty to the public to protect racketeering at their own expense." 22 Misc. 2d at 1006, 37 N.Y.S.2d at 415.

230. A relatively pure—and rare—expression of the interventionist style is *Roth v. Robertson*, 65 Misc. 343, 346, 118 N.Y.S. 351, 353 (Sup. Ct. 1909) (public policy reasons require directors to be accountable for "hush money" payments made, even though such payments not clearly illegal). *Cf. Miller v. American Tel. & Tel. Co.*, 507 F.2d 759, 762-63 (3d Cir. 1974) (business judgment rule protected directors from liability under common law for noncollection of debt but would not protect them if noncollection was breach of federal campaign law).

231. This hybrid style seems to characterize holdings that a plaintiff instituting a derivative action based on alleged criminal law violations or "fraud" is exempt from the ordinary requirement to make a demand on other shareholders. Such cases typically leave unclear whether the conduct was "nonratifiable" because it violated public policy or because it violated the investment contract. *See Rogers v. American Can Co.*, 305 F.2d 297, 309, 317 (3d Cir. 1962) (vote by majority of shareholders against bringing suit no bar to dissenting shareholder's suit on antitrust charges "which are ultra vires the corporation and are public wrongs"); *Gottesman v. General Motors Corp.*, 268 F.2d 194, 197 (2d Cir. 1959) (no demand on shareholders necessary because complaint alleges illegal acts); *Continental Sec. Co. v. Belmont*, 206 N.Y. 7, 16-19, 99 N.E. 138, 141-42 (1912) (failure of defendant to make prior demand no bar to suit based on directors' acts prohibited by law or against public policy).

to conscript the fiduciary matrix into nonfiduciary service, overriding investor-manager preferences in such a way as to yield outcomes more supportive of noninvestor interests?²³²

There are several reasons to doubt the wisdom of that conscription. Using the fiduciary mechanisms in this way amounts to constituting the company's shareholders as private attorneys general. But the fiduciary context presents a peculiar skewing of normal "attorney-general" incentives. If an illegality—price-fixing, for example—is never discovered and succeeds in raising profits, the shareholders will benefit; if, on the other hand, the company is prosecuted and suffers losses, the derivative action promises to make the investors whole, notwithstanding the losses. The implication is that our potential attorneys general—the investors—will be relatively indifferent²³³ to their agents' efforts to turn a shady dollar on their behalf, and therefore not particularly zealous monitors of misconduct. This peculiar weakness does not, in itself, moot the question of whether to conscript the fiduciary mechanisms into noninvestor service. As a practical matter, no one really supposes that the investors of a giant, publicly held company can feasibly keep their agents under close surveillance.²³⁴ The argument remains, moreover, that fostering the indemnity action in this context simply provides an additional source of discipline of management misconduct, one that reaps no revenues for the public coffers, but at least needs no public funds to implement it.²³⁵

232. Fiduciary mechanisms and agencies seem occasionally to be conscripted into nonfiduciary service, in that investor benefit may be sacrificed to advance noninvestor policies. For example, the Foreign Corrupt Practices Act, 15 U.S.C. § 78m(b) (Supp. III 1979), forces companies to maintain internal audit controls to prevent the payment of bribes in a manner that may reduce sales and increase corporate legal liabilities. Cf. Note, *The Accounting Provisions of the Foreign Corrupt Practices Act: An Alternative Perspective on SEC Intervention in Corporate Governance*, 89 YALE L.J. 1573 (1980) (criticizing SEC regulations as intrusion into corporate affairs unwarranted by FCPA). If these controls were truly in the investors' interests, one suspects that market forces would have done more to encourage their adoption.

233. The relative indifference arises because the corporation's prospective recovery is reduced by plaintiff's counsel fees and other costs of suit and limited by the miscreant executive's capacity to make good on a judgment.

234. Melvin Eisenberg, from an examination of shareholding patterns in public corporations, suggests that there is more effective shareholder control over selection of management and changes in organic structure than has commonly been assumed. M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* 37-64 (1976). But however successfully shareholders may exercise voting power, they certainly lack a comparable ability to scrutinize corporate affairs for evidence of concealed wrongdoing.

235. This argument is, of course, a traditional justification for implied causes of action. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (upholding private cause of action to enforce liabilities for violation of § 14(a) of Securities Exchange Act of 1934 as necessary supplement to SEC regulation). Judicial implication of a private cause of action may turn on whether the investors or corporation can be construed to lie within the zone

The more complicated questions concern the feasibility of alternatives and the implications of the various morality and efficiency considerations that we have already examined. Our principal objection to the employee's indemnity was that it blunts criminal fines and punitive damages levied against agents. By contrast, whatever arrangements the parties make for the employer to pursue *its* recourses against a miscreant agent, society's ordinary powers to sanction the agent directly remain unaffected. Hence, from the perspective of controlling agents, society's stake in the employer's indemnity is not crucial.

From the perspective of controlling the corporation, however, lenient employer's indemnity could be viewed as warily as lenient employee's indemnity, on much the same grounds.²³⁶ This can be illustrated by considering the case where the enterprise has incurred a fine or a penalty awarded in a suit prosecuted under the direction of a public authority. If we assume that the initial allocation of penalties was ideal to realize society's goals of deterrence and retribution, then any shift of the losses onto the agent, even by contract between agent and enterprise, would seem as inappropriate as a shift in the converse direction. The prosecutor, the judge, and the other representatives of the system should direct the law's penalties with care, and then do what is possible to insure that they are not redistributed.²³⁷

When we turn from penalties to consequent damages, the considerations are even more complex. Suppose that the agent's conduct incurs a fine or penalty, and, as a consequence of the same conduct, the employer is sued for civil damages. The enterprise may want the agent to indemnify it, not for the amount of a publicly collected enterprise penalty, but for ordinary or perhaps even punitive damages

of persons the statute was intended to protect. See *Cannon v. University of Chicago*, 441 U.S. 677, 689-90 (1979); *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). And the question whether someone—the corporation, or the investor—is within or without the zone is obviously a flexible enough standard to allow results that are, at the least, “hybrid,” as I have used the term. Compare *Cort v. Ash*, 422 U.S. 66, 80-82 (1974) (shareholders not within class for whose especial benefit statute limiting corporate campaign contributions was enacted) with *Miller v. American Tel. & Tel. Co.*, 507 F.2d 759, 763 (3d Cir. 1974) (fact that shareholders within class for whose protection same statute was enacted gives force to argument that alleged violation of statute should give rise to derivative cause of action under state law).

236. See pp. 48-49 *supra*.

237. If the employer is determined to retaliate against offending employees, removing the indemnity action from the employer's arsenal will not eliminate all opportunity to do so. The errant agent can be discharged, demoted, passed over, or ostracized, in ways that are at least as difficult to police as are the alternatives that the employer and employee may arrange in response to rules restricting employee indemnification. Nevertheless, while devices such as firing can be used to discipline an employee whom society may deem “innocent,” they do not replicate the employer's indemnity action. In non-indemnity disciplinary acts, the employer is not reimbursed, and thus there is no reallocation of burdens imposed by the state.

that the enterprise suffered in a suit controlled by an ordinary citizen. The questions raised here are highly significant because these consequent damages, which an enterprise may suffer as a result of agent misconduct, are often far more severe than the public penalties that stem from the same behavior. In this context, however, it is not as easy to argue, in opposition to the employer's indemnity, that the original distribution of losses onto the enterprise reflected a precise targeting dictated by public policy. Thus, for these potentially more critical liabilities, there is stronger reason to permit employer indemnification. Indeed, it is easy to argue that public policy forbids any agreement to the contrary, which would amount to one party—here, the employer—forbearing recovery of damages suffered in consequence of the other party's crime.²³⁸ And it is certainly plausible that, as a means of strengthening law enforcement against agents, the law might go even further and shift the matrix in favor of recovery.

While there are theoretical warrants for all three positions—permitting, forbidding, and fostering the employer's indemnity in the context of consequent damages—as a practical matter, only the third presents a genuine law-reform issue. My own inclination is that the law generally should leave the resolution to the parties, and that the courts should not be over-eager on “policy grounds” to read an intention to provide such an indemnity in the fiduciary rules and employment agreements. My concern is not merely that consequent damages are potentially draconian, and that in the indemnity action, the managers face them as fiduciaries without the procedural advantages they would have enjoyed as defendants in a criminal suit. The resulting exposure is broad and vicarious, ill-defined, and often unconnected with reasonable expectations of managerial control. Such exposure is not only morally questionable; it is also destined to induce the whole range of unwanted efficiency responses that we examined in Cluster 1. Managers will be excessively cautious and will seek salaries disproportionate to their economic service, and perverse substitution of labor will occur (“good people won’t serve on boards”), all without insuring noticeable improvement in corporate law obedience.²³⁹ Worse, the

238. This argument is a slight variation on the principle that “a bargain to save the promisee harmless from the consequences of an act which is necessarily unlawful is . . . invalid.” 15 S. WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 1749A, at 131 (3d ed. 1972).

239. See Conard, *A Behavioral Analysis of Director's Liability for Negligence*, 1972 DUKE L.J. 895, 904. Conard recommends several alternatives to full employer indemnification, including limiting director liability for negligence to the director's net after-tax income from the corporation for the year in which one or more violations of duty occurred. See *id.* at 914.

entire atmosphere, so imbued with the threat of suit and harassment, undermines the capacity of the directors and top management to attend to their principal responsibility, the firm's general economic health. It may even produce internal organizational responses that are self-defeating. Subordinates, for example, may be induced to shield their superiors from liability by withholding some of the very data that the society most wishes those in authority to receive and to do something about.²⁴⁰

To accommodate these diverse policies and considerations, some federal intervention in this context may be appropriate; it should, however, be circumscribed narrowly. When the employee is alleged to have been guilty of personal criminal misconduct under federal law, and the employer, having suffered consequent damages, sues for indemnity, specific federal standards could override some of the private state-authorized provisions²⁴¹ of the employer's liability action matrix. For example, the otherwise prevailing requirement to exercise "due care" and to rely on corporate books, records, and so on,²⁴² should be partially preempted by federal standards designed to preserve some accounting for the federal interests that are involved. Thus, a federal "after due inquiry, in the circumstances" might be glossed onto the state "due care."²⁴³

Even when the allegations rest merely on the defendants' negligence in having allowed the misconduct of others, and not on any personal participation in the wrongdoing, some federal intervention might still be appropriate. Consider, for example, a company that has been subject to a federal consent decree in circumstances that should constitute constructive notice to the officers and in which the cost of compliance

240. See C. STONE, *supra* note 13, at 147.

241. See note 33 *supra* (recommendations of Professor Cary). Federal law generally controls, of course, but state law is not pre-empted easily. See *Burks v. Lasker*, 441 U.S. 471, 477-80 (1979) (where cause of action against fiduciaries implied under federal statute, state laws not to be displaced if consistent with federal policies).

242. See note 218 *supra* (citing discussion of due care); CAL. CORP. CODE § 309(a) (West 1977) (defining duty); N.Y. BUS. CORP. LAW § 717 (McKinney 1963) (same). The examples of law reform suggested would have limited application in indemnity actions based on defendant's culpability for delicts requiring actual knowledge. They would, however, affect the outcome whenever constructive knowledge or negligence was in issue.

243. Professor Coffee recommends a similar reform. The "net loss" rule, which requires plaintiff to allege that losses of corporate wrongdoing exceeded gains, see *Smiles v. Elfred*, N.Y.L.J., Feb. 20, 1963, at 14, col. 6 (Sup. Ct.) (requiring "net loss" to sustain derivative action), should be modified, Coffee believes, by a presumption that wrongdoing harmed the corporation. Coffee, *supra* note 84, at 1180. The presumption would serve "at least [as] a useful legal fiction to increase the level of deterrence" by making recoveries more likely. *Id.*

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(public and private) can be significantly reduced if top management lends even marginal efforts in support. In a subsequent indemnity action alleging corporate damages in consequence of an indifferent internal compliance response, federal constraints on indemnification comparable to those applicable in cases of intentional wrongdoing might be in order.²⁴⁴

Modifying the fiduciary matrix with such federal standards, narrowly and prudently drawn, could restrict misconduct without unduly diverting the investor-oriented efforts of managers, and without extending their exposure beyond those instances when their indifference to federal law was, in ordinary understanding, "blameworthy." As a compromise, a ceiling could be placed on the recovery allowable from any officer, perhaps tied to his or her salary.²⁴⁵ There would be, it is true, a double cost to the investors—suboptimal incentives for managers to police firm conduct and, for this dubious privilege, the need to bear the costs of suit. Nonetheless, to the extent that the investors would be the beneficiaries of a successful disciplinary judgment, their losses would be cut.

IV. Cluster 3: The Investor and the Corporation: Limited Liability

Among the many relationships struck between the investors and the corporation, several affect noninvestor interests in a manner that raises issues of interventionism. Even the information they agree to pass between themselves can be an object of interventionist concern; witness the periodic proposals that corporations should disclose to their shareholders (and, hence, put on public view) items about their social behavior beyond what most shareholders probably want to be told.²⁴⁶

244. See *Graham v. Allis-Chalmers Mfg. Co.*, 41 Del. Ch. 78, 83, 188 A.2d 125, 129 (Sup. Ct. 1963) (indicating casual manner in which defendant executives claimed to have learned of and evaluated prior consent decrees under which company was operating).

245. See Conard, *supra* note 239, at 914 (recommending that director's negligence liability be limited to percentage of net after-tax income from corporation for year of violation).

246. See R. NADER, M. GREEN, & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 62-71, 140-57 (1976) (proposing federal chartering of large corporations and conditioning charters on continuous disclosure of steps taken to comply with various regulations). The SEC has moved gradually toward requiring similar disclosure. See Securities Act Release No. 5704, Securities Exchange Act Release No. 12414, 41 Fed. Reg. 21,632 (1976) (adopting rules requiring same disclosure concerning compliance with environmental regulations, but rejecting proposed broader disclosure requirements).

Of course, investors want a certain amount of information about contingent liabilities and potential loss of good will—bad publicity, for example, occasioned by activities such as environmental despoliation—just as they desire information reflecting any contingencies that will affect profits. For this reason, under the pressures of capital market competition, good accounting practices should tend to place in the hands of investors whatever infor-

There is a comparable interventionist flavor to the increasing number of SEC actions and shareholder suits prosecuted by public interest law firms. Despite the form of the action, these suits appear intended to bend the investor-corporation relationships in order to advance a larger public interest, such as preventing bribery, even if it involves some sacrifice of investor welfare.²⁴⁷ But the most significant interventionist questions that arise from this cluster of relations concern the limits upon the investor's personal liability for the undischarged debts of the corporation.²⁴⁸

To understand the significance of these liability limits, we must place them in the context of general principles of agency. Although corporations have become increasingly accountable for a broadening

market interests warrant, considering the costs of supplying such information. Conceivably, then, proposals to force more disclosures are investor oriented, grounded in the notion that there are market failures in the supply of information that need to be corrected.

If, however, such proposals contain implicit "public policy" goals and require dissemination of information over and above the margin that investors would pay for, the issues raised are more complex. It is highly questionable whether investors, the group that receives the information, have the desire or ability to influence management to achieve nonprofit goals, particularly at the sacrifice of profits. If the companies are sensitive to extra-legal and perhaps extra-market pressures, one imagines that the most effective agent for change will vary depending upon the character of the action required. Environmental action groups will exert the most pressure in cases of environmental information, and various religious and racial minority groups will do so in instances of racial discrimination. Why, then, conscript the information machinery that has been designed for the benefit of investors? One answer is that reform occurs through public embarrassment, and that there is some virtue in making executives themselves learn facts that they would rather ignore. Moreover, because there are already procedures for preparing and disseminating investor reports—and because noninvestor pressure groups have access to them—the incremental costs of disclosing this sort of social performance data are low if the data are combined with the investor information. Thus, the use of the investor information channels for the benefit of noninvestors is not an idea that can be rejected out of hand, if the case can be made that the social benefits of such information exceed its costs—an argument not dealt with here.

247. One example is *SEC v. Allied Chemical Corp.*, No. 77-0373 (D.D.C., filed Mar. 4, 1977), filed in the wake of the Kepone episode, *see* note 269 *infra*, which was settled upon agreement that Allied's board of directors maintain and review policies, practices and procedures affecting the risk of environmental damage. All this was done in a context that suggested that the protection of investors was the principal aim. It is at least as plausible, however, that the SEC was achieving a form of structural relief that sacrificed investor welfare, and that might more appropriately have been achieved and policed by the Environmental Protection Agency. Another example appears in *Goldman v. Northrop Corp.*, 603 F.2d 106, 107-09 (9th Cir. 1979) (discussing *Springer v. Jones*, unreported shareholder derivative suit charging that political contributions by Northrop violated federal law and constituted fraud; suit settled when Northrop agreed to restructure board of directors and other decisionmaking bodies).

248. The burden no longer falls on the shareholders to arrange limited liability by making a special provision in the charter, as was once required. *See Handlin & Handlin, Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 9-10 & n.46 (1945). Under modern general incorporation codes, the choice to operate subject to limited liability comes into play when the investors agree to incorporate—or to invest in a limited liability partnership—rather than in some alternative form of business organization.

range of their agents' acts in furtherance of the corporation's interests—even if in disregard of the corporation's instructions—the liability connections between the corporation and the shareholders, in many respects also one of agent to principal,²⁴⁹ have not evolved in parallel fashion. We might as plausibly consider corporate wrongs to have been done in furtherance of the shareholders' interests. But assuming that the shareholders have not participated directly in the liability-creating acts,²⁵⁰ they are, as a rule, only secondarily liable as guarantors of unsatisfied corporate debts, and even then only under conditions somewhat more stringent (and vague)²⁵¹ than are required to hold an ordinary master liable for his servant's acts.²⁵² The principal interventionist question in this section is whether we ought to intervene to alter this preferred position of the shareholder.

Let me stress that I am not questioning here the appropriateness of these special liability limits in protecting the investor from the corporation's undischarged debts to voluntary creditors, but rather from the debts that stem from dealings with noncontracting parties

249. See Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANCIAL ECON. 305 (1976) (examining firm structure as response, in part, to dynamics of principal-agent relationship). The principal-agent model is not, however, a perfect fit: for example, unlike the ordinary principal, the shareholders cannot discharge their agents (here, the directors) at will. See *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*, [1906] 2 Ch. 34.

250. A shareholder who participates in liability-creating acts may be held individually liable for the consequences of such acts. See *Redmond v. United States*, 8 F.2d 24 (1st Cir. 1925) (individual criminal liability for mail fraud of corporation); *Georgia Portland Cement Corp. v. Harris*, 178 Ga. 301, 173 S.E. 105 (1934) (individual liability for stock fraud); 13A W. FLETCHER, *supra* note 219, § 6214 (rev. ed. 1961) (general rule of individual liability).

251. The general rule is that "a corporation will be looked upon as a legal entity . . . until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify a wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." 1 W. FLETCHER, *supra* note 219, § 41 (rev. perm. ed. 1974).

252. Judge Cardozo observed that "[d]ominion may be so complete, interference so obtrusive, that by the general rules of agency the parent [shareholder] will be a principal and the subsidiary [corporation] an agent" for purposes of tort liability. *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 95, 155 N.E. 58, 61 (1926). But it is clear from the cases that the dominion and interference required to establish the master's liability, where the wrongdoing servant is a corporation and where the master is its investors, are greater than in the ordinary agency. Surely corporate investors, unlike masters, are not presumed subject to liability for the corporation's wrongs, committed while the firm is acting in the scope of its employment. Cf. RESTATEMENT (SECOND) OF AGENCY § 14M (1957) ("[a] corporation does not become an agent of another corporation merely because a majority of its voting shares is held by the other.") How well the limited liability cases fit into ordinary agency doctrine is unclear because the Restatement defines master and servant in terms of "the right to control . . . the performance of the service," *id.* § 2(1). As to how the shareholder's right to control compares with that of other masters, see *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame*, [1906] 2 Ch. 34 (simple majority of shareholders cannot control and discharge directors freely but must abide by articles of association).

and, in particular, from judgments incurred for delicts. The distinction, for the present analysis, is critical in theory if not always crisp in practice.²⁵³ Voluntary creditors can account for the added risks of nonpayment by adjusting their demands—requiring, for example, security, personal cosignatures, or higher interest terms.²⁵⁴ By contrast, noncontracting parties generally cannot adjust so readily to the prospect that their claims will go unsatisfied.

When creditors are not protected by contract, these restrictions on investor liability, whatever their justifications when contract creditors are concerned, come into conflict with at least two legal ideals. First, they undermine the compensation of victims. Second, they make, at worst, a mockery of deterrence,²⁵⁵ for they raise the possibility that those who stand behind an enterprise can disregard in their calculations any levels of penalty beyond the firm's capacity to pay.²⁵⁶ In effect, the law appears to use these liability limits for the benefit of a select group of social actors,²⁵⁷ thwarting with one hand the control strategies that it is legislating with the other.

253. No hard and fast line can be drawn between voluntary and involuntary creditors so far as negotiating costs between a corporation and a creditor are concerned. Some contract creditors, such as trade creditors, are as unlikely to examine the character of the enterprise they are dealing with as the person whom the enterprise injures in a tort. On the other hand, one can imagine two firms in a noncontractual but unacceptable relationship—for example, one imposes pollution costs on the other—such that they will bear the costs of negotiating a solution. In fixing the terms of their solution, they will account for characteristics of the enterprises involved, including whether an obligor enjoys limited liability.

254. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 292-93 (2d ed. 1977) (suggesting conditions under which parties to credit arrangement would find limited liability ideal). Furthermore, the demand for limited liability may be such that voluntary creditors must recognize it. The limited liability doctrine, rather than individual agreements with creditors, is the most convenient way to arrange the matter. See *id.* at 292-96.

255. See Note, *Should Shareholders Be Personally Liable for the Torts of Their Corporations?* 76 *YALE L.J.* 1190, 1195 (1967) (limited liability thwarts punishment of those personally culpable). However, in many circumstances where "punishment" is most desired, the wrongdoer can be reached directly through alternative approaches. See pp. 71-72 *infra*.

256. Limited liability regarding tort claims is only a partial expression of the disregard for tort creditors in collection law. Under the new bankruptcy law, they are subordinated to secured creditors, to taxing authorities, and to employees, and they share dollar-for-dollar with contract creditors. 11 U.S.C. § 726 (Supp. III 1979). The law's posture shifts somewhat, however, when we turn to the collection of penalties. Fines, penalties and punitive damages rank low in participation, *id.* § 726(a)(4), but fines and penalties cannot be discharged, *id.* § 523(a)(7). The law also denies discharge for judgments arising from willful and malicious injuries to the person or property of another. *Id.* § 523(a)(6). This nondischargeability may reflect a policy that, if applied in the area of limited liability, would preclude investor immunity from judgments for such debts. The provision that bankrupt corporation's debts are not dischargeable, *id.* § 727(a)(1), seems rather hollow if the investors, who would otherwise stand behind those debts, enjoy limited liability.

257. This group includes not only corporations, but also limited partnerships, government agencies protected by the laws of sovereign immunity, and often charities.

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This potential for conflict is not a new observation. Commentators ordinarily presume, however, that limited liability has won its accepted, if anomalous, place in the law by virtue of historically prevailing sympathy for capital formation.²⁵⁸ In other words, just as we have seen the law express through penalties a collective aversion to certain outcomes, so limited liability can be understood as the expression of a conflicting preference: to increase the supply of at least one form of business organization beyond ordinary market and legal warrants. But even assuming the value of large-scale capital accretions, it is hardly persuasive to justify the liability limits as social subsidies. Subsidies typically, and at their best, reward positive performance along narrowly defined lines. It is an odd subsidy that rewards those who do nothing more than fill out various documents of incorporation, that dilutes the disincentives for the flouting of public policy, and that singles out the injured as contributors rather than finding support from the community at large.²⁵⁹ The bankruptcy laws, which present the readiest analogy, do not go this far, particularly regarding fines and penalties.²⁶⁰

The “settled gloss of history” argument is troubled, moreover, by the fact that the historical pedigree for the invocation of limited liability against involuntary creditors, particularly following delict judgments, comes to us with a clouded title, at best.²⁶¹ Until the mid- to late nineteenth century, it was unclear how far the law would go toward charging a master with the intentional wrongdoing of the servant.²⁶² Even when the law had come to recognize vicarious punitive liabilities in cases where the master was an ordinary mortal, doubts still lingered

258. See Note, *supra* note 255, at 1190 n.† (quoting Nicholas Murray Butler) (“[T]he limited liability corporation is the greatest single discovery of modern man Even steam and electricity are far less important . . . and they would be reduced to comparative impotence without it.”) A recent report from China indicates that the People’s Republic of China is offering limited liability for joint ventures authorized by its Foreign Investment Commission in order to attract foreign capital. See Birenbaum, *Doing Business with China*, Wall St. J., Aug. 31, 1979, at 6, col. 4.

259. See Note, *supra* note 255, at 1196 (criticizing use of limited liability to encourage industry as unfair to individual tort victims).

260. See 11 U.S.C. § 727(a)(1) (Supp. III 1979) (corporation’s debts nondischargeable); *id.* § 523(a)(7) (fines and penalties nondischargeable).

261. That limited liability was not an inherent feature of earliest business corporations has been noted frequently; so far as I can discover, however, the historical uncertainty of its warrant to defeat collection of judgments for torts and crimes has largely escaped comment. Indeed, while social policy would seem to support piercing the corporate veil to establish investor liability more in tort and crime than in contract, the doctrine of “piercing” seems to operate more on behalf of voluntary (relying) creditors. See Note, *supra* note 255, at 1192-93.

262. See W. SEAVEY, *supra* note 43, § 89, at 155 (until second half of nineteenth century, master’s liability mostly limited to negligent acts of servant).

about doing so in the case of the corporation, which as a *persona ficta* seemed doctrinally incapable of intention or *mens rea*.²⁶³ These doubts sheltered the corporation itself from liability for various classes of intentional misconduct well into the nineteenth century and even until the early twentieth, particularly in the case of certain crimes.²⁶⁴

Thus, as long as the corporation itself could not have been liable for various classes of wrongdoing, questions of the investor's secondary liability for consequent unsatisfied judgments for those liabilities could not have arisen. In the period in which limited liability was gradually becoming the accepted practice—firmly, by the 1820s or 1830s²⁶⁵—no one would have expected the doctrine to entail any more than protecting investors from unsatisfied claims of the corporation's voluntary creditors,²⁶⁶ and perhaps from judgments arising from the agents' ordinary negligence²⁶⁷ within the scope of employment. Only later, when corporate liability for serious wrongdoing had grown from the exception to the rule, could the principle of limited liability have taken on, imperceptibly, a meaning not originally signified: that it gave investors the privilege to externalize the risks of judgments even for the most serious and deliberate misconduct.²⁶⁸

The question arises whether, whatever the theoretical misgivings about the doctrine, and whatever the historical clouds on its title, the limits on investor liability make much practical difference. In the case of most giant, publicly held corporations, there will almost inevitably be enough funds in the treasury to satisfy virtually any un-

263. See note 14 *supra* (discussing reluctance to attribute culpable states of mind to corporation).

264. See, e.g., *People v. Rochester Ry. & Light Co.*, 195 N.Y. 102, 88 N.E. 22 (1909) (manslaughter indictment does not lie against corporation because corporation not "person" under penal code).

265. See O. HANDLIN & M. HANDLIN, *COMMONWEALTH* 145-47 (rev. ed. 1969).

266. The personal liability of shareholders to voluntary creditors of an assetless corporation was clearly established by *Salmon v. Hamborough Co.*, 22 Eng. Rep. 763 (Ch. 1671). See Handlin & Handlin, *supra* note 248, at 13.

267. Corporate liability even for intentional torts did not emerge until the first half of the nineteenth century. In *Yarborough v. Governor & Co. of the Bank of England*, 104 Eng. Rep. 991 (K.B. 1812), the defendant corporation was held liable in trover, although perhaps because the action in question was taken under the corporation's common seal. Hallis traces agents' trespass as a source of corporate liability to *Mound v. Monmouthshire Canal Co.*, 134 Eng. Rep. 186 (C.P. 1842) and corporate liability for malicious torts to *Citizens' Life Assurance Co. v. Brown*, [1904] A.C. 423. See F. HALLIS, *supra* note 14, at xliv-xlvii.

268. In C. STONE, *supra* note 13, at 23-24, I suggest that the growth of limited liability was "a sort of historical *quid pro quo*" for investors, a protection extended in exchange for the increased range of corporate liability. Another possible explanation is hinted at in Note, *supra* note 255, at 1196 n.27, which questions whether "legislatures would have adopted limited tort liability in the first place had insurance been as generally available in the early nineteenth century as it is today."

insured legal judgment imaginable. As a result, the principle is likely to conflict with public policy only in the case of the thinly capitalized venture engaged in a high-risk activity. Nevertheless, we should not underestimate the continuing potential of limited liability to work social mischief. The problems extend far beyond the financially unaccountable taxicab companies that supply the paradigm case for the law schools; I have in mind, even more troublesomely, the firms that produce and handle such products as toxic chemicals. As long as limited liability is available as a protection, it is precisely in such areas of substantial third-party risk that we can expect to find a disproportionate population of small, financially unaccountable companies. Major firms will incline to externalize the risks of their more jeopardous undertakings by establishing subsidiaries; by leaving the "dirty business" to small, specialized outfits that are themselves questionably capitalized; or by creating "independent suppliers" whose umbilical cord to the firm is a loan and output contract, rather than stock, so that the major company that in reality stands behind the operation may be able to avoid some of the entanglements of being a technical stockholder-parent.²⁶⁹

To deal with some of the situations where limited liability most strongly conflicts with fundamental law-enforcement goals, prosecutors and plaintiffs can, with varying degrees of satisfaction, circumvent the

269. The history of Allied Chemical's production of Kepone, the highly toxic pesticide, illustrates the latter model, which involves the so-called "independent supplier." Allied manufactured Kepone in its own plant in 1966 but transferred production in 1973 to a newly formed corporation, Life Science Products, Inc. (LSP). LSP set up shop in an abandoned gasoline filling station next door to Allied's plant, processed the components that Allied delivered to it, and sold the finished product exclusively to Allied. The new company had two stockholders—both former employees of Allied—each of whom put into the company no more than \$1,000 of his own money but who were nevertheless able to secure a \$175,000 loan from a local bank. While LSP was nominally the borrower, Allied agreed with LSP to make the repayments through a "surcharge" Allied would pay on each pound of Kepone until the loan had been retired. Later, when the likelihood of far-reaching damage to the environment and worker health was revealed, Allied was subject to large fines, but only for the period during which production was carried out in "its own" plant. For the period after the date production had been shifted to LSP, LSP—not Allied—was convicted and fined \$3.8 million, a judgment that it could not satisfy, reportedly having \$32 in the till. Wall St. J., Oct. 6, 1976, at 2, col. 2. The government attorneys tried to hold Allied liable, but because LSP was technically not a subsidiary, but "an independent contractor"—however thinly capitalized and pseudo-separate its existence—the prosecution felt it had to fall back on charges that Allied had "aided and abetted" LSP in its wrongs, an allegation that presupposes some proof of actual knowledge. Allied was acquitted apparently on the basis of insufficient evidence. See Goldfarb, *Kepone: A Case Study*, 8 ENV'T L. 645, 658-60 (1978).

The moral may be that if Allied had arranged LSP's existence at the start of Kepone production, in 1966, it presumably could have eliminated its own criminal liability altogether. If this is the law, it would seem to encourage other companies contemplating high-risk ventures to set up similar arrangements with suppliers and disposers.

doctrine. In close corporation contexts, for example, where the firm's investors are often also its managers, there is the possibility of holding the key individuals directly accountable, both in crime and in tort, on the basis of their personal participation.²⁷⁰ Particularly where a subsidiary is involved, plaintiffs can allege a joint tort, a conspiracy between the two entities, or aiding and abetting.²⁷¹ There are, moreover, special legislative possibilities that would deal with some of these problems on an area-by-area basis: mandatory insurance,²⁷² for example, or, where licensing is required, a condition that companies engaged in high-risk ventures demonstrate financial capability adequate to meet the expected liability claims.²⁷³

Whatever the merits of these various options, none of them can be regarded as the functional equivalent of piercing the corporate veil. It is one thing to hold investors secondarily liable for judgments secured against the corporation for the corporation's wrongs, and quite another and more difficult task, especially where criminal-law burdens of proof are concerned, to establish their independent culpability by showing a conspiracy or aiding and abetting.²⁷⁴ Moreover, while mandatory insurance for companies engaged in high-risk activities may be appropriate to advance compensation goals,²⁷⁵ it would not be

270. See note 250 *supra* (citing authority that participation will bring liability).

271. See note 269 *supra* (prosecution in Allied Chemical case sought to hold Allied criminally liable on basis of conspiracy with "independent contractor"); Goldfarb, *supra* note 269, at 658-60 (discussing same case). For examinations of the doctrine of conspiracy between parent and subsidiary under the Sherman Act, see McQuade, *Conspiracy, Multi-corporate Enterprises, and Section 1 of the Sherman Act*, 41 VA. L. REV. 183 (1955); Comment, *Intra-Enterprise Conspiracy Under the Sherman Act*, 63 YALE L.J. 372 (1954).

272. See Note, *supra* note 255, at 1201-04.

273. See Price-Anderson Act § 4, 42 U.S.C. § 2210(a)-(c) (1976) (empowering Nuclear Regulatory Commission to establish levels of financial protection for each licensed facility); Outer Continental Shelf Lands Act Amendment of 1978, § 305(a)(1), 43 U.S.C. § 1815(a) (Supp. III 1979) (owners of vessels using offshore oil facilities must maintain evidence of ability to satisfy judgment for liability in maximum amount to which owner is exposed under Act); Clark, *The Duty of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 551 n.123 (1977) (discussing methods by which corporations could be required to be able to compensate tort victims).

274. See Goldfarb, *supra* note 269, at 659-60 (difficulty of establishing "actual domination" and "aiding and abetting" in Kepone affair). Even in civil litigation, prevailing collateral estoppel rules may force the plaintiff to undertake a separate action against the investors after judgment is returned unsatisfied against the corporation. See *Minton v. Cavaney*, 56 Cal. 2d 576, 581-82, 364 P.2d 473, 476, 15 Cal. Rptr. 641, 644 (1961) (second litigation required because investors not represented in first suit); Comment, *Res Judicata and Collateral Estoppel Beneath the Corporate Veil*, 66 CALIF. L. REV. 1093, 1100-03 (1978) (discussing present rule).

275. Not even these goals will always be satisfied, however. Apparently, standard liability policies exclude all contamination or pollution liabilities except when due to a sudden and accidental discharge or release. See HOUSE COMM. ON PUBLIC WORKS AND TRANSPORTATION, 96TH CONG., 1ST SESS., COMPENSATION FOR VICTIMS OF WATER POLLUTION 370-71 (Comm. Print 1979).

well suited for specific deterrence, since the consequences of intentional wrongdoing are generally uninsurable.²⁷⁶

There will remain, therefore, a considerable range of circumstances in which specific deterrence is desired, but will be realizable only by resort to “piercing the corporate veil.” Unfortunately, the standards for doing so remain, as Judge Cardozo lamented fifty years ago, “enveloped in the mist of metaphor,”²⁷⁷ and are, ironically, more readily available to contract creditors who can claim to have relied on the investors’ assets than to noncreditors, like the public prosecutor, who obviously cannot.²⁷⁸

The better approach would be to reverse the present presumption that limited liability is the norm, at least when applied to certain corporate delicts. The argument is built on the same principles already set forth in the discussion of Clusters 1 and 2. There are certain outcomes that society is particularly anxious to restrict, as evidenced by the superimposition of penalties on the market-determined, general-deterrence base that we have associated with harm-based liability rules (HBLRs). One way to restrict this excess is to increase the legal pressure on those with control over their supply, a technique examined in Cluster 1 in the context of imposing liability on managers as a way of inducing them to exercise intensified control over their subordinates. The same, obviously, could be done by intensifying the liability of the investors for the acts of the managers, who can be conceived of as the agents or subagents of the investors.

Even if increased investor liability could improve deterrence, its potential is restricted by much the same efficiency and morality constraints that we saw earlier. Particularly as share ownership diversifies, with all the problems of high monitoring costs for large numbers of investors, each with a relatively small stake, the level of monitoring we can realistically expect from the investors declines. In all likelihood, the added legal risk to investors would increase the cost of equity capital without significant reduction in unwanted behavior (other than through some unlamentable decrease in investment available for jeopardous activities). And from a moral perspective, there are the same reservations about imposing vicarious punitive liabilities on superior agents—in this case, the investors. Indeed, one wonders

276. See Bishop, *supra* note 181, at 1160 (noting common law rule against insurance for intentional wrongdoing); cf. *Hartford Accident & Indem. Co. v. Village of Hempstead*, 48 N.Y.2d 218, 397 N.E.2d 737, 422 N.Y.S.2d 47 (1979) (no insurance coverage of punitive damages awarded against municipal officers in federal civil rights action).

277. *Berkey v. Third Ave. Ry.*, 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926).

278. See R. POSNER, *supra* note 254, at 296-97; Note, *supra* note 255, at 1192-93.

whether the imposition of a "penalty" on the numerous, faceless shareholders of a defunct corporation would advance any of the real moral goals of the law.

But if these are, as I assume, the considerations that form the true basis for the present presumption in favor of limited liability, they constitute not so much warrants for protecting shareholders from liability absolutely, as for protecting them from the peculiarly onerous character of the joint and several liability that would prevail in the absence of limited liability.²⁷⁹ That is, if the limited liability rules are withdrawn, the only option that exists in present law may be to treat the investors, *inter se*, as partners,²⁸⁰ in which case each shareholder of a corporation like the Penn Central would have to stand behind every delict judgment in its indivisible entirety.²⁸¹ This would surely be unacceptable. But our choice need not be restricted to limited liability or ordinary partner's liability as the only alternatives. As a compromise, we could provide that when an insolvent corporation has unpaid debts arising from a criminal fine or punitive damage award, or perhaps even civil liabilities arising under federal statutes whose policies do not appear fully discharged by compensation,²⁸² shareholders would be held liable on the debt as guarantors but not as partners: each would be liable only in proportion to his or her equity interest.²⁸³

279. For a general discussion of the reach of joint and several liability, see 1 F. HARPER & F. JAMES, *THE LAW OF TORTS* § 10.1 (1956).

280. See R. HESSEN, *IN DEFENSE OF THE CORPORATION* 21 (1979) ("[a] partner who may be willing to pay his *proportional* share may, understandably, be unwilling to pay the whole amount"). Hessen would apply vicarious liability only to "those shareholders who play an active role in managing an enterprise or in selecting and supervising its employees and agents. The tort liability of inactive shareholders should be the same as that of limited partners . . ." *Id.* at 20. But as well as introducing the difficult distinction between "active" and "inactive," this proposal may beg the question that society wants asked—who ought to have been managing?—or may discourage shareholder participation and so reduce the amount of shareholder control to a socially suboptimal level.

281. Each would, of course, have the rights but also the expenses of indemnity or contribution against his co-venturers.

282. Cf. *Hartford Accident & Indem. Co. v. Village of Hempstead*, 48 N.Y.2d 218, 223-24, 397 N.E.2d 737, 740-41, 422 N.Y.S.2d 47, 50-51 (1979) (judgment under federal civil rights statute apparently punitive as well as compensatory).

283. Of course, if such a rule is applied only to shareholders, it will drive up the cost of equity financing and create an incentive to finance corporate enterprises through other instruments. Therefore, in order to reach appropriate results in the face of pseudo-separate "contractual" arrangements of the type used in the *Allied Chemical* case, see note 269 *supra*, a parallel rule defining "equity interest" for these purposes must be developed, with consideration for capital investment and other consequences.

There is also a related time problem: why create liabilities for those holding shares at the time that the corporation fails to satisfy the judgment rather than for those who held during the course of, and who perhaps benefitted from, the wrongdoing that led

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In effect, this proposal would dispense with the present practice of deciding whether to disregard corporateness—absolutely and after the fact—by reference to metaphorical, vague, and often questionably relevant inquiries into whether the actors maintained the various traditional niceties of separate corporate existence: adequate capitalization, separate books, different officers, and segregated bank accounts.²⁸⁴ In their place, we would substitute a relatively simple, predictable, *ex ante* rule, under which the risk that the investors might bear punitive liabilities would rise, but only in some proportion to their actual ability to select and monitor their management. In the typical giant, publicly held enterprise, where the fragmentation of shareholdings makes controlling agents extremely costly, and the small-stakes problem makes doing so less worthwhile, no ordinary investor's exposure would be more than nominal. But as we move into situations where the investors constitute an increasingly tight-knit control group—the limiting case being the corporation that has set up a wholly owned subsidiary aimed at externalizing the risks of legal hazard—the prospective *pro rata* liability of each investor would rightly increase. In these small-number settings, moreover, the investors could arrange in the management-compensation contracts for an indemnity against the responsible managers, thereby bargaining towards the most efficient balance of risk bearing and control.

Whether or not we adopt this proposal, in cases where the corporation appears unable to discharge penalty debts, prosecutors should intensify efforts against responsible corporate agents, giving increased consideration to imprisonment, even in circumstances where such penalties would otherwise not be indicated. Indeed, harsher punishment could well be imposed on superior agents whose vicarious responsibility for the misconduct itself seems attenuated, if, as controlling persons or directors, they had responsibility for maintaining capital levels to permit satisfaction of the penalty and appear derelict

to the judgment? There are several partial answers. First, legal liabilities of such a magnitude as to jeopardize the continued existence of the corporation are those that probably can best be anticipated by buyers, who will account for the jeopardy in their price. Second, purchasers of such securities who took without notice of what would obviously be material facts might be able to sue for fraud. Finally, shares of the pseudo-separate companies we are ordinarily concerned with are generally not traded.

284. See Annot., 46 A.L.R.3d 428 (1972) (discussing factors relevant to attempt to pierce corporate veil). These tests seem to reach their most blithering uselessness when plaintiff's efforts to pierce are disallowed for failure to allege that the defendants were "*actually* doing business in their individual capacities." *Walkovszky v. Carlton*, 18 N.Y.2d 414, 420, 223 N.E.2d 6, 10, 276 N.Y.S.2d 585, 590 (1966) (emphasis added); see *Walkovszky v. Carlton*, 23 N.Y.2d 714, 244 N.E.2d 55, 296 N.Y.S.2d 362 (1968) (upholding complaint repleaded to include such allegation).

in not having done so.²⁸⁵ It is true that, if the law should move in this direction, managers will demand additional compensation when their companies are thinly capitalized relative to the penalties they are likely to incur. But the resulting incentives are, after all, the very sort that an adequate model of corporate control should provide for our society.

Conclusion

The law grew up around notions of what was possible, effective, and just in the control of ordinary human beings in ordinary, extra-institutional contexts. As corporations came to assume an increasingly prominent role in social activity, the law, by the simple device of deeming them "persons," fitted corporations into the preexisting system for the control of misconduct. But the value of these borrowed approaches is becoming more and more suspect as applied to modern complex bureaucratic organizations and to those who labor within them. Hence, some reevaluation is in order of the premises and techniques that underlie our efforts to control corporate conduct.

Such a reevaluation demands that we accord the control of corporate organizations the concentrated attention of an independent field of law. This requires us to be prepared, on the one hand, to recognize the fundamental differences between formal organizations and ordinary persons, and, on the other, to appreciate the significant features that the several organizational types possess in common, and on which a comprehensive approach to corporate control must build. An article such as this, which singles out business corporations for sustained consideration, can provide at best a prolegomenon to the creation of the necessary model. Nevertheless, at least two insights of common and considerable significance can be gleaned from the discussion.

First, it seems evident that, of all the types of corporate bureaucracy that the law may seek to discipline, the business corporation is most appropriately suited to the technique of enterprise liability. Ideals of acceptable social conduct are conveniently transmitted in monetary signals that the business organization can translate, in turn, into its

285. For instance, it has been suggested that the Clean Water Act be amended so that "individuals who do not provide adequate insurance or reserves . . . be treated like those who cause injury with malice." *Hazardous and Toxic Waste Disposal: Joint Field Hearings Before the Subcomms. on Environmental Pollution and Resource Protection of the Senate Comm. on Environment and Public Works*, 96th Cong., 1st Sess. 223 (1979) (statement of Peter Weiner). If such rules are adopted, they should not make corporate officers individually liable for penal debts where the firm's inability to pay is the result of unanticipated commercial losses. Prosecutorial discretion and ordinary mitigating factors such as lack of knowledge or intent should remedy any possible unfairness in the rule.

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native tongue, the language of profits and losses. The approach has the further advantage of entrusting to the superior expertise of the enterprise participants the task of putting their own house in order. Yet even as applied to the business corporation, where we can expect them to work best, enterprise liability measures, with their “black box” respect for interior relationships, have their limits. In some circumstances, it becomes necessary to replace or reinforce enterprise liability with various interventionist techniques that restrict the autonomy of the participants. These interventions—overrulings, we might say, of the ordinary presumption in favor of managerial expertise—range from displacing the enterprise from full control over its agents’ conduct and compensation, to subjecting the enterprise to certain constraints on the selection of bureaucratic and production variables. The more our attention shifts to forms of organization less clearly animated by profit or by some analogously vital resource that an enterprise sanction can jeopardize, the stronger the case will be for interventionist alternatives, particularly for bureaucratic Standards.

Second, the selection of techniques cannot be implemented with tunnel vision. The aims that are sought through one technique—say, criminal penalties against agents—can be undone by independent techniques such as indemnification of the agent under state codes. The most rationally calculated threats against the enterprise can be mocked by bars to judgment, such as limited liability in the case of the business corporation. What is required is an imaginative coordination of the many areas that provide the whole panoply of liabilities, privileges, immunities, and indemnities on which the law is framed.