LAW AND CONTEMPORARY PROBLEMS

Volume 60 | Autumn 1997 | Number 4

PRIVATE LITIGATION AND THE DETERRENCE OF CORPORATE MISCONDUCT

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I

INTRODUCTION

No country so empowers its citizens to redress the social harms committed by others as does the United States. Compensating the injured and deterring future violations are frequently seen as complementary objectives of private suits. Our legal system further affirms its commitment to compensation and deterrence through modern joinder rules and class action procedures, not to mention contingency fee arrangements that shift the risks of litigation from the plaintiff to the attorney who can better absorb the suit's risks.

The lofty vision that a private suit deters misbehavior while also compensating its victims is not free of doubt; the unease with this proposition is greatest when the source of the misconduct is committed by corporations. This article examines the linkage between private litigation and the deterrence of corporate misconduct. Part II considers whether holding the entity strictly liable for the misconduct of its agents maximizes the deterrence effects of vicari-

This article is also available at http//:www.law.duke.edu/lcp.

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The author benefited greatly from the reviews provided by Professors Steven Choi, John Payne, Randall S. Thomas, and Elliott J. Weiss, as well as all the participants of the *Deterring Corporate Misconduct* conference. The author would also like to express his appreciation for the support of the E.T. Bost Research Fellowship during the preparation of the article; to Mr. Charles R. Dilts and Ms. Shulamith Klein, for their assistance in obtaining much of the insurance data examined in Part II of the article; and to Mr. Seth Neyhart, for his research assistance.

ous liability or whether a duty-based entity liability standard would lead to more aggressive deterrent efforts by the entity. Because misbehavior is carried out by individuals and not inanimate entities, the initial focus is to understand better why employees misbehave. Part II then reexamines the predictive value of the economists' model that proffers that deterrence is best achieved by pricing the conduct. Though pricing the offense is a crucial strategy to deterring misconduct, Part II concludes that much more is achieved by increasing the detection efforts for misconduct than by increasing the sanction that is imposed for detected misconduct. This leads to the question whether detection is encouraged or hampered by holding the corporation strictly liable for its employees' misconduct or whether the corporation's surveillance efforts will be greater if its liability is duty-based. The article takes a pragmatic approach, and thus considers the environment in which private litigation exists. No environmental consideration is more practical or dominant than the scope of the corporation's director and officer ("D&O") insurance policy. Part III considers the impact of insurance on the deterrence objectives of private suits for corporate misconduct. Much of what is developed in Part II depends on the employees' misconduct subjecting the corporation's agents or the corporation to the financial consequences of such misconduct. To the extent that any liability is borne by the corporation's insurer, it shields both the agents and the corporation from these consequences. Part III next considers to what extent insurance undercuts the deterrence effects of private litigation. In Part IV, we conclude by reviewing the evidence and arguments that present a more positive view of the deterrence effects of private litigation.

II

DOES VICARIOUS LIABILITY DISSERVE DETERRENCE?

A. Misbehavior Through the Economists' Lens

With the simplifying, albeit reasonable, assumption that individuals or their employing entities are utility maximizers, the economists' response to how to deter misconduct is to price any misbehavior. Assuming the entity and its agents are rational economic actors, misbehavior will occur only when its expected utility exceeds the disutility of its accompanying punishment. Central variables to this equation are the size of the fine and the joint probabilities of detection, prosecution, and conviction for the violation. Deterrence under the model occurs by affecting the violation's disutility by varying the amount of the fine and/or the probabilities associated with the sanction's imposition.

Because the probability of the sanction's imposition can always be expected to be less than unitary, the expected sanction must, under the model, be greater, and one would expect in most cases would have to be significantly greater, than the social harm caused by the violation if misconduct is to be deterred by assigning a price to its occurrence. If the economists' model captures fully the forces that guide one's decision to misbehave, we are in very serious trouble because there is powerful reason to believe that misconduct is substantially undeterred. On this point, consider that after analyzing sentencing data of the federal courts, Professor Cohen concludes that total sanctions for business offenses approach, but do not equal, the social harm of their offenses.[1] Thus, though the rising level of entity sanctions appear to force prosecuted entities to internalize the social costs of their misbehavior, the imposed sanctions, as collected by Professor Cohen, have not risen to a level sufficient under the economists' model to convince firms of the disutility of engaging in misconduct. Simply stated, on average, crime appears to pay, and its profitability arises because crime is underpriced.

There are many reasons to believe that the economists' model captures poorly the forces that cause a corporation's personnel to cross the line. To the extent the model fails to understand why individuals misbehave, its prescriptive value for deterring misbehavior is weakened substantially. One major concern with the economists' model is that it assumes misconduct is the product of a rational economic person; acts are taken and avoided by the calculus of their utility to the actor and indirectly their effects on the employer. This assumption stands in sharp contrast to the insights provided by organization behaviorists, social psychologists, and others who have studied the inner-workings of business enterprises. Collectively their work identifies a broad array of forces that guide the behavior of managers and their subordinates, many disconnected to the near perfect wealth maximization assumed in the economists' model.[2]

Not the least to qualify the notion that deterrence can be achieved by pricing misconduct is the insight that as the scale of business enterprises grows, firms and their agents cease to function as mere extensions of the 19th century economic man.[3] Managers do not act solely to maximize their firm's profits, but also to maximize the managers' interests that can, in the long term, conflict with profit maximization. Managers may, for example, choose to pursue growth in assets, sales, market share, or simply power, which may not correlate closely to the employer's profit objectives. Separately, the manager's delicts frequently are in response to the pressures placed on them by the employer-imposed goals for profit, sales, etc.[4] And there is a growing awareness that organizational structures within the firm are important contributors to the will-

1. *See* Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-1990*, 71 B.U. L. REV. 247, 253 (1991). In an earlier study, using data that did not reflect the impact of the Sentencing Guidelines on corporate violators, Professor Cohen concluded that the median sanction represented only 13% of the violation's social harm. *See* Mark A. Cohen, *Corporate Crime and Punishment: A Study of Social Harms and Sentencing Practice in the Federal Courts, 1984-1987*, 26 AM. CRIM. L. REV. 605, 618 (1989).

2. For a review of the disconnection between the economists' model and the body of social science and business research regarding the motivation and behavior of company personnel, see John Byrne & Steven M. Hoffman, *Efficient Corporate Harm: A Chicago Metaphysics*, *in* CORRIGIBLE CORPORATIONS & UNRULY LAW 101-36 (Brent Fisse & Peter A. French eds., 1985).

3. *See id*. at 114.

4. The leading study to document this cause for middle manager misbehavior is MARSHALL BARRON CLINARD, CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT (1983).

ingness of managers to misbehave.[5] Each of these considerations confound the element of choice that underlies the utility-maximizing economic man.

Further disquiet with the economists' model arises after understanding the unlikelihood that misconduct can be fully priced in the corporate setting. Whether the object of the sanction is the firm or its misbehaving agents, serious practical problems arise with a substantial sanction's imposition. With regard to the agent, there is the well-recognized problem of the sanction dwarfing the agents' personal assets so that the sanction arguably will not achieve its full deterrent effect.[6] Thus, if the misconduct produces a social harm of $1 million and the probability of the misconduct being sanctioned is twenty percent, the sanction must not be less than $5 million to balance the utility of misbehavior with its disutility. The argument proceeds, however, that if the agent's wealth is less than the prospective sanction, for example her net worth is $350,000, there will be under-deterrence of the misconduct if the agent in this case is the sole focus of the misconduct. The entity's responsibility for some portion or all of the expected sanction completes the equation. Entity liability spreads the cost of the violation so that the entity also faces incentives to curtail its agents misbehavior when it is efficient to do so. But entity liability can lead to draconian results on the entity and its shareholders.[7] Because there is a very low likelihood of detection and prosecution for most offenses, or that a sanction will be imposed as a consequence of such prosecution, the sanction in most instances must be extremely great to deter the misconduct. Thus we can understand why corporate sanctions remain low in comparison to the level called for by the economists' model.

Even stronger challenges to the economists' model are to the economists' assumption that the actor conforms his conduct to expected utility theory,[8] which states that decisions made under uncertainty are rational if, for any given level of risk, the actor seeks to maximize expected returns (defined as the expected outcome weighted by the probability of an outcome's occurrence) and the actor seeks to minimize the level of risk for equivalent expected returns. Thus, consider the problem of the manager faced with the choice between acting collusively with competitors to fix prices or not colluding and facing serious repercussions with her manager. The cause of this choice is her employer offering a $50,000 bonus as well as a favorable report of her leadership if her division achieves a certain level of sales. The manager is aware that she will not meet her employer's goal unless she colludes to set prices with her competitors. There is but a ten percent likelihood that her colluding will be detected; if de-

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5. *See, e.g.*, Gilbert Geis, *Criminological Perspectives on Corporate Regulation: A Review of Recent Research*, *in* CORRIGIBLE CORPORATIONS & UNRULY LAW, *supra* note 2, at 78-80.

6. *See* Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 863-65 (1984).

7. John C. Coffee, Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 396 (1981).

8. The leading work on this subject remains JOHN VON NEWMANN & OSKAR MORGENSTERN, THEORY OF GAMES AND ECONOMIC BEHAVIOR (1944).

tected, the sanction is a civil fine of $50,000 plus a decline in her future earnings in the amount of $1,150,000.[9] We further assume that if she does not collude, so that the sales goal is not achieved, there is a fifty percent likelihood she will be fired and her future life-time-earnings will be $150,000 less than if she were not fired; there also is a fifty percent likelihood that she will not be fired for missing the employer's sales goal, but she will receive an adverse performance rating which will prevent any future appreciable change in her future income. If the above figures are the likely outcomes for the choice facing the manager, obeisance to expected utility theory (not to mention her conscience) would call for her to avoid colluding. Both choices present the same (negative) expected value, but the choice to collude is by far the riskier choice with a variance around this expected value being +$50,000 to -$1.2 million compared with the tighter variance of the noncollusive choice of $0 to -$150,000. It should also be noted that the decision not to collude is driven by the sanction that will follow from her being caught. Though the state-imposed portion of the sanction is only $50,000, the collateral effects of being caught increase the total sanction for the violation to $1.2 million. Thus, pricing the offense in this situation will lead to the result that the economists argue is necessary to deter the manager's misbehavior. But this result depends on the manager acting pursuant to expected utility theory.

The expected utility model is challenged from many sectors in the social sciences. The most fundamental qualification to the theory is found in research of cognitive psychology that teaches that individuals process complex information, such as that accompanying risky choices, in a serial fashion and use a variety of heuristics to keep that process within the bounds of their capabilities.[10] With such bounded rationality, actors simplify complex decisions by employing various editing techniques so as to bring the decision within their competence. The consequence of such editing is that decisions that are ultimately reached frequently vary from that predicted by the expected utility model.[11]

A far more reliable model in capturing the decisionmaking process actually employed in making risky choices is that offered by Professors Kahneman and Tversky, which is more generally known as prospect theory.[12] Among the tenets of prospect theory is that choices are first edited in terms of their outcomes' relation to a specific target point. For example, in the uncomplicated choice

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9. The decline in her life-time earnings is attributable to her reputational loss as a consequence of having engaged in price fixing.

10. For a clear and insightful examination of this area, see Eric Johnson & John Payne, *The Decision to Commit a Crime: An Information-Processing Analysis*, *in* THE REASONING CRIMINAL: RATIONAL CHOICE PERSPECTIVES ON OFFENDING 170, 172-83 (Derek B. Cornish & Ronald V. Clarke eds., 1986).

11. *See, e.g.*, Paul J. H. Schoemaker, *The Expected Utility Model: Its Variants, Purposes, Evidence and Limitations*, 20 J. ECON. LIT. 529 (1982) (stating that decisions that are consistent with the expected utility model are more the exception than the rule).

12. Their classic work is Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979). *See generally* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982).

above, each outcome was assessed in terms of its impact, positive or negative, on the manager's present wealth. Thus the bonus was viewed by the manager as a positive net addition because it added $50,000 to her wealth. But consider the important change in the manager's decisionmaking if she frames her choice differently so that her reference point is not in terms of how her wealth changes if she meets her employer's sales goal.

In the above example, consider the results if the manager instead of believing that she had to prove herself to gain the $50,000 bonus viewed that as an expected outcome; that is, the bonus was hers to lose. From this choice-editing perspective, the target point is now the $50,000 which she believes is within her grasp. Thus, the outcomes expected by colluding are a ninety percent chance of having no effect on her and a ten percent chance of yielding a $1.2 million negative impact on her wealth; if she avoids colluding, there is a fifty percent chance of losing $50,000 and a fifty percent chance of suffering a $150,000 loss. Another way of phrasing the choice facing the manager when the target point is "retaining" the $50,000 bonus is that collusion is the only option that will enable her to meet her employer's sales goal. Each outcome for the noncollusion choice produces a sure loss. With the hypothetical so rephrased, the most fundamental insight of prospect theory, namely that managers generally are both risk averse and risk preferring,[13] becomes important in understanding the manager's consideration of the two choices. Under prospect theory, aversion to or preference for risk depends upon the outcomes of choices in relation to the target point. For example, studies have with fair consistency demonstrated that managers are risk preferring whenever most of the outcomes posed by the choices facing them fall below the target point.[14] In such a situation, managers tend to prefer the choice that affords a chance of meeting or surpassing the target point. Correlatively, risk aversion is typical when the expected values are above the target point.[15] The manager acting according to prospect theory, therefore, will likely choose the risk-preferring choice to collude since it has the only outcome that satisfies her target point regardless of its potential accompanying sanctions.

Equally important in the manager's decision is that the choice not to collude presents an outcome that the manager will view as ruinous—a fifty percent

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13. The pathbreaking work in this area is Kahneman & Tversky, *supra* note 12; *see also* Peter C. Fishburn, *Mean-Risk Analysis with Risk Associated with Below-Target Returns*, 67 AM. ECON. REV. 116 (1977). For empirical support of the theorem, see John C. Hershey & J.H. Schoemaker, *Risk Taking and Problem Context in the Domain of Losses: An Expected Utility Analysis*, 47 J. RISK INS. 111 (1980); John W. Payne et al., *Translation of Gambles and Aspiration Level Effects in Risky Choice Behavior*, 26 MGMT. SCI. 1039 (1980). For a general review of work in the field, see Schoemaker, *supra* note 11.

14. *See, e.g.*, Duncan M. Holthausen, *A Risk-Return Model with Risk and Return Measured as Deviations from A Target Return*, 71 AM. ECON. REV. 182 (1981); John W. Payne et al., *Further Tests of Aspiration Level Effects in Risky Choice Behavior*, 27 MGMT. SCI. 953 (1981).

15. *See* Payne, *supra* note 14, at 954 (stating that strong aversion shown for choice that presents the least downside risk and, when all outcomes for both choices are above the target level, they prefer the choice having the highest minimum outcome, even though that choice presents the lower expected value overall).

chance of termination and a consequent loss of future earning power. When a choice includes such a ruinous outcome, the tendency is to edit that choice in such a way that the ruinous outcome is eliminated from further consideration.[16] This most likely would occur by assigning an even higher weight to that outcome so that its negative effect assumes even greater significance in the manager's ultimate decision. Though the decision to collude also entails the ruinous outcome—a ten percent chance of detection and termination—we may expect that the lower probability associated with this outcome will receive not nearly as much weight in the manager's decision as the risk of termination for failing to meet her superior's target point.

In the above example, we may well ask why a manager would even consider the risk of colluding and being subject to a $1.2 million sanction if caught when the reward of colluding is the disproportionately smaller $50,000 bonus from her employer. Prospect theory could be invoked to explain this behavior. Under prospect theory, the weights assigned to outcomes are determined not by the probability of an outcome's likely occurrence, as is the case under expected utility theory, but are determined by further editing of the facts facing the actor. In this process, actors tend to ignore highly unlikely events and tend to view highly probable events as certain events.[17] "This characteristic implies that a potential criminal may well ignore low probabilities of apprehension and see high probabilities of gain from breaking . . . [the law] as a certain outcome."[18] It should be noted here that the choice preferred by the manager, to collude, is unaffected by the violation having been priced; the sanction assumes no importance when (1) the decision is framed so that the only choice that produces possible outcome at or above the target point is to violate the law or (2) the outcome of not being caught is perceived as a certain one rather than merely a probable outcome. In the above hypothetical, both of these standard editing characteristics are present.

We can also explain the fount of the conflict facing the manager's choice between colluding and abiding by the law with a new assumption. The manager's true conflict is not between her conscience and $50,000, but instead it is between her conscience, on the one hand, and, on the other hand, a $50,000 bonus *plus* a favorable evaluation, which we assume produces an expected gain in her earning potential that has a present worth of $700,000.[19] Under this new assumption, the expected value between the two choices are no longer equal. Expected utility theory now provides much less descriptive power regarding the

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16. *See* Dan J. Laughhunn et al., *Managerial Risk Preferences for Below-Target Returns*, 26 MGMT. SCI. 1238 (1980).

17. *See* Kahneman & Tversky, *supra* note 12, at 283. It is also noteworthy that the decision-maker consistently assigns greater weight to losses than to gains, thus reflecting the lower value placed on marginal gains vis à vis marginal losses. *See* Pamela Lattimore & Ann Witte, *Models of Decision Making Under Uncertainty: The Criminal Choice*, *in* THE REASONING CRIMINAL: RATIONAL CHOICE PERSPECTIVES ON OFFENDING 129, 148 (Derek B. Cornish & Ronald V. Clarke eds., 1986).

18. Lattimore & Witte, *supra* note 17, at 143.

19. This reflects the reasonable assumption that her value in her employer's eyes, not to mention the general market for managers, increases because she met her employer's performance goal.

manager's likely decision since there is no clear choice for the rational actor under the dominance rules, discussed earlier. One choice clearly presents more risk, but higher rewards, than does the other. Under expected utility theory, the choice exercised becomes highly personal to the manager, depending on her own unique utility function.

Prospect theory, in contrast, is much more helpful in explaining the likely choices facing the manager when those choices present both different expected returns and different risks. The true rewards for colluding now equal $750,000 and enjoy a probability that approaches near certainty. Though this is the riskier choice than not colluding, having more upside and downside potential than staying within the bounds of the law, missing the target point, and suffering the consequences, prospect theory suggests that the manager will be risk preferring because collusion is the only outcome that provides a result above the target point. Again, the pricing of the offense appears not to drive the manager's assessment of the choices facing her.

B. Why Should the Entity Be Liable

Justification for entity liability lies in its role as an instrument for regulation.[20] The blameless entity and its innocent owners operate under threat of liability for the misdeeds of their agents so as to stimulate managers to employ procedures to deter possible agent misbehavior.[21] Moreover, entity liability places responsibility upon the party with the greatest knowledge and control of the risks of its activities because it is the best party to undertake appropriate

20. Though private liability serves both deterrent and compensatory objectives, in the courts' eyes the latter dominates the former when a compensatory objective appears lacking. *See* James D. Cox, *Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984). For example, derivative suits are dismissed when there is evidence the corporation benefited from the fiduciary's misbehavior. *See, e.g.*, Bordon v. Cohen, 231 N.Y.S.2d 902 (N.Y. Sup. Ct. 1962); *see generally* Note, *Pleading and Proof of Damages in Stockholders' Derivative Actions Based on Antitrust Convictions*, 64 COLUM. L. REV. 174, 179 (1964). Furthermore, punitive damages must bear a reasonable relationship to the actual harm inflicted on the plaintiff. *See* BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 580-81 (1996). The private suit's compensatory orientation is even more evident in its support for the entity's vicarious responsibility for the acts of its agents. Even though doctrines such as *respondeat superior* liability can separately be justified out of efficiency consideration since it forces the entity to internalize fully the costs of its operations, it is equally true that entity liability provides greater likelihood that those harmed by the agent's misconduct will be compensated than if they were left only to the much smaller resources of the misbehaving agent. *See, e.g.*, Kraakman, *supra* note 6, at 865; Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563 (1988).

21. Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 27 (1980) (stating that even though there is cause to question the morality of imposing liability on innocent shareholders it is acceptable to impose such responsibility on investors for ordinary tort and contract damages); Kraakman, *supra* note 6, at 875 ("[S]tigmatic connotations of legal breach have already largely disappeared" in the corporate commercial setting. "Personal liability . . . is already understood as a neutral incentive, akin to a tax on risk taking, rather than a 'punishment.'"). This is especially noteworthy when the entity's responsibility arises in a criminal proceeding rather than the civil setting that is the focus of this paper because the traditional criminal law basis for responsibility, blameworthiness, is absent when responsibility is imposed vicariously. *See* Albert W. Alschuler, *Ancient Law And The Punishment of Corporations: Of Frankpledge And Deodand*, 71 B.U. L. REV. 307, 312-313 (1991).

strategies either to reduce or insure those risks.[22] Thus, entity liability conscripts the entity's resources to the deterrence of its agents' misconduct. The corporation's conscription is especially appropriate because its relationship to its agents provides both the authority and the power to influence their behavior.[23] Furthermore, within the complex entity, where tasks are frequently fragmented among multiple actors and responsibility is shared, difficult causation questions may arise regarding who within the organization should be held responsible. This consideration becomes overwhelming when one considers the various organizational influences—the decentralization of decisionmaking, production and profit targets, an emphasis on financial rather than societal objectives, and the absence of aggressive monitoring programs—which can cause agents to misbehave. When such factors are considered, it is reasonable to conclude that the fault is not merely that of the agents, but is systemic so that organizational responsibility, not simply individual responsibility, should follow. Finally, entity liability imposes liability on the party best able to address the social burdens of its activities, and more fairly reconciles the burdens and benefits of its activities than to condition responsibility on a finding of fault.[24]

One clear difference between the predictive value of expected utility theory and prospect theory is that the strategy suggested by the former is that deterrence is achieved by pricing the offense through varying either the sanction or the likelihood of detection. On the other hand, prospect theory suggests that the probability of detection is far more likely to have an impact on agents than will increasing the sanction when there is a very low probability of detection. This makes a strong case for entity liability, since enlisting its efforts to detect its employees' delicts will, under prospect theory, favorably affect deterrence of its employees' misconduct. Also, the employer should credibly communicate its commitment to sanction severely employee misbehavior, and it should consider structuring the sanction so that it more than meets any perceived "ruinous result" criteria its employees should apply. Again, under prospect theory, this would cause employees to exclude choices that include an outcome that produces such a ruinous result.[25]

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22. *See* Kraakman, *supra* note 6, at 874.

23. Stone, *supra* note 21, at 29 n.115.

24. *See generally* Gregory C. Keating, *The Idea of Fairness in the Law of Enterprise Liability*, 95 MICH. L. REV. 1266 (1997) (arguing that though most commentators have examined entity liability for defective products from an economic perspective of efficient prevention of accidents and the spreading of losses such that enterprise liability exists even for risks that are no different than those that commonly confront citizens, considerations of fairness justify entity liability only for those risks that its own activities produce; otherwise, absolute liability for defective products does not lead to fair result or to results that foster individual choice).

25. Though encouraging employers to sanction its employees severely is a worthy objective, it may be one that cannot realistically be achieved. The most severe sanction would be termination. Even here the sanction may not be viewed as ruinous if the employees can find that their entry into the labor market is not affected by their employer's sanction; this is particularly the case if the employer is unwilling to publicize the true causes for termination. The cause for such reluctance is that it may invite suit by the discharged employee who may then invoke, perhaps extortionately, that she was libeled by her former employer or the former employer may wish not to draw attention to the misconduct by the employee for fear it will invite legal actions by third parties against the corporation because of the

To be sure, the agent and employer may well contract around the problem so that efficient absorption of the risk occurs, despite society's choice whether to first impose fault on the agent or the employer.[26] Any such *ex ante* contracting, however, will be imprecise and, more specifically, will entail significant transaction costs by the parties, so that *ex ante* contracting is likely to prove inefficient. Moreover, the best we can expect in such contracting is that the parties will impound in their contract only the average expected misbehavior of the agent, which will understate the harm actually caused by the agent who does misbehave. Because of the agent's limited resources, the entity can, with vicarious liability, therefore not be able to protect itself fully, absent insurance. Agents also will be most interested, when contracting, with whether they enjoy broad rights to either insurance or indemnification. For these reasons, a far more efficient response would be an *ex post* settling up between agent and entity, such as that provided by indemnification or insurance,[27] discussed below. Nevertheless, there are several independent reasons that justify the entity's responsibility, although, as will be seen, those justifications are not so compelling as to exclude the responsible agent from being jointly responsible for the sanction.

C. Does Entity Liability Cause Perverse Effects?

Even in the face of so many broad reasons supporting entity liability, vicarious strict liability continues to be under review, even assault, by those who complain it is unfair and under deters misconduct. One level of attack on entity liability focuses on the fairness of imposing financial burdens on the corporation and, indirectly, its shareholders for its personnel's misbehavior, which can as easily be seen as driven by managerial self interest as by the employer's interests. This cause for complaint is most seriously advanced in the context of securities class action litigation.

> [M]any forms of open-market securities fraud bear a closer family resemblance to insider trading . . . [so that] we are left to wonder why the law makes insider trading largely a matter of individual liability, while self-serving securities fraud is addressed almost completely from an entity liability standpoint.[28]

Data in support of this view of securities violations can be found in a study of 111 frauds on the market in which 67.5% of the cases involved instances where the managers' apparent motive for misrepresenting their firm's financial position and performance was to gain time so that they could possibly overcome the operating problems plaguing the firm. Such a motive implicates the managers' self interest since reporting the adverse effects being experienced by the firm necessarily questions the managers' stewardship.

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former employee's misbehavior.

26. *See generally* Roberta Romano, *Theory of the Firm and Corporate Sentencing: Comment on Baysinger and Macey*, 71 B.U. L. REV. 377 (1991).

27. *See* Kraakman, *supra* note 6, at 865.

28. Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 ARIZ. L. REV. 639, 655 (1996).

One can easily extrapolate from the reasoning applied to securities fraud cases a template for managerial self interest that can apply across a wide range of misbehavior committed on behalf of the corporation. The antitrust violations committed in the great electrical conspiracy five decades ago are traced to the firm's managers who faced increasing competition that threatened to reduce the profits reported by their division.[29] Because they did not wish to report lower profits for fear it would jeopardize their advancement within the firm, the mangers conspired among themselves when submitting bids for sales to governmental entities. Similarly, environmental violations frequently are committed to assure that production schedules are met or that operating results remain favorable to the managers' budget.[30] Indeed, there is hardly any behavior within the corporate setting that cannot be linked to advancing a manager's self interest.

Challenges to entity liability premised on an argument that managers are acting out of self interest must address the question whether the managers' self interest—buying time to right the floundering ship, maximizing profits, or meeting production schedules and making budget—are opposed to the corporation's interest. Fault on the organization's part may well be found in the demands it makes directly on its personnel to contain costs, expand market share, and increase margins, as well as its responsibility for the culture it naturally spawns to accomplish these objectives.[31] It is important here to understand that when managers misbehave in the scope of their employment, they normally do so for an objective they believe will advance their employers' interest. When this occurs, their misbehavior can easily be seen as that of the employing organization.

Not surprisingly, the most serious challenge to entity liability argues that vicarious liability leads to the under-deterrence of misconduct. The attack is not against entity liability as such, but upon the entity being liable without fault on its part, as occurs under the standard application of respondeat superior liability. The most developed argument for this position is that offered by Professor Jennifer Arlen, who counsels that vicarious liability produces "perverse effects."[32] She reasons that, because incremental expenditures by the corporation

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29. *See* Gilbert Geis, *The Heavy Electrical Equipment Antitrust Cases*, *in* WHITE COLLAR CRIME: CLASSIC AND CONTEMPORARY VIEWS 143 (Gilbert Geis et al. eds., 3rd ed. 1995). Because the environment varies so greatly among companies, it can be said that the socio-economic forces vary from firm to firm and further variations arise because each firm has its own subcultural influences. Moreover, individual firms do not each face the same national and international competitive forces nor do they or the employees have the same opportunities to misbehave. We would also expect that the relative cost for each to commit a crime to be quite different across firms. *See* Charles A. Moore, *Taming the Giant Corporation? Some Cautionary Remarks on the Deterrability of Corporate Crime*, 33 CRIME & DELINQUENCY 379, 386 (1987).

30. *See, e.g.*, HIGH COUNTY NEWS, June 26, 1995, at 3 (discussing the case of a company and the two former managers of its Olathe, Colorado plant who were indicted on 56 counts for tampering with emissions monitor and increasing production at might when polluted smoke was harder to see).

31. *See, e.g.*, Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

32. Jennifer Arlen, *The Potentially Perverse Effects Of Corporate Criminal Liability*, 23 J. LEGAL

to detect employee misconduct not only reduce the amount of employee misbehavior but also make the corporation's own prosecution for detected violation more likely, strict entity liability for its agents' delicts gives the entity a powerful disincentive to engage in strong detection efforts because such efforts make its liability more likely.[33]

Arlen demonstrates the gravity of the perverse effects with a straightforward illustration in which it is assumed that all seven of a firm's employees will commit crimes if the firm has no compliance program and that the likelihood of any crime being detected absent a compliance program is 1/20. With the initiation of a compliance program at cost *C*, the illustration assumes that only four employees will commit a violation and the likelihood of detection of any violation will increase to 1/10. Furthermore, the assumed cause for the employees' misconduct is to benefit the corporation, thus yielding a fixed benefit of the misconduct of *B*. The "fine" accompanying any detected violation is *F*. She concludes that the corporation's wealth is maximized by foregoing a compliance program under a regime of vicarious strict liability because

$$7B - (7/20)F > 4B - C - (4/10)F.$$

Only if the magnitude of the fine were significantly large[34] versus the benefit garnered by a violation does an expenditure on a compliance program become justifiable under the above assumptions. In the shadow of the formula, we are provoked to ask what economically rational corporation would engage in nontrivial expenditures on a compliance program that would both reduce its benefits and expose the firm to a heightened likelihood of being prosecuted?

Economic analysis provides an important acid bath for close analysis of legal conventions and commercial practices. Such is the case with the challenge posed by Professor Arlen and others who question vicarious corporate responsibility.[35] Though the argument that strict entity liability produces perverse effects has some intuitive appeal, it nevertheless is quite contrary to practices that prevail across most American corporations. Professor Arlen's model counsels that corporations should forsake compliance programs, whereas contemporary practices among American companies is to collectively adopt compliance programs and expand those already in place. Indeed, corporate demand has spawned a cottage industry for the design and implementation of compliance programs. Do corporations fully appreciate the number of *B*'s they forgo by

STUD. 833 (1994).

33. *See id.* at 842. Though the article frequently uses expressions of criminality, its implications apply equally to civil liability. Indeed, in her discussions of sanctions incurred and avoided, Professor Arlen includes civil liability as well as reputational harms incurred by the corporation as a consequence of its employees' misbehavior. *See id.* at 844 n.40.

34. If we assume that *F* reflects the harm, *h*, caused by the violation, the order of magnitude for *F* to increase in the above formula is 30 times to place the compliance program strategy on a footing equal to that of the noncompliance program strategy. *See id.* at 847.

35. For others who have called for a fault-based system for employer liability, see Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319 (1996).

their choice to deter misconduct aggressively? The following discussion reviews several reasons why the above model poorly captures the role of compliance programs in maximizing the value of the firm and counsels that companies do not incur perverse effects by continuing to aggressively pursue compliance programs under a threat of absolute vicarious liability for their agent's misconduct.

Under the above formula, however, the most significant cause of inequality between the noncompliance program and compliance program scenarios is the amount of benefits forgone due to the adoption of a reasonably designed law compliance program. First, we may wish to quibble with the assumption that misconduct is accompanied by any benefit to the firm. Clearly such a benefit cannot be expected for all the misbehavior of the firm's agents. There are a good many violations that occur without producing a benefit to the firm; they produce only costs, especially upon detection of the violation. For example, a manager may engage in a variety of employment practices that are both offensive and illegal, but that do not reduce the overall cost of operations or enhance its production. Consider for example, the recent settlement of gender discrimination claims by Home Depot Corporation involving allegedly extensive discrimination against women in the promotion of its employees.[36] Certainly such misbehavior can hardly be seen as increasing the firm's profits, since Home Depot did not avoid the higher salaries for managers by its alleged practice of discriminating against women when it promoted its employees to managerial positions. Similarly, in the classic decision of *SEC v. Texas Gulf Sulphur Co.*,[37] the officers released an unduly pessimistic press release with no apparent benefits to the corporation.

Assuming that all violations yielded no benefits, there would nonetheless still exist an inequality that, under the above set of assumptions, would cause the noncompliance program to appear more valuable, because

$$-(7/20)\,F > -C - (4/10)\,F.$$

Even if we assume there are never any benefits that accompany a violation, we may question whether the sanctions that arise in the noncompliance and compliance program scenarios will on average be the same. Because a sanction includes both civil and criminal awards, there are at least two grounds for believing such inequality will not arise. First, under the U.S. Sentencing Guidelines,[38] mitigation of the fine is available both for the firm having an effective compliance program and reporting the violation. Thus, for many fed-

36. *See Business Brief, Home Depot, Inc.: Judge Approves Settlement of Sex-Discrimination Suit*, WALL ST. J., Dec. 8, 1997, at B4 (announcing the $65 million settlement of a class action sex discrimination suit).

37. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

38. U.S. SENTENCING COMM'N GUIDELINES MANUAL § 8C2.5(f) (1997).

eral violations,[39] the fines will not be the same under the two scenarios. Second, and more importantly, a noncompliance program may cause the period of a single violation to be prolonged, thus proportionally increasing any resulting civil liability. Hence, the absence of an effective audit committee may permit a corrupt relationship between the managers and the firm's outside accountant to continue so long that misleading statements appear not in a single annual report but a series of annual reports. This then would increase the total damages for which the company and its accounting firm would be liable to investors who traded during the period of the ongoing fraudulent reporting practices. Or failure to monitor a plant's discharge into neighboring waterways may prolong the release of toxins and thereby increase the civil liability for damages done to others' property and businesses. If we thus rewrite the formula to use the symbol F for sanctions arising when there is no compliance program and f for the sanction that applies if there is a compliance program, we can then conclude that $F > f$, so that we can no longer express an opinion about the relative benefits of compliance to noncompliance assumptions for the preceding illustration's assumptions. In each such instance, the ultimate consequence accompanying F may be substantially greater than f, so that

$$- (7/20)F \neq - C - (4/10)\, f.$$

We also may question the relative likelihood of detection under both regimes as well as management's heuristics in assessing those odds. Under the original set of assumptions, noncompliance is optimal, but only if we assume that a compliance program doubles the likelihood of detection of employee misconduct. If the compliance program were expected to quadruple the likelihood of prevention so that only one employee will engage in misconduct that produces no offsetting benefit to the firm, then the cost of the two strategies would be

$$- (7/20)F \leq - C - (1/5)F$$

assuming C is not more than 3/20 F. Without data to support estimates of the likelihood of employee compliance or noncompliance in light of the employer's commitment to monitor operations, it is at best difficult to premise any social choice regarding entity liability on bare assumptions such as those invoked by Professor Arlen.

We should also consider that compliance programs serve purposes quite independent of reducing the firm's exposure to vicarious liability. One role of compliance programs is to protect the firm from its employees' fraud. In a recent study of the experiences of the 2000 largest U.S. corporations by KPMG Peat Marwick, we find a powerful incentive for companies to develop and sustain a variety of compliance programs. Seventy-six percent of the corporations

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39. Mitigation, however, is not available for crimes committed by senior managers. *See id*.

had experienced fraud by their employees during the previous twelve months; one-fourth of the firms suffered losses exceeding $1 million with the average company loss of $200,000.[40] Compliance costs designed to protect the corporation from frauds against it by its employees, as well as costs to assure that employee practices are, therefore, consistent with the firm's goals and policies. Indeed, such a concern is likely to represent a more significant component of overall compliance costs than do expenditures undertaken solely to shield the firm from vicarious responsibility for the misdeeds of its employees.

At a minimum, we would expect a good many joint costs, such that corporations rarely make the decision to undertake a compliance program solely out of a concern to avoid criminal or civil sanctions that arise for its employee's misbehavior. More generally, the cost of such compliance programs—whether to reduce the firm's exposure to vicarious liability for harms its employees cause third parties or to protect itself against being the victim of its employees' misdeeds—may well be, and quite likely is, an important dimension of management's broader concern for reasonable stewardship of the firm. Surveillance, detection, and educational efforts that constitute the standard features of compliance programs cannot simply be isolated to a strategy to avoid vicarious liability. Such efforts are at least as important in the officers' and directors' need to oversee their subordinates' behavior to assure that the company's policies and practices are being achieved. The total cost of such efforts should not, therefore, be assigned exclusively to an equation that considers the benefits and detriments of compliance efforts in a regime of absolute vicarious liability. These are costs that must be incurred for the effective and responsible management of the firm.

In a recent article, Professors Jennifer Arlen and Reinier Kraakman suggest that if entity liability is premised instead upon the absence of care in preventing or detecting its employees' misconduct, the perverse effects of entity liability are overcome.[41] It is their concern for the perverse effects of strict vicarious liability that causes them to favor a composite liability regime that layers duty-based and strict liability features to induce the optimal amount of entity enforcement efforts. To generalize, Professors Arlen and Kraakman believe that strict liability leads to optimal enforcement with respect to encouraging the employer to sanction its errant employees and to undertake preventive efforts to deter misconduct; however, they reason that strict liability discourages the entity from undertaking detection efforts and reporting their employee's misconduct.[42] They favor a duty-based system that provides credit in the sanctioning process for reasonable detection efforts and reporting its agents' de-

40. *See* William T. Geary, *Corporate Fraud: The Employee's Perspective*, *in* CORPORATE MISCONDUCT THE LEGAL, SOCIETAL, AND MANAGEMENT ISSUES 109 (Margaret P. Spencer & Ronald R. Sims eds., 1995) (discussing KPMG Peat Marwick's 1993 Fraud Survey Results).

41. *See generally* Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997).

42. *See id.* at 701-18.

licts.[43] Though the principle focus here is to question the premise for their argument, namely that strict liability leads to under-deterrence because of its perverse effects, and not to examine the many facets of their tightly considered argument favoring a composite entity liability regime, other aspects of their analysis are also examined to illustrate possible differences between their conclusions and the ones reached here.[44]

With the entity's vicarious liability being duty based, the firm's liability turns on its failure to police its employees optimally, a calculation that entails comparing the costs of policing against the social costs of its employees' misconduct. Under this formulation, employers need not seek to deter any and all wrongdoing, as occurs currently with strict liability, but only need conform to an objectively determinable level of policing. The most profound problem with such a duty-based regime is the likely indeterminacy of the undertaking to engage in "optimal" compliance efforts. Such a finding will be made *ex post* and there likely will be little guidance *ex ante* as to what constitutes optimal compliance efforts. Though numerous court decisions over time may provide greater certainty for the meaning of optimal monitoring efforts, it appears more likely that each decision would be so fact specific that it will be difficult to extrapolate reliable guidance from determinations made in decided cases.[45] This point is acknowledged by Professors Arlen and Kraakman.[46] There are, however, several other considerations that counsel strongly against the advantages they believe will accompany a duty-based regime for vicarious liability.

First, the perceived benefits of a duty-based system lie in its amelioration of the harshness of a resulting fine, not from its lightening of the absence of a benefit derived from an employee's misbehavior. When examining the merits of a duty-based vicarious fault system, both Arlen, and now Arlen and Kraakman, cease discussing the benefits the corporation forgoes by using a compliance program. This omission appears a wise strategic decision on their part because considering the foregone benefits may be damaging to their argument. If a duty-based system leads to more aggressive compliance programs than does a strict liability system, then it would appear that the perverse effects would be even greater with a duty-based system than under strict liability because it will lead to a greater reduction in *B*'s to the employer. By focusing on only considerations of the fine/sanction and compliance costs, they avoid a somewhat paradoxical result.

Second, there is a need to unpack the content of contemporary compliance programs. Corporate efforts to reduce employee misbehavior can be crudely

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43. *See id.* at 735-41.

44. One major source of difference is that of perspective. Throughout the analysis below, we combine civil (both private and public) and criminal sanctions into our consideration of the deterrence effect of strict liability. In contrast, Professors Arlen and Kraakman consider only sanctions imposed by the state. *See id.* at 691 n.13. With such simplification, many of the considerations raised below are necessarily overlooked or given insufficient weight in their analysis.

45. *See generally* Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523, 1539-40 (1984).

46. *See, e.g.*, Arlen & Kraakman, *supra* note 41, at 705, 730, 731 n.105.

divided between prevention efforts and detection efforts. The division is crude because one can well imagine that no swifter prevention of misconduct occurs than the imposition of strong public punishment on those caught misbehaving.[47] Thus, detecting and sanctioning employees who misbehave certainly reminds others that their careers and families are poorly served if they cross the line. Nevertheless, there clearly are preventive strategies that do not also involve a detection component. Such strategies include educating employees on the demands of the law and the company's practices in complying with the law, developing procedures that make it expensive and difficult for employees to misbehave, and screening employees to assure their trustworthiness. Similarly, there are numerous oversight activities whose primary compliance benefits lie in detecting misconduct; as seen above, such monitoring obviously has deterrent effects if there are sanctions that arise for violators.

That is, a firm may well undertake substantive preventive steps but not invest in detection efforts. The inherent ambiguity as to the precise duties imposed on firms under a duty-based system do not allow crisp answers as to whether aggressive preventive steps that are accompanied by weak detection steps would overall be deemed an optimal monitoring strategy under a duty-based system. But, more broadly, the unpacking of compliance efforts questions the major thesis that underlies the perverse effects argument. The force of the perverse effects argument arises from the observation that a compliance program increases the likelihood of the firm's liability for its agent's misconduct because it brings to light the offending agent's misbehavior. However, nontrivial prevention efforts may not affect the likelihood that misconduct actually engaged in by agents will be detected, though such efforts can be expected to reduce the frequency of agent misconduct. As such, there does not appear to be any perverse effects associated with preventive efforts. Professors Arlen and Kraakman address this situation by recommending incentives for the entity undertaking detection and reporting efforts.[48] In particular, they suggest reducing the sanction where the entity has a well-designed system to detect and report employee misconduct. They narrow considerably their concern for vicarious liability's perverse effects.

Even so narrowed, we should question whether such perverse effects exist. As seen above, a corporation may take steps to detect employee misconduct for many reasons. Most notably, the entity may seek to reduce any private liability that is proximately caused. Thus, the rational entity will not be content to undertake merely preventive steps; it will also seek, within limits, to detect mis-

47. Professors Arlen and Kraakman do emphasize in their analysis the importance of requiring entities to report the employee misconduct that is discovered through their compliance programs. They persuasively argue that through the entity's demonstrated commitment to report employee misconduct, the employer credibly signals that it is serious about reducing its agents' misconduct. In other ways, Professors Arlen and Kraakman do not appear to consider here whether the employer can signal its firm commitment to discipline misbehaving agents. One such strategy would be the resources it allocates to compliance programs as well as depending on informal information systems, such as rumors, to accompany explanations of why employees were not promoted, demoted, or terminated.

48. *See* Arlen & Kraakman, *supra* note 41, at 736.

conduct that will expose it to liability. Once it discovers misconduct, it may be reluctant to publicize the misconduct for fear this will enhance the likelihood of the private suit. Here we may question whether the entity's detection efforts are in any way adversely dampened by its failure to report what those efforts produce. In contrast, an obligation to publicize misconduct that detection efforts unearth runs the risk of deterring aggressive investigative efforts. Thus, Professors Arlen and Kraakman appear to have created the very perverse effects they seek to avoid.

They do make a powerful point that the reporting of misconduct unearthed through its detection efforts is valuable because it allows the entity to signal that employee misconduct will be sanctioned. Yet, it would seem far wiser merely to defer to the entity to weigh the costs and benefits of publicizing the discovered misconduct where the benefits would be signaling and the costs would possibly be attracting a claim by a third party. Moreover, this approach would allow the entity to consider and develop other strategies for successfully signaling its commitment to curbing employee misconduct.[49] A reporting requirement otherwise would appear to invite a weaker commitment to detection than would occur if there were no reporting requirement.

It is an undue simplification to assume that detection pursuant to a compliance program necessarily leads to a criminal or civil action against the company. There is every reason to believe that much more misconduct is unearthed within the corporate setting than is publicly disclosed. To be sure, there are very visible instances where third party involvement forces a public disclosure of prior misconduct. The independent auditor's withdrawal of a prior certification of financial statements because of recently discovered defalcations of the books is such an example. But short of a regulatory setting that demands such disclosure, the firm's incentive is to put the problem quietly behind itself so that the perverse effects of any accompanying public prosecution are unlikely to occur.

A final concern with a duty-based system is where it leaves the plaintiff who has been harmed by the activities of the firm. Assume there was a duty-based system and that the firm had a reasonably designed compliance program to curb price fixing by its employees. Though the system is reasonable, it is not foolproof, so that its agents may well fix prices in the shadow of even the most carefully developed and supported compliance system. Since prices are rarely fixed to assure a loss, we can assume this misbehavior enriched the firm and harmed its customers. Would a duty-based system provide restitution of the ill-gotten gains to those harmed by the price fixing?

A major weakness in Professors Arlen and Kraakman's recommendation that sanctions be reduced when the entity has an optimal detection and reporting system is their failure to consider private litigation in their analysis. Had they viewed the entity's position more widely, they would have considered

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49. *See supra* note 47.

that the incentive they offer in the governmental action pales in comparison to the greater private liability that flows from a violation. For example, the entity whose employees fix prices would seem to have a strong incentive to detect the violation as soon as possible so as to reduce the magnitude of its liability arising from any private antitrust suit. More importantly, the natural tendency for the entity is to keep private what it discovers about its employees' misconduct. A reduction of the fine recoverable by any government action appears to be a large cost to incur to invite private suits by publicly reporting that the company has fixed prices.

Even more troubling is the more common case where the misconduct's benefits to the firm are more difficult to isolate than in the case of price fixing. For example, the maverick chief financial officer issues a materially false financial report in the hopes it will enable the firm to secure a line of credit needed to meet its payroll. The investors who purchase the firm's shares in the open market are harmed because they pay a higher price for the shares than if the company had accurately described its financial distress in the released reports. If we are to assume that the misconduct was an isolated event, and that the company otherwise maintained a reasonable system for the release of financial information, a duty-based system would absolve the firm of responsibility for issuing the financial report. Though a benefit was sought by the violation, and the misdeed was committed on behalf of the corporation to secure that benefit, it is not a benefit for which restitutionary relief would be in order as, for example, in an instance of price fixing. On the other hand, it is difficult to envision in this case what perverse effects accompany the corporation being strictly liable. Its burdens to identify the misleading statement would not be great and its independent accountants will, in connection with their annual audit, likely require a corrected statement so that a compliance program itself does not lead to the publicity that results in the firm being sued. Indeed, as seen earlier in this type of case, a compliance program may have the beneficial effect of reducing the firm's liability exposure by shortening the period of time during which investors purchase the shares at the inflated price.[50]

50. A final harmful effect of a duty-based system is the impact it would have on many types of social equity litigation, such as employment discrimination cases. Even though a company may have a reasonably designed compliance system that satisfies the demands of a duty-based system, its employees may still engage in unlawful employment practices. Given the limited resources of most employees and managers who carry out these practices, a judgment against the misbehaving personnel is likely to be an empty one. To have value, the suit must be brought against the firm. The benefits of social-based suits, such as employment discrimination, transcend the involved litigants. They affirm important qualities of our culture and they exhort us to be better than we are. A duty-based system would likely seriously weaken the appeal of such suits. At a minimum, an important uncertainty exists whether the employer has breached its obligation to maintain an optimal compliance program. Thus, those clearly injured by discrimination may well believe the risks to proceed against the employer are too great in light of the suit's expected value. Furthermore, a duty-based system would, as seen earlier, move the focus to the more neutral grounds of the firm's compliance program meeting the minimum requirements of optimality, rather than its agents' discriminatory practices. The full social meaning of the discrimination claim and its related opprobrium would thus be muffled.

D. Wrapping up: A Purpose for Strict Entity Liability

Holding the entity strictly liable serves a variety of social purposes and serves those purposes better than the duty-based system recommended by Professors Arlen and Kraakman. First, strict entity liability avoids the awkward result that the entity could retain the ill-gotten gains of its agents' misconduct merely by proving it acted consistent with the optimal level of deterrence standard under the circumstances. Second, strict entity liability avoids the uncertainty and inefficiency of visiting on the courts and the litigants the indeterminacy in an *ex post* setting of just what was the right level of prevention, surveillance, and sanctioning demanded of the corporation by the duty-based standard. Third, the efficacy of the duty-based standard is that corporations under a strict liability standard lack sufficient incentives to detect and sanction employee misconduct. As seen, this assumption is flawed because the "perverse effects" argument fails to understand that the entity's sanction, F, when it has no compliance program is greater than the sanction, f, that exists if there is a compliance program.

Related as well to this cost-benefit equation is the failure to value fully that compliance programs, and particularly surveillance efforts, are but a component of directors' and managers' larger stewardship obligations. Moreover, there is an assumption within the perverse effects argument that the corporation's detection of its employees' delict necessarily leads to publicity of their misconduct so that the corporation's liability to third parties becomes more likely. As seen, there is no basis for such a crucial assumption. In the end, the case for a duty-based standard, even as limited to surveillance efforts, as counseled by Professors Arlen and Kraakman, is not a convincing one.[51]

Regardless of whether the entity is strictly liable or has its liability determined under a duty-standard, we should question whether the cause of deterrence is undercut through the corporation's purchase of insurance. As seen above, entity liability serves not only to provide the deep purse into which the plaintiff can seek to place its injured hand, but it is the major incentive for the corporation to deter its employees from misbehaving. And, even though the agent's resources are more modest than those of the corporation, concern for liability should also provide him with an incentive not to misbehave. When the

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51. A more positive view of the perverse effects argument and the thoughtful refinements proposed by Professors Arlen and Kraakman is that there in fact is little ground that separates their views from those advocated here. From a distant perspective, we may see that we each understand that $F > f$ and the only difference between our approach here from that of Professors Arlen and Kraakman is that they propose the central feature for determining whether the corporation has satisfied the due care requirements with respect to monitoring its employees will be the harm that actually occurred as a consequence of the delict. So understood, the issue is the corporation's standard of care as guided by the consequences of its employees' misconduct, *i.e.*, the consequence of employee misconduct is factored into the equation for judging the marginal benefits of added units of compliance efforts as compared with their marginal costs. However, this occurs *ex post*, not *ex ante*, as is generally the case with such a duty-based system. If this were indeed the case, it would appear all the more compelling argument to retain the present strict liability standard. Any *ex post* settling up process introduces transaction costs to the litigation process with no apparent benefits other than a dilatory defense that will have the effect of reducing the settlement value of suits.

plaintiff's recovery is funded exclusively, or nearly so, from an existing insurance policy, we should consider whether insurance disserves the role the private litigation has in deterring corporate misconduct. Stated differently, does entity liability serve any greater purpose than to identify who has an interest in being assured that this year's premium on the insurance policy has been paid? This question is addressed in the next section.

III

IS INSURANCE SOLELY COMPENSATORY?

A natural correlative of the entity having ultimate financial responsibility for its agents' misbehavior is a robust market for insurance.[52] Because entity liability forces the employing organization to incur nontrivial costs to prevent its agents' misbehavior, the expected prevention costs can be weighed against the alternative strategy of insuring against any resulting harm, so that insurance will be preferred to compliance programs when insurance protection can be acquired more cheaply than the costs to prevent the insured event. Indeed, insurance is a relatively inexpensive strategy; a recent survey reflects that insurance premiums for D&O insurance liability coverage for a small firm (those with assets under $30 million) average $120,446 annually, whereas firms with assets of $1.5 billion to $5 billion incur average yearly premiums of $554,047.[53] Because of its relatively low cost, most firms carry insurance.[54] Insurance is independently attractive, of course, because there are events that the entity will be held responsible for which no reasonably designed compliance program can be expected to deter efficiently.[55] Though insurance is a rational strategy for the entity's response to the risks of its agents' misbehavior, we should nevertheless consider whether it is socially harmful.

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52. Even without entity liability, one would expect the same result to occur indirectly. If there were only agent liability, then agents would contract with their employer to demand higher compensation for the risks they would likely incur in the discharge of their responsibilities. In the abstract we might believe such contracting to be inefficient because it may be argued that the agent-entity employment contract would only reflect an average expected level of misconduct for agents similarly situated. *See* Kraakman, *supra* note 6, at 865. However, in the context of insurance, where risk is spread across all such actors, such risk spreading would appear to be an efficient response. To be sure, we would expect some agents to lack the bargaining power to extract higher compensation to meet their needs for insurance. But we may also expect the bargaining power to be correlated with the agent's sophistication and wealth. Agents who are essentially judgment proof have little cause for such insurance whereas senior managers, with independent large endowments, are more likely to seek insurance to protect their accumulated wealth. It is for such executives that we would expect the employment contract to embody a component that responds to the employee's need to insulate his personal wealth from claims arising from the discharge of her employment duties.

53. *See* 1996 Watson Wyatt Directors and Officers Liability Survey, 28 tbl. 17C [hereinafter "Watson Wyatt" Survey]. Watson Wyatt Worldwide annually surveys a sample of corporations in preparing its report. The 1996 report surveyed the experiences of 1010 corporations for a 10-year period ending in 1996.

54. *See id.* at 10 (reporting that 88% of the surveyed firms purchased D&O coverage).

55. *See* In re Caremark International, Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (approval of settlement includes discussion of directors' obligations to maintain reasonable, but not foolproof, compliance systems). *See generally* Cox, *supra* note 20, at 755-63.

A. The Insurance is a Societal Menace Argument

There is much evidence that insurance is not simply an important component in tort litigation, it is the *dominant* consideration.[56] "Most American tort litigation would simply not exist if there were no liability insurance."[57] "[R]ich and poor may be alike in the eyes of the law, but insured defendants differ markedly from judgment-proof ones in the eyes of a plaintiffs' lawyer."[58] The insurance policy's power is not limited to identifying those worthy of the plaintiff's attorney's attention. Its influence is even more evident from an analysis of available data comparing settlements to the amount of insurance carried by the defendants. One can argue that the greatest condemnation of the securities class actions is the evidence that approximately ninety-six percent of securities class actions are within the limits of insurance policy's typically carried by corporations so that for most suits the policy is the sole source of settlement funds.[59] The testimony reported that companies commonly have D&O liability coverage of $10-$20 million, and that approximately forty percent of the cases settle for under $2.5 million, forty-three percent for between $2.5 and $10 million, and about thirteen percent for between $10 and $20 million.[60] Such data can too easily be interpreted in many conflicting ways. Most charitably, it may well be concluded that data on settlements that fall fairly consistently within the range of available insurance is consistent with the view that the insured acquire coverage that is appropriate for the amount of risk they face. Alternatively, the data is also consistent with the view that insufficient incentives exist for the class's attorney to pursue the defendants beyond the range of available insurance.

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56. Insurance's force is merely part of the larger concern for the plaintiff's attorney that the suit's expected value must equal the cost (including opportunity costs to the plaintiff's attorney) of its prosecution. Thus, there is evidence of substantial under-enforcement of securities claims arising with the promotion of IPOs, where the particular IPO is relatively small so that the expected recovery will be insufficient to justify its prosecution regardless of the presence of insurance. *See* James Bohn & Steven Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 936, 948 (1996).

57. Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1640 (1994).

58. Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction?*, 72 TEX. L. REV. 1655, 1662 (1994).

59. *See Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 139 (June 17 & July 21, 1993) (statement of Vincent E. O'Brien) [herinafter "1993 Hearings"].

60. On this data, consider the following using data in Willard T. Carleton et al., *Securities Class Action Lawsuits: A Descriptive Study*, 38 ARIZ. L. REV. 491, 499 tbl.2 (1996), on class action settlements compared with estimates of the actual damages suffered by the class:

> One observation that could be made from the . . . study of Professors Carleton, Weisbach, and Weiss is that using the two-trader model with conventional estimates for its variables, the above settlement data indicates that companies carry insurance that comes very close to estimating the median expected damages in securities fraud matters. That is, the median estimate of damages is $11.1 million for the two-trader model assuming that 20% of the shares are held by traders who account for 95% of the share volume. Thus, 83% of settlements occur within the Carleton-Weisbach-Weiss median expected damage level.

James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997).

The most profound complaint is whether insurance is harmful because it immunizes insured individuals and entities from the full effects of their misconduct. The intertwining rationales for imposing liability and the expansive scope of liability taken together make any blanket moral judgment about liability impossible. Liability insurance is morally defensible in the abstract because it does more than shield bad people from the just consequences of their acts; rather, insurance can also be seen as protecting good people from bad circumstances. Unfortunately, however, the benefits of insurance, like the rain, fall on the good and bad alike. Does the availability of insurance simply institutionalize moral hazards? This fear becomes a reality if the effect of insurance is to assure that those most likely to engage in misconduct will also be the most likely to acquire insurance; those most prone to misbehave can, through insurance, deflect to others much of the burdens of their misconduct. A somewhat different perspective is that taken by Dean Kent Syverud who argues that insurance's social harm is its impact in stimulating ever increasing amounts of litigation with concomitant larger recoveries so that both the frequency and the amount of settlements and judgments increase lock-step with the prevalence and amounts of insurance carried.[61] A social benefit of insurance under this view is the full employment of insurance agents, as well as those whose livelihood depends on the civil justice system.

An equally dark view of insurance is that it represents to the utility maximizing plaintiff's lawyer money that is already on the table. If the aforementioned statistics comparing settlements of securities class actions claims to the amount of available insurance is reliable, the presence of insurance represents not only easy money but in most cases the only money pursued in such suits. This result supports the frequently invoked view that in the settlement process class action attorneys forgo their pursuit of sums beyond the insurance policy because the rewards of doing so are insufficient compensation for the risks they incur by pressing their clients' claim further. Under this view, insurance leads to quicker settlement of disputes, but on average the settlements fail to fulfill either the compensatory or the deterrent objective of the action. In light of these criticisms, the task of presenting a more positive view of insurance is unquestionably a daunting one.

B. Insurance and Entrepreneurial Activity

To evaluate the social effects of insurance requires that insurable events must first be disaggregated and arrayed according to their own social effects. Though there may be no such thing as a beneficial harm from misconduct, the causes of harm are not driven by the same level of misbehavior. Thus, investors who lose their life savings acquiring shares in an IPO whose forecasts of future operations were flamboyantly optimistic and recklessly in error are no worse off than those who lost their savings in a company that consciously mis-

61. *See generally* Syverud, *supra* note 57.

represented its assets and earnings. Similarly, society's loss is equal if our streams are polluted by the slow seepage from waste abandoned years ago when environmental concerns were quite different from what they are today as they are if management purposefully discharges the firm's waste into our rivers. And the worker is not less seriously maimed by a defective lathe if that defect could not be detected by reasonable care than if management had known of the defect and failed to withdraw the lathe from the market. With each of these pairings, there is a natural disquiet, however, of lifting responsibility from the actors when they have acted with knowledge that their misdeeds *would* cause harm. And, in each of the preceding scenarios, there is reason to understand the entity's responsibility and, more importantly, the risks it faces in the conduct of its business.

The social utility of insurance is found by considering corporate law's subvention of risk-taking by business managers. The business judgment rule that is so pervasive in corporate law holds that officers and directors have no personal liability for decisions arrived at reasonably and in good faith.[62] Close review of the case law reveals that the reasonableness standard itself calls for an extreme departure from the level of care that would have been exercised by the objectively qualified director or officer in similar circumstances. At a minimum, the breach must entail nothing less than gross negligence.[63] The requirement that directors' and officers' act in good faith excludes protection for purposeful conflicts of interest. The weak demands that the business judgment rule makes on corporate managers are justified by a concern that their actions should not be easily second-guessed in the courts. Shirking, incompetence, poor judgment, or just bad luck are each to be addressed through a change in control, not in a complaint. With its umbrella spread broadly, the business judgment rule affirms that the business of business is business, so that it is the firm's managers *ex ante*, and not the courts *ex post*, that decide whether the expected return was worthy of the risks posed by the decision. In this way, the business judgment rule underscores our commitment to a market economy.

Our system's reliance on the business judgment rule, and more acutely the rule's beneficial effects in promoting business activity, was much in evidence following the Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom*.[64] The court held that the directors of Transunion Corporation

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62. *See, e.g.*, E. Norman Veasey & William E. Manning, *Codified Standard: Safe Harbor or Unchartered Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980).

63. The leading case for this proposition is *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), but there is no lack of antecedents. *See, e.g.*, Smith v. Brown-Borhek Co., 200 A.2d 398 (Pa. 1964) (finding that an ordinary negligence standard would make it impossible to retain competent directors). This standard is not satisfactory to all commentators. *See* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591 (1983) (stating that gross negligence standard arises because courts focus on consequences of damage awards and give insufficient attention to equitable relief so that applying the standard applied to typical tortious behavior would prove workable standard for director and officer behavior).

64. 488 A.2d 858 (Del. 1985).

breached their fiduciary obligation by acting with gross negligence in acquiescing in the Chief Executive Officer's recommendation that the company be sold to a third party at a price nearly fifty percent greater than the quoted market price of the Transunion shares. *Smith* became an important factor[65] in the insurance crisis that gripped the American boardroom in the mid-1980s, which saw deductibles for D&O insurance soar, coverage shrink, and the overall availability of insurance dwindle. The legislative response to the crisis was swift. The decision further unsettled the legal environment which was already puzzling over the obligations of directors and managers of firms involved in takeovers. Following the lead of the Delaware legislature, two-thirds of the states enacted special authorization for corporations to insulate their directors from liability for their decisions that did not involve purposeful misconduct.[66] Had such a provision been available to Transunion's directors, their grossly negligent behavior would not have given rise to their liability. Not only did the legislatures' enactment of such immunity from liability provisions essentially restore to the directors the protection they enjoyed indirectly through insurance before the insurance crisis precipitated by *Smith*,[67] the legislatures' resolute actions also underscored a broad political commitment to subventing risks incident to the conduct of corporate business.[68]

Just as the business judgment rule provides a shield to managers so as to encourage legitimate and desirable risk-taking, so does insurance. Returning to the preceding scenarios contrasting different levels of blameworthiness for investor losses, environmental damage, or tortious injury, we can further isolate the types of risks for which insurance appears an important social instrument. The examples illustrate the many risks that are naturally incident to the business's environment. The release of optimistic financial reports can easily be

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65. The multiple causes for the insurance crisis are closely examined in Roberta Romano, *What Went Wrong With Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989). Other destabilizing factors identified by Professor Romano include the courts' recognition of the employers' power to sue employees for negligence so that financially distressed thrift institutions could recover on their D&O policies for their employees mismanagement. *See id.* at 26-27. Also, there appeared to be a constriction of the reinsurance market as part of the well-documented ebbs and flows of the insurance cycle whereby high interest rates attract new entrants to the market, who ultimately reduce premiums to attract business. But low premiums yield unprofitable returns and exits from the market as interest rates decline. *See id.* at 19-20.

66. *See id.* at 30-32; *see generally*, Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295 (1988) (reviewing the differing statutory articulations of such immunity provisions).

67. With the insurance crisis that occurred during the same period that *Smith* was decided, directors found that less insurance was available and at a higher cost. The recently adopted state immunity provisions that authorized the articles of incorporation to shield directors from damage actions for nonwillful misconduct provided to the directors insulation from liability that previously occurred through the protective shield of their D&O policy.

68. Corporate law's most visible commitment to encouraging risk-taking is the limited liability provided owners of corporate enterprises. Among limited liability's benefits is its encouragement of passive owners who can safely diversify their investment across numerous enterprises while continuing full time to pursue their own personal expertise, talents or interests, while at the same time depending on a class of active managers to provide expertise and time to overseeing the investment that owners are lacking. It is the arrangement that Adam Smith proscribed and Henry Ford put into practice, specialization of talents.

laid to the culture of business where a "can do" attitude is a desideratum and manufactured products do contain defects that even reasonable care cannot prevent.[69] These are risks that are endogenous to the business, and insurance can be seen as a reasonable strategy to address an enterprise's risks. Insurance's contribution here is not merely its efficiency in distributing the cost of certain types of business risk over time and across numerous insureds, but also because in doing so it provides an important subvention for risky activities. The availability of insurance to cover many of the risks naturally incident to the conduct of business, especially through a complex multi-actor entity, most certainly has a beneficial impact on the firm's cost of capital as well as the company's overall willingness to undertake new ventures. We may also reach the same result in the case of purposeful misconduct, for example, intentionally misrepresenting the company's financial performance. The agent's willful misbehavior may well be the result of numerous environmental forces endemic to her employer's business. Here, however, the availability of insurance would provide incentives for much more than risky entrepreneurship. And, not surprisingly, insurance practices withhold such approval and avoid serious risks of moral hazard for claims such as these.

The firm's manager's first layer of insulation is her firm's D&O insurance policy. Though significant but subtle differences exist among carriers with respect to the terms of their coverage,[70] several general characteristics with regard to the scope of their coverage do exist. The standard policy is a two-part document.[71] The first part reimburses the corporation for any sums it indemnifies its directors or officers. Thus, the policy has an important interface with applicable state corporate law regarding the indemnification rights of directors and officers. The policy's second part reimburses directors and officers for any losses that are not indemnifiable. Though the first part of the policy is generally subject to a deductible, there customarily is no deductible for claims made under the policy's second part. The policy covers such agent's "wrongful acts," a term variously defined but which generally reaches actual or alleged neglect, misstatements, or breach of duty committed in their capacity as a director or officer.[72] Numerous exclusions from coverage appear for both the standard company general liability and its D&O policy. Among the most important exclusions in the standard D&O policy are for dishonesty (this usually requires a final adjudication of dishonesty), breaches in which the director or officer has gained personally, intentional wrongdoing, punitive, treble, or other exemplary damages arising from intentional misconduct, pollution and environmental li-

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69. *See generally* Langevoort, *supra* note 31.

70. For a recent collection and comparison of D&O policy terms, see THE WYATT CO., SUMMARY OVERVIEW OF TYPICAL PROVISIONS OF D&O POLICIES (1993).

71. For a thorough review of the standard D&O policy, see RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD § 13 (1997).

72. *See id.* at § 13.04(1) (citing as an example "actual or alleged error, misstatement, misleading statement or act, omission, neglect, or breach of duty by the insureds while acting in their individual or collective capacities as directors or officers of the company, or any other matter claimed against them by reason of their being directors or officers of the company").

ability, and claims arising concerning ERISA and retirement, welfare, and benefit plans.[73] In addition to such standard exclusions, the insurer may also exempt claims arising from merger and takeover transactions, securities violations, or claims brought by the insured corporation itself.[74] Another important exclusion is for costs associated with government investigations or prosecutions.

The entity's general liability policy is much narrower in its coverage than is the standard D&O policy. Today's "commercial general liability"[75] ("CGL") is an occurrence based, not claims made, policy. The policy is divided into three distinct types of coverage, each with its own set of exclusions: "Coverage A" deals with bodily and property damage liability, "Coverage B" deals with personal and advertising liability, and "Coverage C" deals with medical payments. As the policy sections' rubrics indicate, the CGL's coverage is not focused, as is the D&O policy, on all types of misbehavior committed by the enterprise through its agents. The most general coverage is that provided for "bodily injury and property damage," which does not reach wrongful employment practices absent their being accompanied by evidence of physical injury such as ulcers or hypertension.[76] Many practices that produce the requisite physical harm

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73. *See, e.g.*, *id.* at § 13.05; LOUIS F. SCHAUER & PAUL F. MATOUSEK, INDEMNIFICATION AND INSURANCE FOR DIRECTORS AND OFFICERS A-18 (1995). For an extensive analysis of D&O insurance exclusions and their respective interpretations, see WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS ch. 25 (5th ed. 1993). Special policies are sometimes available, however, for excluded areas. The most prevalent of such special policies is that for ERISA-based claims, under the so-called fiduciary liability policy. *See id.* at 26-2. Because standard policies provide little or no coverage for employment-related claims, such as age, race, or gender discrimination, insurance for such claims was introduced on a limited basis in 1992. *See id.* at 26-5 (1996 Supp.). However, such coverage of intentional disparate treatment of age, race, or gender groups is not likely to withstand public policy attacks. *See id.* Special riders are also available for certain environmental claims, such as those arising for the gradual release of contaminants that otherwise would not be covered. *See* Michael Misch et al., *Recent Developments in Insurance Coverage Issues*, 31 TORT & INS. L.J. 335 (1996).

A well-recognized response to possible disputes with the insurer has been the plaintiff's attorney's artful cooperation with the alleged wrongdoers in drafting the pleadings and mapping the case's prosecution so as to not take the defendant's conduct outside the scope of an existing insurance policy's coverage. Equally clear is that confusing characterization issues arise with respect to the underlying wrongdoing whereby both the plaintiff's attorney and the insured have a direct financial interest in the claim not being seen as one falling within the policy's many exemptions. Thus, there is a well-recognized practice that the complaint be drafted with a close eye on the scope of available insurance. For example, officers who knowingly issue a misleading financial announcement would act outside the D&O policy coverage which customarily exempts intentional misconduct. However, the policy becomes available by the plaintiff pleading that announcement was recklessly prepared; this also is attractive to the responsible officers, who thereby are more likely to be able to deflect their own personal liability to the insurer. For troubling illustrations of how attorneys mold substantive claims and defenses to gain strategic access to an applicable insurance policy, see Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 1995 DUKE L.J. 255, 258-60.

74. *See, e.g.*, FERRARA ET AL., *supra* note 71, § 13.05; Schauer et al., *supra* note 73, at A-18.

75. Before it was altered in 1986, the standard general liability policy was the "comprehensive general liability insurance policy." For there standard forms, see 1986 *Commercial Liability Insurance Policy*, *reprinted in* TOD I. ZUCKERMAN & MARK C. ROSKOFF, 2 ENVIRONMENTAL INSURANCE LITIGATION LAW AND PRACTICE app. A (1997) [herinafter "CGLI Form"]. The discussion that follows pertains to the 1986 form.

76. Joseph P. Monteleone, *Coverage Issues Under Commercial General Liability and Directors' and Officers' Liability Policies*, 18 W. NEW ENG. L. REV. 47, 60-61 (1996).

to the plaintiff or her property are excluded under the standard exemption for "bodily injury or property damage expected or intended from the standpoint of the insured."[77] This exemption mirrors the D&O exclusion for willful and intentional tortious misconduct and is an important limitation on the employer's ability to deflect to its insurer the financial consequences of its agent's misconduct. Among the policy's standard fourteen exclusions for Coverage A claims are those that bar harm for the discharge or escape of pollutants[78] and liability for defective products.[79]

Most clearly, insurance insulates entities and their agents from the financial consequences of a broad range of "misbehavior" and, to that extent, lifts the deterrent effect of any resulting liability. However, there is reason to believe that insurers, acting out of their own financial interest, have also complemented reasonable social interests by limiting their coverage to claims that are risks of the type that are both inherent to business organizations and pose no serious potential for moral hazard on the part of the insured. As described above, the overall character of the insurance exemptions is that they lift responsibility from the entity and its agents for losses that can best be seen as the natural risks of an operating enterprise. Thus, for example, reckless, even flamboyant, financial forecasts that prove to be erroneous and careless management are each insurable claims, whereas intentional manipulation of financial records and misappropriation of the company's assets are not. But insurance is not a perfect copy of the business judgment rule and, in certain cases, appears to have no direct relation to the release of entrepreneurial energies. As seen, gross negligence and reckless behavior, though within the coverage of the standard D&O policy, are not protected under the business judgment rule. The argument that insurance liberates the entrepreneurial qualities we seek for managers is more easily made for third-party injuries that could not be avoided by the exercise of reasonable care or otherwise anticipated. This would be the case of the defective lathe and the changes in waste cleanup requirements described in the earlier illustrations. Reckless disclosure practices are more difficult to justify as being entrepreneurially driven.

On the other hand, insurance appears to complement nicely managerial decisions whether to expand activities, add more employees, or decentralize decision-making. Expanding the operation quite clearly removes senior managers from the activity levels of the firm because expansion generally means more employees and, quite likely, more levels of supervisors between senior managers and the firm's activities. Such expansion must be made with a healthy re-

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77. *See* CGLI Form, *supra* note 75, § I, 2a.

78. *See id.* § I, 2f. The exclusions are designed to overcome the problems of the earlier general liability insurance policy forms whose exclusions for "the discharge, dispersal, release, or escape of . . . waste materials" did not apply if "such discharge, dispersal, release, or escape is sudden and accidental" have been interpreted against the insurance insurers so that they have excluded intentional, but not accidental, discharges of pollutants. *See generally* Nancy Ballard & Peter M. Manus, *Clearing Muddy Waters: Anatomy of the Comprehensive General Liability Pollution Exclusion*, 75 CORNELL L. REV. 610, 630 (1990).

79. *See* CGLI Form, *supra* note 75, § I, 2m.

spect that as organizations grow, the challenges become greater to assure that employees do not misbehave. As seen earlier, insurance is a useful strategy for the firm to manage the risk of its liability because of the delicts of its employees. To the extent insurance is cheaper than the costs of other law compliance efforts, insurance can be expected to be an understandable strategy for managing the risks that attend expanding businesses. We can therefore see that from an entity perspective, insurance nurtures entrepreneurial efforts by providing an economical means to address one component of the costs of those efforts.

But, with insurance so understood, our disquiet continues that insurance will become a substitute for compliance efforts, not to mention dampening the incentive for agents to stay within the bounds of the law. Much like the economists' argument that misconduct need merely be priced, insurance appears to say that the only price that matters is the D&O insurance premium. Though this is partly true, it is also clear that there are many forces, examined in the next section, that prevent insurance from totally eroding the deterrent effects of private liability.

C. The Discipline of the Market for Insurance

Insurance companies are best understood by viewing their sale of insurance as a source of funding for profitable investment management. Insurance companies make their money probabilistically; their profits arise through a process of setting premiums against the expected loss of a pool of insureds, as well as through successful financial management of their reserves. The insurance company's cost of capital is imbedded in the risks it underwrites in policies it issues. Insurers face the inherent industry risk that they will incur too great a cost for the funds they raise. This occurs if policy premiums are inadequate in light of the claims incurred on behalf of their insureds or if the returns on insurance reserves are insufficient in light of the resulting claims experience. As between these two sources of risk, the insurers have far greater capacity to control the risks insured than the unexpected shortfalls in the returns garnered on reserves. A major focus of the insurers, therefore, is to manage those risks over which they have the greatest control. To accomplish this, insurers employ multiple strategies.[80]

The first line of risk management is through the policy itself. Standardization of policy terms not only reduces inefficiencies (such as coverage disputes) but also permits risk assessments to be standardized since the insurer is underwriting the same categories of risk for large numbers of insureds. Furthermore, deductibles and exemptions eliminate or avoid many types of risks. A second strategy is that of transferring risk to others. Co-insurance and re-insurance are two common approaches to spreading risk to others. A final strategy involves active managerial efforts by the insurer. Some of these efforts are focused on

80. *See generally* David F. Babbel & Anthony M. Santomero, *Financial Risk Management by Insurers: An Analysis of the Process*, 64 J. RISK & INS. 231 (1997).

the behavior of its agents. For example, agent commissions that are tied to both policy sales and any future claims against the underwritten policies provide an incentive to its agents to discriminate prudently among potential insurers so that the agents do not aggressively pursue those with greater likelihood of producing claims against the policy. Insurers also screen potential insureds through guidelines and profile analyses.

The insurers' efforts to reduce their underwriting risk are tempered by several structural conditions that dominate the D&O insurance market. Foremost among the problems they face in managing underwriting risk is that of competition within the industry. There are numerous D&O carriers with few barriers to entry for new competitors should underwriting profits attract their attention. The carriers' competition problems are exacerbated by the fact that D&O and CGL policies are largely sold through independent sales agents who represent multiple insurers.[81] In its most recent survey, Watson Wyatt Worldwide reports that the top twenty independent insurance brokers account for more than eighty percent of the D&O policies that are sold.[82] Such concentration among insurance brokers provides greater power among agents vis-à-vis insurers because of the independent agent's ability to shift their clients from insurance company to insurance company as market conditions warrant. Thus, insurers are subject to even greater competitive pressures. To be sure, insurers who overreact to competition by incurring above-market risks for below-market premiums face serious risk of financial distress. The well-recognized insurance cycles that so characterize the D&O and CGL market reflect the excesses of the competitive market that prevail for these types of insurance. The full effects of competition that exist within the industry are reflected in the volatility that can be observed in year-to-year premiums. For example, the historical Watson Wyatt D&O Premium Index spiked from 682 in 1986 to 746 in 1988 then declined to 720 by 1991, only to increase to 806 in 1994 before steadily declining so that in 1996 it was at 726.[83] More importantly, competitive pressures must be understood to seriously weaken the disciplining effect of managerial behavior on insurance premiums and related screening practices carried out by insurance companies.

The insurance market functions best from the insurers' perspective when an equilibrium prevails among industry-wide casualty losses, premium levels, and coverage quality. A distortion of any of these factors not only unsettles the equilibrium, but leads to unprofitable underwriting.[84] Hence, an important component of insurance underwriting is assessing the risks posed by the in-

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81. *See id.* at 237.

82. Watson Wyatt Survey, *supra* note 53, at 41. It is of further interest that despite the freedom of agents to choose among competing carriers, two insurers, A.I.G. and Chubb, account for 51% of all D&O policies that were issued. *See id.* at 33 fig. 17.

83. *See id.* at 3 exh. 1.

84. For a view that conditions prevailing in the current D&O market resemble those that existed just before the insurance crisis in the mid 1980s, see Phillip N. Norton & Lisa A. Bastian, *Focus on D&O, Past, Present and Future*, 43 RISK MGMT. 13 (Jan. 1996).

sured. General characteristics such as size and industry classification are important, but even more specialized inquiries apply, including the experiences of the firm's managers, its organizational structure, and internal risk management operations.[85] There is evidence that D&O applicants for insurance are rated more rigorously than are physicians seeking malpractice insurance, though both events for which insurance is sought share the common characteristic: high severity claims that occur with low frequency. Malpractice insurers rate on more general characteristics of the applicant's area specialty and geography.[86] In contrast, D&O insurers give close consideration to the unique characteristics of their applicants. This inquiry extends to evaluating the quality of management, volatility of earnings and revenues, antitrust potential, political activity, and litigation history.[87]

To illustrate the level of attention given to D&O applicants, consider the review steps undertaken by insurers of employment practice riders for D&O policies. The fastest growing source of liability claims are those arising from employment practices, an area historically exempted from coverage under general as well as D&O policy coverage.[88] Employment practices liability insurance ("EPLI") is the newest form of special policy coverage and is designed to cover a broad range of wrongful employment practices arising from the promotion, termination, and recruitment of employees.[89] As proof that such insurance is a very pragmatic purchase, employment practice disputes account for 25.5% of all claims arising under D&O liability insurance policies; in contrast, fraudulent reporting practices arising under the securities laws account for 15.7% of such claims.[90] Among the criteria for underwriting such coverage are whether the firm has a human resources department (required for firms with

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85. *See* KNEPPER & BAILEY, *supra* note 73, at 383-85. No two insurance carriers use the same rating formula. Because no organization systematically collects D&O insurance premium information, it is difficult to quantitatively observe the overall effects of the insurers' risk ratings on premiums or the availability of coverage. On this point, consider the following: "[T]here can be wide variations in premiums between two organizations within the same experience class with respect to ownership, business, size, merger, acquisition, and divestiture activity, and after-tax losses." Watson Wyatt Survey, *supra* note 53, at 25. Thus, though the most recent survey of claims experience under D&O policies reports that companies with assets of $1-$2 billion are four times more likely to have a claim on its D&O policy than a firm whose assets are less than $100 million, there is no report within the survey whether the industry groups, merger activity, and the like are the same for each asset category. *See id.* at 42 tbl. 25.

86. *See* FRANK A. SLOAN ET AL., INSURING MEDICAL MALPRACTICE 167-69 (1991).

87. *See id*.

88. Though 61% of the surveyed respondents do not carry employment practices liability insurance, 74% reported their company faced employment practice claims. Reasons advanced for not carrying the insurance are (1) it would reflect a loss of confidence in internal risk management steps and (2) it may have the perverse effect of stimulating more suits much as D&O insurance is believed to have attracted more insurance. *See* Lee Ann Gjertsen, *Cost of Risk Lower, Aon Survey Finds*, 101 NAT'L UNDERWRITER PROP. & CASUALTY-RISK & BENEFIT MGMT. 13 (1997).

89. EPLI was first introduced in 1992 to meet the emerging demands for coverage that was either exempted or extremely limited under standard liability coverage. *See* Knepper & Bailey, *supra* note 73, at § 26.5 (1996 Supp).

90. *See* Watson Wyatt Survey, *supra* note 53, at 33-34 tbl. 34. However, shareholder-based claims result in larger payments from the policy, average slightly in excess of $7.2 million in comparison to employee-based claims, which average $3.2 million. *See id.* at 47 exh. 14.

more than 150 employees) and published policies to discourage sexual harassment and discrimination, and whether its job application forms do not inquire about race, age, religion, marital status, handicap, or health problems.[91] Insureds are encouraged to undertake self audits to assure they are complying with employment laws.[92] Equally important to underwriting the coverage are the claims history of the company, industry, and state in which the insured operates.[93] Indeed, employment practices insurance is seen as posing an unusual underwriting challenge because each organization's overall risk is so closely tied to its own unique culture and mix of managers and employees that change frequently.[94] Policy premiums thus reflect the insurer's assessment of the risks facing the insured.

The underwriter's watchful eye does not close with its agreement to insure the insured. Critics tell us that insurance companies are good at receiving premiums but are lousy at paying claims. Claims in excess of $10 million rarely get paid without litigation between the insurer and the insured; annually, insurance companies spend over $1 billion disputing whether to fund insurance coverage litigation against their own policyholders.[95] Coverage disputes are especially common under D&O liability policies because the policy covers only claims against the firm's officers and directors, and in 80-90% of such cases the employer is also held liable for its managers' misbehavior.[96] Thus, in the most recent survey of insureds' experiences under D&O policies, fifteen percent reported having coverage disputes with the insurer, with fifty-eight percent of these disputes arising from allocation issues and twenty-eight percent involving more general disputes of whether the officers' or directors' conduct fell outside the policy's coverage.[97] To such charges, insurance companies argue that general liability and D&O policies are complex documents and in the business setting, where multiple actors are involved in transactions producing the claim, difficult allocation issues naturally arise.[98] Needless to say, an insurer's practice of disputing its responsibility has the effect *ex ante* of depriving officers, directors, and others of any certainty they will be insulated financially from bearing responsibility for the consequences of their delicts. And when the insurer successfully establishes the breach was beyond the policy's scope, the misbehaving employee has only the employer's fisc to rely upon. Even here, the under-

91. *See* Orin M. Kurland, *Looking at EPLI Underwriting Requirements*, 41 RISK MGMT. 54, (1994).

92. *See Work Week*, WALL ST. J., Nov. 18, 1997, at A1.

93. *See* Kurland, *supra* note 91, at 57.

94. *See* Stan Zolna, *Businesses Look For Cover from Employee Suits; Insurance Coverage*, NAT'L UNDERWRITER PROP. & CASUALTY-RISK & BENEFIT MGMT., Feb. 12, 1996, at 9.

95. *See* Eugene R. Anderson & Laura V. Jones, *D&O Insurers: Fair Weather Friends?*, 17 CORP. BOARD, May 1996, at 10.

96. *See* Watson Wyatt Survey, *supra* note 53, at 46.

97. *See id.* at 47 exhs. 11 & 12.

98. Joseph P. Monteleone & Nicholas J. Conca, *Bringing D&O Insurance Right on Target*, 42 RISK MGMT. 44, 45-46 (1995).

standing hand of the employer may well be withheld from lightening the financial demands the misconduct has placed on its agent.[99]

A further consideration in the impact of D&O insurance on management misbehavior is that the standard feature is that such insurance applies on a "claims made" basis. Except for the most open forms of wrongdoing for which there was swift prosecution of claims against the wrongdoers, the D&O claims customarily arise from misbehavior that occurred in a year earlier than the year for which the policy premium was incurred to obtain coverage. The disjunction between the period for which the wrong was committed and the year in which the claim will be pressed against the wrongdoers introduces additional uncertainty on the wrongdoer's part as to whether she will bear the brunt of the financial burdens from her delicts. There is the natural question whether there will be insurance available to cover the event. One can well imagine that publicity of the wrongdoing may cause insurers to reject providing any insurance for the company and its officers for fear that there most certainly will be claims against the policy. And, if the D&O claim is pressed for conduct that was committed before the insured's application for such coverage, there most surely will be a coverage dispute premised on whether the insured provided sufficient disclosures of the facts or transactions giving rise to the claim in its application for insurance. Additionally, any publicity may well have led to the agent's termination, thus casting further doubt when the policy does not expressly cover the misdeeds of former agents.

Also, because of the cyclical forces that affect the availability of D&O insurance, there is a risk, albeit modest, that the claim may be asserted during that portion of the insurance cycle when deductibles are high and coverage amounts are low. The cunning wrongdoer must not only worry that she will be caught, but that if caught, whether it will be during a period of bountiful D&O coverage. To be sure, insurers are now providing "extension of coverage" riders whereby claims that arise in a future period are covered by policies issued in the period during which the rider was entered. However, the insured may find this coverage unavailable if the insurer successfully argues that the insured did not fully disclose its agent's acts for which a claim is being pressed under the rider. Thus, the "claims made" feature of the standard D&O policy, even if potentially relaxed by an "extension of coverage" rider, provides limited assurance to the agents that their delicts will be borne by their employer's insurer even though their misconduct is of the type (that is, nonwillful) that falls within the policy's normal scope of coverage. Though uncertainty regarding whether there will be indemnification for the agent's misconduct from the company's

99. *See, e.g.*, Waltuch v. Conticommodity Serv., Inc., 88 F.3d 87 (2d Cir. 1996) (finding that broad indemnification rights provided under company's articles of incorporation was qualified by Delaware indemnification statute that conditions indemnification on the agent having acted in good faith which excludes purposeful misconduct such as that engaged in by the officer). More generally, the misbehaving officer may well be separated from the company as a consequence of adverse publicity surrounding his misconduct so that there will be a less sympathetic ear meeting his request for indemnification.

D&O policy may not cause the company's agents to avoid misbehaving, it also may be the case that this uncertainty neutralizes the existing D&O policy as a consideration in the agent's decision to misbehave.

There are also important strategic choices that confound the deterrent value of the private suit. As seen above, settlements that directly implicate the agent in wrongdoing that is beyond the D&O policy's coverage are not likely to be reached by the plaintiffs and the defendants unless there is reason to believe that the corporation's fisc stands ready to absorb the resulting vicarious liability. The alleged wrongdoer's resolve to clean his name is also greatly reduced by the prevalent D&O provision that limits the insurer's liability to the amount of any settlement offers made by the plaintiff that was accepted by the insurer but rejected by the insured.[100] Thus, the insurance policy, and more particularly the insurer, is a powerful force that drives the parties to settle the matter, perhaps with less regard for the actual merits than there would be in other types of disputes.

Moreover, will the insurers act strategically in their response to settlement offers? On this point, consider the evidence recently analyzed by Professors Gross and Syverud. They found that more than sixty percent of the medical malpractice cases included in their study proceeded to trial without any meaningful pretrial negotiations.[101] Since a zero offer is never a reasonable assessment of the costs of continuing to defend the suit, they conclude that "[r]efusing to settle increases the risk to future litigants and may discourage future claims, and taking winners to trial may be worth the cost if it helps you bluff successfully in negotiating with plaintiffs in future cases."[102]

Interestingly, only eighteen percent of the commercial cases proceed to trial without an offer, suggesting that there is less strategic value to the insurer in the continued defense of commercial cases than for malpractice cases. A further revelation by the Gross and Syverud data is that more than twenty-five percent of commercial cases go to trial, a percentage that is much higher than that generally believed to apply to many types of class action suits against corporate defendants.[103] However, the commercial cases studied by Professors Gross and Syverud are quite different from those commonly arising from corporate misconduct. Their study focused on suits in the California Superior Court where most commercial litigation is company against company. In such suits, contingency fee arrangements customarily are not involved, so the plain-

100. *See* 2 Wyatt D&O Maps, *supra* note 70, § 4.04, at 9. Consider here the even more pernicious phrasing in the CNA Insurance Company's policy: "Insureds agree that they shall not knowingly take any action which increases the Insurer's exposure for loss under this policy resulting from any claim." *Id.* at 6. Contrast this with the "consent to settle" clause common to medical malpractice policies that enable the insured to compel the suit's continued defense so that physicians sometimes push the aggressive defense of the suit, despite the defense costs, so as to protect their reputations. *See* Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 U.C.L.A. L. REV. 1, 58 (1996).

101. *See id.* at 28-29, tbls. 15, 16.

102. *Id.* at 56.

103. *See id.* at 29, tbl. 16 at 29.

tiff bears the burdens of any decision to reject a settlement and proceed to trial.[104] The greater frequency of trials between commercial litigants may also reflect that the losses that may arise at trial are not nearly as great as those believed possible in the customary class action suit. Furthermore, the class action suit may on average be more complex and more costly to defend. Finally, in suits between two commercial enterprises, there may be strategic reasons for delaying the date of judgment, and those strategic reasons may overwhelm the costs of continued litigation. In any suit, many types of strategic judgments affect the parties' eagerness to settle the case. In contrast to other types of litigation, most strategic considerations in the corporate misconduct cases, at least from the insurer's perspective, seem to favor settlement and not prolonging the litigation process.

There are, of course, many other costs involved in private litigation beyond the attorneys' fees and the resulting civil sanctions that are not recompensed by insurance. For most managers, the burden of being a defendant in a law suit is not an experience they wish to repeat. Being deposed is tedious, time consuming, and humiliating. It is interesting that within the congressional hearings leading up to reforms for securities class actions, the executive personnel who supported the necessity for reducing the frequency of such suits uniformly mentioned not the cost to the firm of the litigation, but the personal burdens to the executives targeted in such suits.[105] Though these complaints were raised by those who argued they were wrongfully targeted in the suits, the point to be understood here is that civil litigation imposes its own costs on the defendant, and certainly these costs are not less in the instance of those who have misbehaved. And this burden is not lightened by insurance.

A further consideration is the injury to the executive's reputation that accompanies suits charging serious misconduct. There is ample reason to believe that executive misconduct, whether prosecuted criminally or civilly, seriously impacts the reputation and future earning power of such executives.[106] The extent of the reputational loss and accompanying decline in future earnings are, however, much influenced by the type of misconduct charged. Clearly, professionals whose misbehavior occurred in the context of breaching professional standards and more particularly confidences demanded in the discharge of their

104. *See id*.

105. *See, e.g.*, 1993 Hearings, *supra* note 59, at 12 (statement of Edward R. McCracken).

106. Most of the research on reputational loss has focused on the impact of adverse publicity on the corporation. *See, e.g.*, BRENT FISSE & JOHN BRAITHWAITE, THE IMPACT OF PUBLICITY ON CORPORATE OFFENDERS (1983); Brent Fisse, *Sanctions Against Corporations: The Limitations Of Fines And The Enterprise of Creating Alternatives in* CORRIGIBLE CORPORATIONS & UNRULY LAW, 137, 147-149 (Brent Fisse & Peter A. French eds., 1985); Peter A. French, *Publicity and the Control of Corporate Conduct: Hester Prynne's New Image, in* CORRIGIBLE CORPORATIONS & UNRULY LAW, *supra,* 159-164. Sound intuitive appeal and supporting anecdotal evidence similarly suggests that such adverse publicity also harms the career and social standing of those individuals identified as wrongdoers. *See* Coffee, *supra* note 7, at 429-34 (stating that corporate investigatory report, after receiving wide publicity, ultimately leads to resignations of executives responsible for massive bribery practices by a major public corporation).

professional engagement suffer the greatest loss.[107] This is a personal loss that is not removed by payment. However, for breaches that are not as closely tied to the callings of a profession that demands absolute fidelity to the client or customer, the evidence is not nearly as systematic or reassuring that publicity of the breach shames the violator. For the prospect of publicity of the misbehavior to deter managers from misbehaving, both the manager and the public must believe she acted shamefully.[108] Though insurance protects the defendant's assets from the demands of the suit, so that she can continue to meet the annual membership fee at the club, the opprobrium from the suit may nevertheless mean she will drink alone at its bar.

D. Risk on Risk

From the above, we should understand that both the employee and the corporation face a good deal of uncertainty as to whether the liability arising from the employee's misbehavior and the entity's vicarious responsibility will ultimately be borne by their insurer. First, there are some inconveniences and burdens of such litigation, such as its distractions or any accompanying loss of reputation, for which insurance provides no protection. Of greater concern is whether the misconduct falls within one of the numerous exclusions. Because willful misconduct is beyond the scope of the policy, exclusions have their greatest impact on the willful violator. With insurance unavailable, the only basis for arguing that insurance undercuts the deterrence effects of private liability is if the plaintiff's lawyer drafts the complaint so as to allege misconduct that is not excluded from the policy's coverage. Here, the evidence described above regarding coverage disputes between carriers and their insureds serves as a sobering reminder to those considering whether to misbehave; they then proceed on less than certain ground. Further uncertainty arises because of the uncertainty that insurance will be available when the claim is asserted. As seen above, most D&O insurance is on a claims-made basis and the insurer can be expected to dispute coverage if the application for insurance does not fully disclose the events and the facts that underlie the asserted claim. Moreover, the insurance cycle may rear its historic ugly head so that deductions are raised and coverage amounts lowered from the levels available when the misconduct occurred that gave rise to the claim. Finally, there is evidence that carriers *ex ante* seek to manage their claims experience through screening applicants for insurance. Their efforts in this regard are weakened by several structural features of the market, such as the insurers' dependence on independent agents to sell in-

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107. Consider the account of the lives of important professionals who were convicted of trading on insider information in some of the more celebrated prosecutions brought in the 1980s. *See What Happened to 50 People Involved in Insider Trading Cases*, WALL ST. J., Nov. 18, 1987, at 22, *available in* 1987 WL-WSJ 295620.

108. *See* Peter A. French, *supra* note 106, at 163 (for adverse publicity to deter misconduct, wrongdoers must not be shameless so that they understand that their conduct has reduced their status in the community).

surance and the strong competition for underwritings during certain periods of the insurance cycle.

The above would appear to provide little assurance to those who contemplate purposeful misbehavior that the D&O policy will hold them harmless. If this is so, then private liability would seem to serve a meaningful deterrent for purposeful misbehavior even when the suit is premised on the entity's strict vicarious liability for its employee's willful misconduct. Insurance's impact on private litigation's deterrence of negligent or reckless misconduct is obviously more mixed. To find it does not weaken deterrence, we need to place great strength on insurers to screen out applicants who are likely to have weak managers, operating systems, and other activities that contribute to their future misconduct. Also, we must have faith that the claims-made nature of the policies, and coverage disputes, occur with such frequency that the insured does not forsake its own compliance efforts. These are nevertheless unknowns at this point, so it may well be that insurance has the unintended consequence of undercutting the deterrence effects of suits that do not fall within the exemptions of the D&O policy.

IV

CONCLUSION

The rational economic person is a far more complex person than is captured in the economists' model. Though that model is a useful beginning point in understanding why individuals misbehave, namely the weighing of benefits against costs and their associated probabilities, bounded rationality assures that the heuristics used by the individual are much more complex than merely the weighing of the rewards of each outcome and its associated probabilities. This makes the approach to deterrence of pricing offenses too limited to accomplish the aims of deterrence so that other strategies must be considered.

We saw above that the corporation very much has a dog in the fight over deterrence. This arises not solely because its enterprises produced the harms committed by its employees, but also because subjecting entities to vicarious liability increases the likelihood of both prevention and detection of misconduct. As developed above, it appears there are no perverse effects that accompany holding the entity strictly liable, whereas there are very profound adverse social effects of conditioning its liability on only a highly problematic *ex post* inquiry under a duty-based liability standard.

Insurance has some distinct negative impacts on our culture, but it is also argued that insurance serves a social function of unhooking liability concerns from entrepreneurial activity. This benefit appears not to produce any adverse impacts on the deterrent effects of private liability actions, at least not where the misconduct falls within the standard exemption of intentional misconduct. Our views are not as sanguine with respect to negligent or reckless misconduct that falls within the insurance policy's coverage. Thus, it may well be that insurance has the unintended effects of nurturing carelessness by managers or careful pleading by the plaintiff's attorney to avoid alleging conduct that takes the defendant's behavior outside the scope of the policy. Even here, the high frequency of coverage disputes between insurers and their insureds is a sober reminder that insurance coverage may be more apparent than real.

Thus, it appears that neither entity liability nor the prevalence of insurance obstructs the deterrent value of private litigation. To be sure, the disquiet continues over why more suits do not recover funds other than the sums available through insurance or why directors or officers, who are the subject of the suits, are not more frequently called upon to contribute to the sums recovered. There is probably little doubt they would be called upon if there were no insurance. But the absence of recovery from the misbehaving officers or directors does not itself suggest that deterrence is ill-served by such suits. As seen above, private liability provides an incentive for the corporation to pursue a joint strategy of compliance programs and insurance.

The fact that, in the ultimate settlement of the case where employee misconduct is alleged, the misbehaving employees contribute nothing toward the settlement says nothing about whether such private suits fail to deter misconduct. It would appear that the failure of misbehaving officers or directors to contribute toward the settlement speaks to the weaknesses of the settlement process itself without necessarily eroding the deterrent value of the private suit.[109] To be sure, the cause of deterrence would be even more strongly served if the misbehaving directors and officers were required to contribute to the award recovered in the private suit. Yet, even when recoveries are limited to the vicariously liable corporation and/or its insurance company, the private suit remains an important force in the deterrence of corporate misconduct.

109. *See* SEC Staff Report, Subcomm. on Securities of the Senate Comm. on Banking, Housing, & Urban Affairs, 103d Cong., 2d Sess. (May 17, 1994); Cox, *supra* note 60, at 515-24.